A PRINCIPLED APPROACH TO COLLECTION AND ACCURACY-RELATED PENALTIES

By Richard C. Stark

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This report seeks to place discussion and debate regarding civil tax penalties within the context of general social science thinking regarding civil sanctions and procedural fairness. It goes on to propose guiding principles derived from this thinking and then uses collection and accuracy-related penalties to illustrate the way in which these principles might be used to review the policy and administration underlying these penalties. Out of this review grow several legislative and administrative recommendations.

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I. Introduction

Our tax laws impose economic detriments on taxpayers for failure to file returns, for misreporting of tax liabilities, and for nonpayment of amounts due. These and similar detriments — which take the form of civil tax penalties and interest — are the subject of this article. It begins by discussing the limited role that monetary sanctions play in the administration of our tax laws and the importance of other factors and programs. It then discusses general principles that should govern the enactment and administration of such sanctions. Finally, it examines existing sanctions and suggests certain changes in them and in how they are administered.

Our tax laws penalize many actions having little or nothing to do with the administration of our tax laws. Thus, for example, the Internal Revenue Code imposes particular economic burdens on greenmail transactions, participation in international boycotts, misconduct by pension funds and exempt organizations, and a host of other activities. This article does not deal with such provisions, although they can be criticized for the complexity and confusion that they add to our tax laws.[1]

The dearth of information regarding the effectiveness of civil penalties limits one's ability to make sound comments on the ideal structure and levels of penalties. Some changes in penalties over the last two decades seem immaculate concepts, unfathered by empirical (or even strong theoretical) reasoning. While discussion of the area has a distressingly ontological cast, I have attempted to set forth below my particular views on the general subject of tax compliance, and the role of penalties in it, in the hope that this will lead to useful discussion of current issues within a shared framework.

Each year, Americans and American companies file tax returns, reporting their taxable incomes and tax liabilties. For many taxpayers, this annual occurrence is a mechanical and simple matter. Their employers have already withheld sufficient taxes from their paychecks, and the prompt filing of their returns will yield them a pleasant surprise — a refund within a few weeks. For others, it is an unavoidable exaction; they may think the computation and payment of taxes overly burdensome or unwarranted, but their employers nevertheless withhold the requisite taxes and the simplicity of their economic situations prevents any tax avoidance. Still others, including most self-employed individuals and American companies, have more complex affairs and income not subject to withholding, permitting them a good deal of judgment regarding the size of the tax liability that they should acknowledge. For these taxpayers, the tax liability reported flows from a series — sometimes a few, sometimes thousands — of judgments concerning the application of complex, ambiguous, and occasionally yet-to-be-determined rules. Even the most sophisticated advisers sometimes waver on how to report particular situations and limit their advice to whether a particular way of reporting an item rests on a reasonable interpretation of the law or meets another of several different gradations of certainty. For those business taxpayers who wish to aggressively minimize their reported tax liabilities, the complexity and ambiguity of the law make a high degree of such conduct possible, creative and aggressive advisers support it, and the low probability of audit adjustment and penalty insufficiently inhibit it. Finally, some taxpayers simply do not comply with our tax laws, either failing to report the receipt of some income, claiming clearly erroneous deductions, or failing to file returns at all.

The filing of returns and payment of income tax each year concludes a complex and demanding process. Over the years, Congress has increased the certainty with which taxes are reported and collected by developing complex rules regarding the gathering of information, and it has accelerated the timing of collection by tightening rules governing the advance deposit of taxes. Financial institutions must report on interest paid to depositors, corporations must report dividends, partnerships must report distributions, employers must report payments to employees and independent contractors, and real estate brokers must report certain sales. The Internal Revenue Service collects all of this and other information and uses it to assure that taxpayers are complying with the law. Similarly, when politically feasible, Congress has removed the payment of taxes from the control of the taxpayer, shifted this obligation to the person obligated to pay the taxable amount, and required deposits of taxes — sometimes, within a day of payment. Thus, taxes on wages are withheld by employers, gasoline and diesel excise taxes by the purchaser, and so forth. A complex set of sanctions supports this system of information reporting and tax deposits, which in many ways is now the backbone of our tax system.

The scope of the undertaking by the American taxpayer is truly staggering. In 1998, more than 224 million income, estate and gift, employment, and excise tax returns and more than 1.15 billion information returns were filed, and taxes voluntarily paid exceeded $1.7 trillion.[2] Given the tremendous importance and complexity of, and effort expended in, preparing and filing tax returns and depositing and paying tax liabilities, and the importance of taxes in funding our government, one should approach cautiously changes from the status quo, which, after all, does currently produce the funds on which our federal government operates. On the other hand, the existing system does not work perfectly. A recent estimate of the taxes due from legal-source income that are not paid voluntarily is $195 billion.[3]

II. Limited Role of Civil Penalties

Taxpayers choose to comply or not to comply with our tax laws for many reasons, of which monetary sanctions are one. Psychologists, sociologists, economists, legal scholars, and others have identified many reasons for compliant and noncompliant conduct.[4] Readings in the literature of tax compliance

[1] *See* Zolt, "Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions," 37 *UCLA L. Rev.* 343 (1989).

[2] Unless otherwise noted, all statistics are found on IRS's Internet Web site, at http://www.IRS.gov in the IRS Data Book under "Tax Stats" and will hereinafter be cited to "IRS Data Book" with the appropriate table reference. *See* IRS Data Book, Tables 98db01co, 98db02nr, and 98db32ir.

[3] Webster, *Review of the Internal Revenue Service's Criminal Investigation Division*, at 2 (IRS: April 1999).

[4] *See, e.g.*, Alm, Sanchez, and deJuan, "Economic and Noneconomic Factors in Tax Compliance," 48 *Kyklos* 3, 4-7 (1995) (in addition to risks of detection and punishment, other factors influencing taxpayer compliance or noncompliance include the burden of taxation, whether the taxpayer receives the benefits of government expenditures, overweighting of low probabilities relevant to tax compliance, and the social norm of paying one's taxes); Carnes and Englebrecht, "An Investigation of the Effect of Detection Risk Perceptions, Penalty Sanctions, and Income Visibility on Tax Compliance," 17 *J. Am. Tax'n Ass'n* 26, 38-39 (Spring 1995) (compliance decisions are influenced by penalty sanctions, risk of detection and income visibility). *See also* Joint Committee on Taxation, *Tax Amnesty* (JCS-2-98), January 30, 1998, at 2, 9-10 (decision on whether to evade taxes depends on probability of detection, the potential sanctions if detected, the tax-

(Footnote 4 continued on next page.)

reveal a smorgasbord of contributing factors, though unavoidable limitations in the research leave great uncertainties. One theme that rings clearly throughout the literature, however, is that many instances of noncompliance have little to do with the failure of our system of civil sanctions and cannot be corrected by correcting perceived shortcomings in them.[5]

The most important reasons that most Americans pay taxes are four: First, we have, whether articulated or not, an appreciation of the fact that government provides important services to us in exchange for our tax dollars. We are, by and large, willing to pay for highways, the national defense, the public safety, environmental protection, and so on; and we accept that our tax system is a reasonably fair way of collecting for these costs. Second, we know that intentional or willful noncompliance with our income tax laws can constitute a criminal offense punishable by fine and imprisonment, and we are not willing to risk a criminal sanction. Third, the rules and instructions for determining our tax liabilities and self-assessing and paying them are clear enough for us to understand and comply with them. And, finally, we know that the IRS audits taxpayers and that, if we do not comply with our tax obligations, we may be caught and required to pay up. Only this fourth factor possibly involves civil penalties.

Each of the foregoing reasons has its own complexities and countercurrents. For example, perceptions that our tax system is relatively fair probably grow in large part from the fact that much of the collection of taxes is beyond the control of the taxpayer. Thus, our extensive and efficient wage withholding and information return systems probably lead most taxpayers to accept that a high degree of horizontal equity exists among wage earners.[6] On the other hand, excessive complexity and ambiguity in our tax laws and special tax expenditures for narrow constituencies necessarily creates suspicion and doubt in the minds of those who cannot, or who choose not to attempt to, benefit from such complexity. Further, stories of egregious and successful tax avoidance,[7] whether true or not, must strike at the heart of perceptions of our system as fair.

While one can still assert that, in a broad way, we accept our tax system as a fair way to collect the costs of needed government services, one need not stray too far into the popular press to find that this view is not universally held. Indeed, assertions from Capitol Hill that the IRS is an agency out of control,[8] promises by presidential candidates to end the IRS as we know it,[9] excoriation of the code as a disgrace to mankind,[10] and the parading of self-proclaimed victims of the IRS across the TV screen while using section 6103 to muzzle any IRS response[11] all have the effect of undermining passive acceptance of the legitimacy of our tax system. Similarly, legislation to increase the trappings of the audit process as an adversarial[12] one bodes ill for efforts to maximize perceptions of IRS neutrality and fairness.

At some level, such rhetoric and legislation reflect real issues with our tax system and may help generate the political will for change, both within and without the IRS. But they also feed the beliefs of existing tax protester groups; and the accompanying rhetoric can also be seen as dangerous in the extreme, since one's perception of the tax system as relatively fair probably in large part reflects one's perceptions of the way others — including, in particular, one's political leaders and the media — think about taxes. It is hard to know where such bashing of the tax system will lead, since we do not know how to measure the stock of fairness-perception in existence, at what rate (or indeed whether) it is declining, or to what extent any loss is tempered by other factors. It does, though, seem doubtful that adjustments in civil monetary sanctions can do much to affect this.[13]

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payer's ethics or degree of honesty, the potential damage to the taxpayer's reputation if the evasion were detected, the taxpayer's level of risk aversion, and the perceived benefits to be derived if the evasion is successful).

[5]*See, e.g.*, Scholz and Pinney, "Duty, Fear, and Tax Compliance: The Heuristic Basis of Citizenship Behavior," 39 *Am. J. Pol. Sci.* 490, 505-09 (May 1995) (increasing audits and penalties will do little to increase compliance unless accompanied by educational and persuasive strategies to inform taxpayers of the change, because there exists a "striking disjuncture between subjective and objective risk of being caught"); Sheppard, "News Analysis: Tax Evasion: What We Don't Know," *Tax Notes*, June 20, 1994, p. 1534 at 1535 (analyzing working paper by two IMF economists entitled "A Primer on Tax Evasion," in which the authors suggest that raising penalties will not have deterrent effect if likelihood of being caught remains too low).

[6]Information reporting promotes compliance in other ways as well. *See* Kamdar, "Information Reporting and Tax Compliance: An Investigation Using Individual TCMP Data," 23 *Atlantic Econ. J.* 278, 290-91 (December 1995) (information reporting leads to increased compliance because it increases taxpayers' fears of detection for noncompliance and / or because it simplifies taxpayers' computation of their liabilities).

[7]Novack and Saunders, "The Hustling of X Rated Shelters," *Forbes*, Dec. 14, 1998, p. 198.

[8]Sen. Trent Lott, R-Miss., News Release, *Doc 98-23152 (1 page), 98 TNT 140-23.*

[9]Presidential candidate Bob Dole, quoted in Fleming, "Ending the IRS as We Know It: Thoughts From Outside the Beltway" *Tax Notes*, Oct. 28, 1996, 502.

[10]"The Federal income tax system is a disgrace to the human race." Jimmy Carter, quoted in Yablon, "As Certain as Death — Quotations About Taxes," *Tax Notes*, Dec. 29, 1997, p. 1485.

[11]For a bibliography of coverage of the Roth hearings and an interesting perspective on how section 6103 can hamstring IRS response to taxpayers' public allegations, see Donmoyer, "Disturbing Questions Continue to Dog Senate's IRS Hearings," *Tax Notes*, May 31, 1999, p. 1271.

[12]*See, e.g.*, Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, sections 3001 (shift of burden of proof to IRS); 3411 (expansion of confidentiality privilege to nonlawyers); 3415 (taxpayer right to file motion to quash all third-party summonses), 112 Stat. 685 (1998).

[13]A very interesting and original work in this area — from the perspective of the lawyer-psychologist — is Rosenberg, "The Psychology of Taxes: Why They Drive Us Crazy, and How We Can Make Them Sane," 16 *Va. Tax Rev.* 155 (Fall 1996).

Criminal liability for tax crimes is the second critical component of tax compliance, since it provides the ultimate dividing line between permissible and impermissible behavior. The seriousness of incarceration, the high standard of proof required for conviction, and the required proof of scienter all render criminal sanctions ill-suited or inapplicable to all but the most egregious cases. Nevertheless, the criminalization of intentional or willful noncompliance provides a necessary foundation to the perception that our income tax is the law of the land. It is important that one who completes his tax return honestly and timely pays his tax liability know that another who intentionally chooses not to do so is subject to criminal penalty; otherwise, the compliant taxpayer is likely to feel like a chump, and the noncompliant taxpayer to think that noncompliant conduct is rewarded rather than deterred.[14]

Our tax laws have long included a comprehensive set of criminal statutes adequate to criminal enforcement. The declining frequency with which those criminal statutes are applied has been the subject of discussion and criticism elsewhere.[15] In 1978, the likelihood that a return would be subject to criminal investigation was about 10 in 100,000, and it has been dropping ever since.[16] The most recent statistics available indicate that, if one is not under investigation for narcotics violations, the chances of criminal investigation are less than 1 in 50,000, and the chances of actually serving time in prison are less than 1 in 100,000.[17] One must wonder whether the incidence of criminal investigations has dropped — perhaps decades ago — below the level required to establish among compliant taxpayers the view that the deliberately noncompliant have a substantial risk of being caught and convicted, although we can do little more than wonder because the long-term implications of such changes in the level of criminal investigations have not been much studied and are not clear.

Comprehensibility is the third aspect of tax compliance noted above. Clearly, one cannot comply, except by serendipity, with what one does not understand. For many taxpayers, particularly the large number of nonitemizing wage earners, the law and their filing obligations are reasonably simple. For others, the complexity and ambiguity of the law make strict compliance difficult. One need only look at *Money* magazine's annual tax preparation story, in which professional preparers arrive at wildly different liabilities based on a single set of facts, to recognize that many taxpayers sincerely find it difficult or impossible to fully comply.[18] A student of the tax law must learn to drink from a firehose, as the flood of change and complexity seems never to cease. Over the last 11 years, changes to the code have been made in 71 different public laws, many of which include copious amendments.[19] The complexity of the law also provides opportunities for deliberate tax avoidance, as taxpayers choose to interpret the law's ambiguities in their favor; and it makes it difficult, if not impossible, for the IRS to separate the deliberately or negligently noncompliant, who might properly be subjected to civil penalties, from those who simply have made an incorrect reading of the law or are confused.

The fourth major reason that we comply with our tax obligations is civil compliance contacts. These include contacts of many different sorts, including correspondence from a service center, office and field audits, and collection actions. Whatever form it takes, a civil compliance contact should convey a very simple message: "We are watching to make sure you comply with your obligations."

One can divide these contacts into two categories: those situations in which the IRS knows what the taxpayer is obligated to do or has a specific question and those situations in which the IRS's concerns are less focused and less clear. Most service center and collection contacts fall in the former category. Thus, if the taxpayer has not paid the tax shown on the return, has failed to report items shown on an information return, or has made an error on a return, the IRS's expectations are relatively clear and enforcement action is a foregone conclusion. As the IRS's information reporting program has become more accurate and comprehensive, the IRS has gotten quite good at the first type of contact, and this type of contact has become the most common. In 1998, for example, about four million

[14]*See generally* Frank A. Cowell, *Cheating the Government: The Economics of Evasion*, 30-48 (MIT 1990).

[15]Dubin, Graetz, and Wilde, "The Changing Face of Tax Enforcement, 1978-1988," 43 *Tax Lawyer* 893, 906-12 (1990).

[16]*Id.*

[17]*See* IRS Data Book, *supra* note 2, Tables 98db29ci and 98db02nr. Omitting estimated tax and miscellaneous filing brings the total number of returns filed in 1998 to about 166 million, and I have compared this to 3,106 investigations initiated and 1,501 incarcerations. Comparing investigations and incarcerations in 1998 to returns filed in 1998 slightly distorts the results, since the crimes involved would have been committed in earlier years, but you get the idea.

[18]Indeed, on May 25, 1999, a Ways and Means Oversight Subcommittee conducted a hearing specifically addressing the complexity of the tax code, at which members of the ABA Taxation Section, KPMG, the Tax Executive Committee of the American Institute of Certified Public Accountants, the National Federation of Independent Business, and the National Tax Association uniformly condemned the complexity of the Internal Revenue Code and testified that such complexity is undermining both respect for the tax system and taxpayers' willingness to engage in voluntary compliance. *See Doc 1999-18626 (22 original pages), 99 TNT 102-64* (testimony from representative of ABA Taxation Section); *Doc 1999-18677 (6 original pages), 99 TNT 102-65* (testimony from employee of KPMG); *Doc 1999-18678 (32 original pages), 99 TNT 102-66* (testimony from representative of the Tax Executive Committee of the American Institute of Certified Public Accountants); *Doc 1999-18679 (6 original pages) 99 TNT 102-67* (testimony from representative of the National Federation of Independent Business); and *Doc 1999-18680 (14 original pages), 99 TNT 102-68* (testimony from representative of the National Tax Association).

[19]This is the number of public laws listed as amending the Internal Revenue Code since 1989 in the table found at the end of Commerce Clearing House's paperback version of the Internal Revenue Code (CCH June 1, 2000).

taxpayer contacts were made through the IRS's information returns matching program and service centers made an additional 634,000 relatively simple and straightforward contacts.[20] Similarly, the IRS is quite good at noticing failures to meet payment and deposit obligations and following up through billing and correspondence. In 1998, it made nearly 34 million separate penalty assessments for failure to meet such obligations and assessed about $7.5 billion in civil penalties for collection failures.[21] About six million delinquent accounts existed at the end of 1998.[22]

The second type of contact is more expensive and less limited in scope. It involves personal contact by a revenue agent or tax auditor who is free to ask more general questions about the taxpayer's return. Before the advent of extensive matching programs, this type of contact was quite common — audit coverage exceeded 6 percent in 1965.[23] Since that time, audit coverage has declined precipitously. In 1998, revenue agents, tax auditors, and tax examiners together examined about 729,000 returns, while more than 160 million returns were filed — an audit rate of about 0.45 percent.[24] The impact of IRS audits is a matter of some disagreement. Most tax professionals see the incidence of audits as having critical importance in the enforcement of our tax laws, drawing analogies to the highway patrolman parked on the side of the road.[25] Some scholars who have considered limited data sets are less sanguine.[26]

When discussing civil penalties, we must keep in mind the foregoing broader compliance themes, for general perceptions of taxpayers about tax administration, our substantive tax law, and the treatment of tax evaders are undoubtedly far more important than the details of our civil tax penalties. Consider the preparation of tax returns. Willful or negligent errors on such returns engender, potentially, both compliance contacts (from service centers, revenue agents, and tax auditors) and accuracy-related and fraud penalties. As we noted above, in 1998 the IRS made a total of perhaps 5.4 million contacts regarding whether information reported on returns was correct.[27] During the same period, the total number of negligence and fraud penalties actually assessed by the IRS was only 7,343, or a little less than 0.15 percent of this total, and of these, a substantial number were abated.[28] The total amount of these accuracy-related and fraud penalties assessed after abatements was about $178 million, or a bit less than eight-tenths of a percent of the $23.36 billion total increase in tax and penalty recommended for examined returns.[29] Of this total penalty assessment, about $148 million were fraud penalties. Thus, only about $30 million, or a bit more than one-tenth of a percent of the total increase in tax and penalty recommended for examined returns, constituted the net assessment of negligence penalties. It is not possible to tell how many accuracy penalties were actually assessed and not abated during the 1998 tax year because the data show only that, in the aggregate, abatements of accuracy penalties exceeded assessments by 11,725 — a staggering number when compared with the fact that the total number of accuracy-related penalties assessed during all of 1998 was only 1,732.[30] Put another way, in 1998 the IRS proposed a nonfraud accuracy penalty once for every 100,000 returns filed and about once for every 1,000 returns examined. At the same time, it abated about 7½ previously assessed accuracy-related penalties for every 100,000 returns filed and about 8½ such penalties for every 1,000 returns audited.[31] While these statistics can be criticized as primitive and perhaps distorted by errors in assessment in the past, one can fairly use them to question the utility of the accuracy-related penalty regime and to illustrate the extremely modest place that such penalties play in the IRS's existing eompliance programs.

This is not to say that the structure and administration of the accuracy-related and fraud penalties is not important. It is, for reasons explained below, but we must not lose sight of the fact that other factors in the choice to voluntarily comply with our tax laws are much more important, and perhaps much more can be

[20]IRS Data Book, *supra* note 2, Table 98db15ex.

[21]*Id.*, Table 98db28cp.

[22]*Id.*, Table 98db15co.

[23]Dubin, Graetz, and Wilde, *supra* note 15, at 896. The primary source of this statistic is not cited.

[24]IRS Data Book, *supra* note 2, Table 98db15ex. I have excluded an additional 634,000 examinations conducted by Service Centers on the theory that these would have been very limited in scope and akin to the information return inquiries noted previously. Had these been included, the audit rate would have been 0.85 percent.

[25]*See* Guttman, "The Quantity and Quality of IRS Audits: Experts Agree Both Must Improve," *Tax Notes*, Apr. 11, 1988, p. 162 (quoting former IRS commissioners Mortimer Caplin and Jerome Kurtz).

[26]*Compare* Erard, "The Influence of Tax Audits on Reporting Behavior," in *Why People Pay Taxes* (Joel Slemrod, ed.) at 95-114 (1992) *with* Long, "Commentary," *id.* at 115-24.

[27]Four million contacts with taxpayers regarding information on their returns that may not have matched information returns in IRS's possession, 635,000 examination-related contacts from the service centers, and 730,000 examination contacts by revenue agents and tax auditors.

[28]IRS Data Book, *supra* note 2, Table 98db28cp. Abatements of negligence and fraud penalties during 1998 totaled 15,222. Thus, overall during the year, approximately twice as many negligence and fraud penalties were abated as were assessed. Clearly, many of these penalties (but it is not possible to tell how many) would have been assessed in prior years.

[29]*Id.*, Table 98db15ex.

[30]*Id.*, Table 98db28cp.

[31]*Id.*, *see* Tables 98db15ex and 98db28cp at www.irs.gov.

gained by giving them more attention than by continued tinkering with sanctions.[32]

In contrast to the very modest role that civil penalties appear to play in the actual positions that taxpayers take on their returns, some 34.1 million penalties, totaling $7.4 billion in amount, were assessed in 1998 for failure to file returns on time or timely and properly pay amounts due.[33] It is unsurprising that the IRS asserts these penalties frequently, since IRS computers can determine the existence of the mechanical conditions (was the return filed by the due date; was payment received timely; did the check bounce; etc.). On the other hand, one must wonder about the wisdom of a tax system that seems to result in one penalty for every fifth return filed. An incidence of penalties this high suggests that the penalties are not having the desired impact but provides no information about why such a high level of noncompliance persists. An educated guess is that the problem lies not so much in the structure of the penalties, but rather in what taxpayers are required to do, how they are asked to do it, and whether they have the ability to comply.

III. Absence of Data

We have very limited information about civil tax penalties. The IRS captures aggregated data regarding assessments and abatements in broad penalty categories. But not 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. No way exists to track what happens to particular compliance cases from examination, through administrative appeals, to collection, and thence to compliance in subsequent years, and thus the specific deterrence consequences of specific penalty assertions are unknown. Further, the indeterminate number of variables and a lack of even rudimentary data prevents empirical development of answers to the following key questions: To what extent do our existing civil tax penalties encourage compliant (or noncompliant) behavior among those who are not penalized, and what system of penalties and penalty administration is likely to be most effective in encouraging compliant behavior?

Such scholarly work as has occurred in the general area of sanctions has provided many interesting insights into how and why people comply with laws and the roles that sanctions (and rewards) should have in encouraging compliance.[34] But limited research budgets and the inability to replicate on a broad scale the conditions of our tax system limit the reliability of this work. Further, while this work tends to confirm intuitive insights, no work adequately reconciles conflicting insights. For example, penalties that are too harsh are not enforced,[35] while penalties that are too weak or not accompanied by sufficient enforcement are ineffective;[36] however, we probably know more about the temperature of Mama Bear's porridge than we do about the appropriate level of specific tax sanctions. Similarly, the imposition of penalties on transgressors tends to make compliant individuals feel better about complying but may tend to create an adversarial relationship between the IRS and transgressors and therefore make the latter less likely to comply in the future.[37] Unfortunately, this general observation tells us little about which effect is more important in a particular situation or what level of penalty provides the best compromise. In sum, while existing social science thinking provides helpful insights into compliance mechanisms and a vocabulary for discussing them, it provides little in the way of hard, practical information for politically acceptable or administratively feasible recommendations for improvement. As a result, it seems inevitable that we must fall back on statements of belief and principle to guide our thinking and recommendations.

IV. Conceptual Framework

A. Purpose of Penalties

Most of the studies[38] completed in anticipation of the 1989 IMPACT legislation stated as an assumption

[32]*See, e.g.*, Steenbergen, McGraw, and Scholz, "Taxpayer Adaptation to the 1986 Reform Act: Do Tax Laws Affect the Way Taxpayers Think About Taxes?" in *Why We Pay Taxes* (Joel Slemrod, ed.) at 32 (1992) ("Tax attitudes and, ultimately, compliance behavior are only weakly affected by changes in laws, even laws with a considerable impact on individual self-interest. The social processes through which individuals find out about the contents of new laws appear to have considerably more impact on tax schema than subjective evaluations of the laws and objective measures of their impact.").

[33]About 10 percent of these penalties are abated. IRS Data Book, *supra* note 2, Table 98db15ex.

[34]Slemrod (ed.), *Why People Pay Taxes* (1992); Jackson and Milliron, "Tax Compliance Research," 5 *J. of Accounting Lit.* 12-65 (1986).

[35]For example, in 18th century Britain, thieves were routinely convicted of stealing only four shillings, presumably because a conviction for stealing five was punishable by death. Schwartz and Orleans, "On Legal Sanctions," 34 *U. Chicago L. Rev.* 274-300 (1966-67). *See also* Sheppard, *supra* note 5 (analyzing working paper by two IMF economists entitled "A Primer on Tax Evasion," in which the authors observed that "[t]he greater the penalty . . . the less likely it is to be imposed on those who get caught. Couple a large penalty with a very small likelihood of detection, and the result can be public sympathy, rather than contempt, for the few tax evaders who are caught and punished, because what has happened to them appears to be random").

[36]*See, e.g.*, Alm, Jackson, and McKee, "Deterrence and Beyond: Toward a Kinder, Gentler IRS," in *Why People Pay Taxes* (Joel Slemrod, ed.) at 313 (1992) ("It is . . . important to recognize that detection and punishment cannot explain the compliance behavior of all individuals. The percentage of tax returns that are subject to detailed audit is quite small in most countries, and penalties are seldom more than a fraction of unpaid taxes.").

[37]Sheffrin and Triest, "Can Brute Deterrence Backfire? Perceptions and Attitudes in Taxpayer Compliance," in *Why People Pay Taxes* (Joel Slemrod, ed.) at 193-218 (1992).

[38]*E.g.*, Commissioner's Penalty Study, II-3 (IRS 1989); Committees on Civil and Criminal Penalties and on Administrative Practice, Penalties Study Report (American Bar Association Section of Taxation), at 2 (July 28, 1988).

that sanctions should encourage compliance with the tax laws, and this axiom, though something of a tautology, is surely the right starting place. Penalties that discourage compliance, while not hard to imagine, make no sense. And a desire to add penalty revenues to the public coffer would conflict with decreasing noncompliance. Presumably, the best penalty would be the one that is so effective it virtually eliminates noncompliance and thus results in no penalty revenues.

> ***While a no-fault penalty might in some circumstances be a sensible choice, penalizing taxpayers in a significant way purely on the basis of objective criteria can lead to perceptions of unfairness.***

Of course, penalties do have other consequences; they do add revenues to the Treasury, and they do punish the noncompliant. Such consequences seem necessary and unobjectionable so long as they are tributary to the objective of improved compliance. However, instances have arisen in which such consequences have been mistaken for objectives, and in such cases these mistaken objectives can conflict with efficient tax administration. For example, the substantial understatement penalty briefly rose from 10 to 25 percent for revenue-raising reasons,[39] and differentials between under- and overpayment rates of interest have also crept into the code to balance the books.[40] Both changes occurred without any real analysis of probable consequences to taxpayer or IRS conduct. Further, in the absence of some overriding concern, the targeted removal of IRS authority to waive penalties for reasonable cause for transfer pricing adjustments[41] could be interpreted as a legislative dumbing down of the law that reflects a lack of faith (perhaps self-fulfilling) in the ability of the IRS and the courts to administer discretionary waivers. While a no-fault penalty might in some circumstances be a sensible choice, penalizing taxpayers in a significant way purely on the basis of objective criteria can lead to perceptions of unfairness and inconsistent application.

Suggestion has been made from time to time that the use of penalty revenues to fund compliance programs might make sense. A tying of penalty revenues to IRS budgetary needs would encourage the IRS to consider factors other than (and perhaps conflicting with) the encouragement of compliance when deciding whether to assert a penalty. Accordingly, it seems wisest to keep the IRS budget on a completely separate track.

[39]Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, section 8002(a), 100 Stat. 1874 (1986).

[40]Tax Reform Act of 1986, Pub. L. 99-514, section 1511, 100 Stat. 2085 (1986).

[41]Section 6662(e)(3)(D). Section references are to the Internal Revenue Code of 1986, as amended (hereinafter referred to as the "code"), except as otherwise noted.

B. How Penalties Work

Captioning this section "How Penalties Work" assumes away a fundamental question. We cannot at present prove that the penalties currently in the Internal Revenue Code do work. Our system is too complex and changes too frequently. Further, the IRS tracks only penalty impositions — all situations in which noncompliance occurred — not the extent to which penalties result in compliance by taxpayers otherwise prone to noncompliance. The view that penalties encourage compliance, while not at present provable, seems logical and finds support, somewhat vaguely, in existing social science thought.[42] Prior thinking by the IRS[43] seems about right, when it identifies three basic mechanisms.

The first is a penalty's utility in establishing a behavioral norm. Perhaps the most important compliance statistic is the number of taxpayers who file their returns on time and pay their tax liabilities without intervention and without finely balancing the benefits of avoidance against the risk and consequences of apprehension. The generally high levels of voluntary compliance in the U.S. probably arise in part from the absence of opportunity for evasion or avoidance and the likelihood of apprehension, but it seems likely that they also derive in part from taxpayers' feelings that they "should" comply with the tax law because it is "right."[44] Such feelings in turn doubtless have many sources, including generalized support for our system of government, agreement with the way in which federal revenues are spent, general feelings of moral responsibility, positive feelings regarding the legitimacy of the IRS, and positive feelings regarding the fairness of the way in which the federal government in general and the IRS in particular treat taxpayers.[45]

[42]*See, e.g.*, Crane and Nourzad, "Analyzing Income Tax Evasion Using Amnesty Data With Self-Selection Correction: The Case of the Michigan Tax Amnesty Program," in *Why People Pay Taxes* (Joel Slemrod, ed.) at 167 (1992) (penalty rates are one of the four factors commonly found to affect the decision to evade — together with the individual's true income, the tax rate, and the possibility of detection — and, in most cases, a negative relationship exists between the level of evasion and both penalty and detection rates); Alm, Jackson, and McKee, *supra* note 36 at 313 ("[t]here is some empirical evidence that compliance is affected by detection and punishment, at least to a degree. . . . It is, however, important to recognize that detection and punishment cannot explain the compliance behavior of all individuals").

[43]Commissioner's Penalty Study (1989).

[44]*See* Carroll, "How Taxpayers Think About Their Taxes: Frames and Values," in *Why People Pay Taxes* (Joel Slemrod, ed.) at 47 (1992) (with respect to decisions regarding taxpaying, "sociologists and political scientists suggest that taxpayers may not be processing personal consequences, but, rather, are focused on doing the 'right thing,' where 'right' may be determined from legal, moral, social, and utilitarian, as well as a personal consequences viewpoints. This is a 'norm-processing' rather than an 'outcome-processing' model of decision behavior").

[45]*See generally* Tom R. Tyler, *Why People Obey the Law: Procedural Justice, Legitimacy, and Compliance* (1990).

The existence and imposition of both criminal and civil sanctions probably also contribute to feelings regarding the "rightness" of compliance.[46] To choose an extreme analogy, most people are not seriously inclined to commit burglary, and thus, most people need no deterrent to prevent their becoming burglars. However, the fact that burglars go to jail when they are caught is a manifestation of society's disapproval of burglary, and confirms and supports the populace's view that burglary is wrong and should not be committed. In the same way, criminal tax penalties support the proposition that tax fraud is wrong and should not be committed.

The existence of civil tax sanctions support the proposition that a taxpayer "should" do more than merely avoid criminal tax evasion: The taxpayer should strive to comply with the law to the extent necessary to avoid penalty. Thus, civil tax penalties reflect and support the normative nature of tax obligations. As such, they play an important, though not exclusive, role in maintaining the feeling among taxpayers (both compliant and noncompliant) that they should fulfill their tax obligations. Civil penalties establish the propositions that taxpayers "should" disclose aggressive positions, avoid doubtful corporate tax shelters, contemporaneously document transfer pricing decisions, timely file their returns, promptly pay their tax liabilities, and discharge many other obligations.

A second process by which civil penalties do their work is through deterrence.[47] If he is impervious to moral feeling, our potential burglar may be prepared to burgle unless he thinks the sanction he may pay if he is caught, and the likelihood of being caught, make the risk of burgling too high. We call this general deterrence. If our potential burglar is insufficiently dissuaded and burgles and is caught, his incarceration may keep him from burgling afterwards because he will fear being caught and imprisoned again. We call this specific deterrence.

Deterrence theory may be a useful way of thinking through, at least directionally, how big a penalty needs to be, since deterrent effect depends on two factors: how big the penalty is and how likely it is to be applied. Viewing these factors as inversely related seems correct; the less likely a noncompliant act is to be discovered, the higher the penalty would need to be to discourage a taxpayer's propensity for noncompliance. Thus, when noncompliance is identified and dealt with systemically and a penalty inevitably imposed, the penalty probably need not be very large to have a sufficient deterrent effect. For example, if the IRS automatically and inevitably identifies the failure to pay a reported tax liability, bills for the unpaid balance, and promptly follows up with collection action, there seems little need, from a deterrence perspective, for a heavy penalty in addition. On the other hand, if it is hard to identify the noncompliant act, deterrence thinking would argue for a heavier penalty. Thus, the difficulty of identifying tax evaders supports the heftiness of the civil fraud penalty.

> ***The compliant taxpayer does not want to be the chump for someone who does not pay his taxes but nevertheless shares in the collective benefit defrayed by the taxes collected.***

The sophistication of the population to be deterred probably also affects the efficacy of a penalty in deterring noncompliance.[48] For example, for many years, the penalty for a negligent misstatement of tax liability was 5 percent, and no other penalty applied short of fraud. In a series of rather complicated amendments and enactments beginning in 1982 and deriving from the tax shelter concerns of the time, the penalty was increased until today the penalty is a targeted 20 percent of the negligent portion of the understatement. The original impetus for these changes largely expired with the passage of the passive activity loss rules in 1986. It seems likely that the vast bulk of taxpayers have not paid much attention to the negligence penalty's legislative odyssey, and I am aware of no evidence suggesting that today's 20 percent penalty has an impact much different from that of yesterday's 5 percent for most taxpayers. It is probably enough for them to know, vaguely, that a negligence penalty exists.

On the other hand, there are taxpayers, and probably every tax practitioner has encountered them and most of us have represented them, who deliberately take advantage of ambiguities in the code and who carefully do their penalty algebra in evaluating whether to disclose positions and how aggressively they should act. Care must be taken that when the algebra is done, the calculation reaches an answer consistent with compliance concerns. Thus, for example, an increase in accuracy-related penalties associated with an increase in tax shelter conduct could be a rational response from a deterrence perspective.[49]

[46]*See* Schwartz and Orleans, note 35 *supra* at 300 ("the threat of sanction can deter people from violating the law, perhaps in important part by inducing a moralistic attitude toward compliance").

[47]Frank Cowell, note 14 *supra. See also* Hessing, Elffers, Robben, and Webley, "Does Deterrence Deter? Measuring the Effect of Deterrence on Tax Compliance in Field Studies and Experimental Studies," in *Why People Pay Taxes* (Joel Slemrod, ed.) at 292 (1992) ("although the evidence that heavier penalties produce more compliance than lighter penalties is limited, it is undoubtedly the case that fines and other punishments are, to a certain extent, deterrents").

[48]To the extent a correlation exists between a taxpayer's wealth and his financial sophistication, *see* Ahsan, "Tax Evasion: The Developing Country Perspective," 13 *Asian Dev. Rev.* 78, 84, 117 (1995) (emphasis in original) ("evasion is more likely among those who feel that they pay an unfairly high level of taxes" and "an *effective penalty structure and an appropriate audit technology* are possibly the two most important elements that the authorities have control over in its fight against evasion").

[49]*See, however, infra.*

Finally, compliant taxpayers probably like to see noncompliant taxpayers get their just deserts. The law-abiding citizen probably feels good when the apprehended burglar is sent to prison simply because the citizen then knows that breaking the law brings with it unpleasant consequences. All taxpayers know that paying taxes leaves less in their own pockets, and they doubtless draw solace from the fact that others are in the same boat and that the resources thus collected are then spent for the mutual benefit of all. The compliant taxpayer does not want to be the chump for someone who does not pay his taxes but nevertheless shares in the collective benefit defrayed by the taxes collected. Thus, a sense of satisfaction must arise when the noncompliant taxpayer is found out and made to pay the piper.[50]

This observation does not say much about the ultimate amount of penalty the noncompliant taxpayer should pay. Many would surely object to executing our burglar, and similarly a limit exists to the monetary sanctions that should be heaped on our hypothetical shirker. Nor does the observation say much about the likelihood of detection. If our shirker gets away with his tax avoidance, the penalties theoretically applicable are not too important, and the flip side of "just desserts" is that the honest taxpayer is likely to begin feeling frustrated and angry, and perhaps begin to think about mimicry. This fact leads to serious concerns when tax avoidance is highly publicized in a way suggesting that it works and that the IRS is impotent to rein it in.[51]

C. How Penalties Should Be Evaluated

From the foregoing theories, we can derive the axes along which penalties should be evaluated. One axis is the perceived fairness of the penalty. The perception of tax obligations as normative rules must import a view that the imposition of sanctions for failing to perform the obligations are a "fair cop." And the perception that penalizing the noncompliant is simply giving them their just deserts similarly imports the concept of fairness into the compliance exercise. The concept of fairness presumably includes both the idea that similarly situated noncompliers will be similarly penalized and that the penalty will be proportional to the transgression.

While one can easily state the proposition that similarly situated noncompliers should be similarly penalized, applying this concept of horizontal equity in concrete situations is difficult. For example, consider whether taxpayers who understate their tax liability should be penalized at the same rate, regardless of whether their conduct was negligent, intentional, an incorrect assessment of substantial authority, participation in a corporate tax shelter, or the failure to turn over contemporaneous documentation quickly enough. Section 6662 indicates that the answer to this question is yes. Similarly, consider whether the person who pays his own tax liability 16 days late occupies a position different from the employer who is 16 days late in making a federal tax deposit. Since the former pays a ½ percent penalty and the latter pays 10 percent, the code suggests that the employer is 20 times more culpable. Or consider whether a corporation owing a substantial amount after audit is more culpable than a similarly situated individual. The hot interest rate for large corporate deficiencies suggests that it is.

These questions of equitable treatment between classes of taxpayers naturally segue into the question of proportionality — whether the size of the penalty reflects the seriousness of the taxpayer's misconduct. Proportionality is important in a general way; severe disjunctures, such as existed with the pyramiding of tax shelter penalties in the late 1980s, created real problems. Today, fewer issues of disproportionality exist. One may question the wisdom of the quick buildup of failure to file penalties (5 percent per month), which probably causes this penalty to exceed the level needed to encourage timely filing and creates a financial barrier to the resolution of these cases. Similarly, one can question the size of the failure to deposit penalty: A 10 percent penalty seems completely out of proportion to the seriousness of a two-week delay in payment.

A second axis is the strength and structure of a penalty from the perspective of its function as a deterrent. If we have as a goal, as we should, the use of penalties to deter noncompliance, then we must also ask whether they have the right weight to do so. Different taxpayers doubtless have different sensitivities to sanctions. Some taxpayers will want to comply fully with the law, regardless of the existence of a sanction. Some taxpayers will not adjust their behavior even in the face of criminal sanctions. Between these two ex-

[50]*See* Wolfe, "Recovery From *Halper*: The Pain From Additions to Tax Is Not the Sting of Punishment," 25 *Hofstra L. Rev.* 161, 188 and n.125 (Fall 1996) (citations omitted) (The necessity of civil tax sanctions "is absolute to our income tax system. . . . [T]he honest taxpayer must believe that the system works. Trust in the system is imperative: '. . . The high state of taxpayer morale necessary to a self-assessment system can be maintained only if a taxpayer believes the Government is seeing to it that the other persons are doing their fair share. . . . Investigation must be sufficiently efficient and selective to maintain a high level of voluntary compliance'"). *See also* Schwartz and Orleans, note 35 *supra* at 281-82 (sanctions are effective, in part, because "[v]iolation of socially approved norms may be assumed to act as a frustration to many in society. The imposition of legal sanction[s] may serve as the most convenient socially approved expression of aggression against the source of the frustration").

[51]*See* Sheffrin and Triest, "Can Brute Deterrence Backfire? Perceptions and Attitudes in Taxpayer Compliance," in *Why People Pay Taxes* (Joel Slemrod, ed.), at 210-13 (1992) (publicized stories about the "tax gap" gave students a more negative view of the tax system and made them more likely to view other taxpayers as dishonest; "experimental results suggest that publicity concerning the degree of noncompliance and enforcement efforts has the potential for making a large difference in the percentage of the population who choose to evade taxes").

tremes lies a spectrum of taxpayers with varying sensitivities.[52]

One approach might be to make penalties as high as possible, to render the largest possible population of taxpayers responsive to them. However, the perceived disproportionality of such a scheme seems likely to lead to anger and resistance and to inconsistent enforcement decisions as taxpayers fight perceived unfairness and auditors and appeals officers in the field apply the penalties inconsistently to ameliorate perceived injustices.

Another approach might be to establish stepped penalties, as is the case with collection penalties and the section 6662 valuation penalties, so that the more egregious conduct and the less responsive taxpayers are penalized more seriously. When obligations are ongoing and late compliance needs to be encouraged, a graduated penalty may encourage taxpayers to take remedial action. Thus, for example, the opportunity to terminate the accrual of failure to file or pay penalties by late compliance or to avoid understatement penalties by filing amended returns does work as an incentive for correction. However, a need for simplicity and the difficulty of making fine distinctions between taxpayers limits the utility of such an approach.

In sum, penalties probably should encourage late compliance where possible and desired and should be geared to the bulk of taxpayers, with the outliers, if they can be identified, dealt with through waivers, active compliance programs, and perhaps in limited cases targeted penalties. Penalties probably should be, like Mama Bear's chair, not too large and not too small, so that the bulk of taxpayers do see them as a potential economic cost to be avoided and so that auditors feel that the weight of them is not disproportionate to the noncompliance at which they are directed. Finally, they should be subject to cessation of accrual, or reversal, when appropriate to encourage late compliance.

The third axis is practical application of the penalty from the perspective of the taxpayer's understanding of his obligations and exposures. One can probably safely assert that most individual taxpayers do not spend much time thinking about their tax obligations. A general acceptance of the proposition that they should comply with these obligations and an expectation that one who does not do so will be punished appropriately is probably as much as should be expected from them. Propagating and preserving this state of mind seems of high value. While civil penalties have a modest role to play here, it does seem right that, from the perspective of the individual taxpayer, they should be easy to understand and intuitively reasonable.[53] This inevitably leads one toward a fairly simple reasonable man, or negligence, standard as the touchstone for the imposition of most penalties on most taxpayers.

More sophisticated, wealthier, or perhaps aggressive taxpayers make more finely tuned decisions based more strongly on a fine appreciation of the limits of their obligations and the economic consequences of alternative courses. The course of penalty legislation over the last 20 years (particularly in the area of accuracy-related penalties) reflects the view that a negligence standard for such taxpayers does not work well. Instead, penalties seek to alter these taxpayers' economic calculus, both by making aggressive planning decisions that would pass only a negligence standard more expensive, and by providing economic encouragement for precise compliance with more mechanical reporting, deposit, and payment rules.

Whether taxpayers are vaguely aware of potential sanctions or routinely take them into account as a part of a more careful analysis, penalties have a role to play in communicating expectations and requirements. This role seems fundamental but modest. The existence of sanctions is necessary background supporting the obligatory nature of tax obligations. However, the actual imposition of these sanctions is, in most cases, infrequent. The substantive law, existing taxpayer attitudes, and the effectiveness of IRS compliance programs seem much more significant factors in compliance levels.[54]

The fourth axis is the IRS's ability to make effective use of the particular penalty. Ongoing questions about the IRS's effectiveness, the latest reorganization, and staffing and training needs make it somewhat difficult to segregate issues of penalty design. However, there is little to be gained from a penalty that is not or cannot be used effectively by the IRS.[55] Excessive complexity, vagueness of criteria, or severity that is disproportionate to transgression can make consistent, intelligent application difficult or impossible. Further, the factual nature of penalty decisions supports the view

[52]The source of those sensitivities undoubtedly will vary from taxpayer to taxpayer. *See, e.g.*, Linster, "Income Tax Compliance and Evasion: A Graphical Approach," 63 *Southern Econ. J.* 788, 795-96 (January 1997) (considering link between individual's degree of risk aversion and compliance behavior); Kaplan, Newberry, and Reckers, "The Effect of Moral Reasoning and Educational Communications on Tax Evasion Intentions," 19 *J. Am. Tax'n Ass'n* 38, 49-50 (Fall 1997) (considering link between individual's moral development and compliance intentions).

[53]Many commentators would agree that the applicable penalty provisions fail miserably in this regard. *See, e.g.*, Philipps, Mumbach, and Alley, "What Part of RPOS Don't You Understand? An Update and Survey of Standards for Tax Return Positions," 51 *Wash. & Lee L. Rev.* 1163 (Fall 1994).

[54]*See, e.g.*, Alm, Sanchez, and deJuan, note 4 *supra* ("compliance cannot be explained entirely by the level of enforcement . . . [because] the levels of audit and penalty rates are set at such low levels in most countries"); Alm, Jackson, and McKee, note 36 *supra* at 313 ("It is . . . important to recognize that detection and punishment cannot explain the compliance behavior of all individuals. The percentage of tax returns that are subject to detailed audit is quite small in most countries, and penalties are seldom more than a fraction of unpaid taxes.").

[55]*Cf.* Ahsan, note 48 *supra* at 117 (effective penalty and audit structures are potentially powerful tools in the fight against tax evasion, but they may "be rendered impotent if the legal system is unable to enforce the civil and penal provisions of the tax code").

that the IRS should have a fair amount of discretion in the imposition and waiver of penalties, subject to guidelines that support consistency of treatment of similarly situated taxpayers. A theoretically sound penalty that cannot, as a practical matter, be administered in a consistent and sound way should be changed.

V. Administrative Framework

Although the design and wording of the law captures much more attention, it constitutes a mere potentiality until the IRS actually proposes a penalty. Of course, this potentiality may have deterrent effect. Certainly, this is the hope of those who argue for the enactment of very high, unwaivable sanctions against tax shelters and other aggressive conduct. In the long run, however, the deterrent effect of a paper sanction will wane in the absence of assertion. While actually imposing penalties when warranted is important for the reasons set forth above, asserting a penalty may not always advance compliance. IRS action often engenders strong feelings among its targets, and this countercurrent can have offsetting consequences. When a taxpayer suffers, or perceives that he has suffered, procedural injustice at the hands of the IRS, the ripple effect of his sharing that experience may taint the views of others as well. Thus, a discussion of penalties requires attention to the IRS's administrative practices.

As noted above, the IRS makes, and perhaps has, little useful data about penalties available. One can glean general trends from the aggregations available,[56] and the Internal Revenue Manual provides general guidelines.[57] But one can learn little from these summaries about the impact of specific impositions, waivers, and abatements on the attitudes and conduct of the targeted taxpayers. Particularly in the case of accuracy-related penalties, low audit rates and the infrequency of assertions compound this problem and give rise to a landscape rife with opinion and devoid of empirical observation. We know that the way in which the IRS administers sanctions is important, but we lack the evidence to evaluate the decisions that the IRS makes in specific cases or to ground concrete improvements in experience. Thus, theory, analogy, and intuition again provide a somewhat gelatinous skeleton for our discussion.

An assumption of this article is that IRS intervention in specific cases significantly affects taxpayers' attitudes toward the agency and the U.S. tax system; that positive intervention reinforces compliant conduct, both for the taxpayer and those who learn of the interaction; and that negative intervention does the reverse. This view is axiomatic, based on the compliance objectives of penalties, and empirically based; it is also vague. What do we mean by "positive intervention"? We cannot mean that the taxpayer is satisfied with the result, because the result should be imposition of the penalty when consistent with the principles laid out above. We can mean only that the taxpayer and others accept the result as a rational outcome and respect the process by which the sanction was sustained. In this way, the positive effect of imposition is less diluted by sound complaints of unfairness. Our judicial system is based on such a concern for process, and thoughts on administrative due process are derived from similar thinking.[58] Social science research tends to reinforce the importance of process by noting the significance of responsive service and procedural fairness in reinforcing normative commitment to the tax system.[59]

The administrative process appropriate to imposition, compromise, or abatement of a penalty probably depends on the penalty. For collection penalties imposed on late payments, routine assessment and a fairly simple administrative review process seems appropriate for the most part, given the generally objective nature of these sanctions and the likely lack of factual ambiguity in the conditions permitting assertion. Accuracy-related penalties more often give rise to difficult questions, such as the strength of authority and the taxpayer's state of mind or due diligence, and may therefore call for a more elaborate process. Whatever the extent of the process, however, the principles to be applied have been well described. Two formulations are those of Kenneth Culp Davis and Judge Friendly. Davis identifies four ingredients necessary for an acceptable procedure for informal administrative action: (1) that parties be apprised of and have an opportunity to comment on evidence against them, (2) that agencies be as open as possible in reaching their decisions, (3) that any action be accompanied by a statement of findings and reasons, and (4) that agencies try, insofar as possible, to remain consistent through the application of precedent to their decisions.[60] Judge Friendly compiles a more extensive list of the ingredients of judicial due process and then asks, for any

[56]*See* IRS Data Book, *supra* note 2.

[57]*Int. Rev. Man.*, Part XX.

[58]Davis, K.C., *Cases, Text & Problems on Administrative Law*, at 514 (6th ed. 1977), as cited by Fox, *Understanding Administrative Law*, section 60 (2d ed. 1992); Friendly, "Some Kind of Hearing," 123 *U. Pa. L. Rev.* 1267 (1975).

[59]*See* Smith, "Reciprocity and Fairness: Positive Incentives for Tax Compliance," in *Why People Pay Taxes* (Joel Slemrod, ed.), at 225-27 (1992); *id.*, at 246 ("responsive service and procedural fairness are positive incentives that affect normative commitments to tax compliance"); Worsham, "The Effect of Tax Authority Behavior on Taxpayer Compliance: A Procedural Justice Approach," 18 *J. Am. Tax'n Ass'n* 19, 35-36 (Fall 1996) (empirical study concludes that procedural injustice experienced vicariously through learning of another's unfair treatment increased the level of noncompliance); Kinsey, "Deterrence and Alienation Effects of IRS Enforcement: An Analysis of Survey Data," in *Why People Pay Taxes* (Joel Slemrod, ed.), at 271-81 (1992) ("[p]eople who negatively evaluate their personal experience with the IRS appear more likely to tell other taxpayers about it than those with positive or neutral evaluations" and "[h]earing such reports of apparently unjust law enforcement lowers the perceived fairness of income tax laws and increases future intentions of noncompliance").

[60]*See* Davis, *supra* note 58.

particular type of informal agency adjudication, which of these features are necessary or desirable.[61] The IRS has compiled its own recipe, based largely on theories of procedural justice. Its ingredients include consistency of treatment and result, providing the taxpayer the opportunity to be represented and its case heard, unbiased agency action in each case, and prompt and efficient processing.[62]

All of these formulations encompass elements bearing on the ultimate objective of fair treatment of the taxpayer,[63] and the fulcrum of all is the idea that the taxpayer has the right to be heard — the hallmark of procedural due process.[64] In the context of penalty administration, the right to be heard encompasses the taxpayer's understanding of the reason that a penalty has been proposed or assessed;[65] a meaningful opportunity for the taxpayer to communicate with the IRS and to present evidence and arguments against imposition of the penalty to a person authorized to abate the penalty if warranted;[66] and an impartial decisionmaker. Each of these basic requirements presents special challenges when applied to the administration of the federal income tax system.

The right to a hearing before an officer biased in favor of one's opponent may, of course, be tantamount to no hearing at all. A taxpayer's right to be heard is illusory, therefore, unless it includes the right to be heard before an impartial arbiter. A taxpayer is likely to judge a hearing as fair only if he believes that the decisionmaker's sole mission is to achieve the correct result, regardless of its impact on revenue or otherwise. The need to foster both the perception and the reality of impartial arbitration is particularly acute in the context of federal tax administration, in light of the IRS's dual roles as judge and adversary.[67] IRS pronouncements claim that the organization occupies a nonadversarial position.[68] However, it is not the abstraction of the IRS, but rather a specific IRS representative that the taxpayer sees across the table when he is administratively contesting a proposed or assessed penalty, and it is another IRS representative that will serve as the taxpayer's adversary if the matter proceeds to a judicial tribunal.[69] This blurring of roles generates the very real risk that taxpayers will perceive the IRS as biased in its administrative review of taxpayer challenges.[70] It is critical to a system of voluntary compliance

[61]*See* Friendly, *supra* note 58. Judge Friendly's list is as follows: (1) an unbiased tribunal; (2) a notice of the proposed action and the grounds asserted for it; (3) opportunity to present reasons why the proposed action should not be taken; (4) the right to present evidence, including the right to call witnesses; (5) the right to know opposing evidence; (6) the right to cross-examine adverse witnesses; (7) a decision based exclusively on the evidence presented; (8) a right to counsel; (9) the requirement that the tribunal prepare a record of the evidence presented; and (10) the requirement that the tribunal prepare written findings of fact and reasons for its decision.

[62]Commissioner's Study of Civil Penalties, at IV-2 to -7 (IRS 1989).

[63]*See also* Smith, *supra* note 59, at 224 (procedural fairness "concerns such questions as how much opportunity individuals (or other entities) have to tell their side of the issue, how hard the authorities try to be fair to individuals, how correctable decisions are, and how equitably and consistently individuals are treated").

[64]*See, e.g., Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 314 (1949) (citation omitted) ("'The fundamental requisite of due process of law is the opportunity to be heard.'").

[65]Ensuring that a taxpayer understands the nature of the penalty imposed against him is not as simple and straightforward as it might appear at first blush, insofar as the wide array of standards and requirements contained in the various penalty provisions has confounded even seasoned commentators. *See, e.g.*, Philipps, Mumbach, and Alley, note 53 *supra.*

[66]The right to present one's case directly to the decisionmaker is an integral element of the right to be heard, lest the taxpayer be left feeling like the chump who thinks he has reached a deal with the salesroom showman to purchase a new car, only to be told thereafter that the showman's unseen "manager" requires a higher price. *See* Corneel, "The Service and the Private Practitioner: Face to Face and Hand in Hand — A Private Practitioner's View," 11 *Am. J. Tax Pol'y* 343, 355-56 (1994) (private practitioners often are frustrated when a settlement they believe they have negotiated with an IRS employee is undone or rejected by the employee's supervisor, with the practitioner learning only on the rejection that the negotiating employee lacked authority to act as final

(Footnote 66 continued in next column.)

decisionmaker to bind the IRS, and stating that this scenario "seems undesirable from the point of view of fairness and taxpayer relations. The taxpayer and her representative may feel misled into believing they were dealing with one authorized to negotiate and settle on behalf of the Service").

[67]*See* Prescott, "Challenging the Adversarial Approach to Taxpayer Representation," 30 *Loy. L.A. L. Rev.* 693, 740 (January 1997) ("Clearly, the [IRS's] dual role as opponent and decisionmaker makes it a unique adversary").

[68]*See* Corneel, note 66 *supra,* at 346 and n.5 (quoting introduction to IRS's Rules of Conduct, Doc. 7098, Ch. 1, which states that the IRS "must be reasonable and as ready to recognize the rights of the taxpayer as [it is] to protect the rights of the government[;]" and quoting IRS Statement of Principles, Rev. Proc. 64-22, 1964-1 C.B. 689, which requires the IRS "'to perform its work in a fair and impartial manner, with neither a government nor a taxpayer point of view'"). *See also* Prescott, note 67 *supra,* at 707 and n. 62 (quoting IRS Policy Statement P-1-1 (Dec. 18, 1993), 1 *Internal Revenue Manual: Administration* (CCH) 1303-25) ("'The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost . . . and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.'"). The IRS's newly revised Mission Statement continues to express the IRS's nonpartial objective, stating that the IRS will endeavor to "apply[] the tax law with integrity and fairness to all." *See* IRS Pub. No. 3349 (2-1999) at 1.

[69]*See* Prescott, note 67 *supra,* at 732 (footnotes omitted) (at least at the examination stage, "[t]he IRS is not . . . an impartial and passive decisionmaker. Indeed, the IRS, represented by the examining agent, is an active decisionmaker as well as a partisan opponent").

[70]The ABA Commission on Ethics and Professional Responsibility has stated: "few will contend that the Service provides any truly dispassionate and unbiased consideration

(Footnote 70 continued on next page.)

that taxpayers accept the IRS as a reasonably impartial administrator of the law, as well as an adversary.[71] To promote the goals of voluntary compliance, therefore, it is necessary continually to reinforce with revenue agents and appeals officers charged with administering sanctions the need for their impartiality in reviewing taxpayer claims.

In addition to the right to be heard and the right to an impartial decisionmaker, another identifiable element of procedural justice is the right to consistency. Notions of fairness require consistency in the IRS's administration of the penalty system. Such consistency of administration has multiple facets, including consistency among similarly situated taxpayers, consistency from year to year, and consistency with any prior experiences of the taxpayer or any member of his social group.[72] Because two taxpayers rarely present identical circumstances, achieving consistency is not as straightforward as it may seem. Indeed, rigid adherence to the mantra of consistency may sometimes conflict with appropriately nuanced administration. For example, while strict adherence to principles of consistency might support the imposition of penalties in any and all circumstances in which they apply, regardless of how technical or minor the violation, notions of fairness might support the decision not to impose a penalty if the infraction is minor, the taxpayer has a long history of compliance, and the imposition of the penalty would be unfavorably viewed as nitpicking. In the context of penalty administration, therefore, perhaps the goal of consistency is best served by the IRS's promulgation of nationwide guidelines for revenue agents and appeals officers that frame the proper steps of their inquiry but, somewhat paradoxically, afford them the degree of latitude or discretion necessary to excuse the minor infraction in cases where imposition of the penalty may undermine, rather than enhance, perceptions of fairness.[73]

By their very nature, penalties send a distressing message. The proposal or assessment of a penalty reflects the IRS's conclusion that the taxpayer has done something wrong. The mere fact that a penalty is asserted suggests that the wrong was egregious.[74] When a taxpayer earnestly believes that he made a good faith effort to satisfy his tax obligations and that both the penalty and any underlying adjustment are unwarranted, he may view assertion of a penalty as "kicking him when he's down." In a system so heavily reliant on voluntary compliance, any system of penalty administration should embrace concepts of procedural justice, so as to maximize the likelihood that, despite an unfavorable outcome, the taxpayer will feel that he was fairly treated in the process and that the tax system deserves his continued compliance in the years to follow.

One can demonstrate the sort of challenges that the IRS encounters in establishing its penalty procedures by comparing the receipt and contest of a traffic ticket to the assertion and processing of a collection penalty. If a highway patrolman thinks a driver is speeding, he stops the driver while the driver is engaging in the act. The questions involved — the driver's speed and the speed limit — are relatively simple, well understood by the driving public, and subject to objective proof: the speedometer, the speed limit sign, and the radar gun are generally readily available. The driver has an immediate, face-to-face interaction with the patrolman and can question the ticket at this time. All in all, the issuance of the ticket is a straightforward, contemporaneous act, providing the driver the opportunity to attempt an excuse and to question the patrolman. The driver likely has no trouble understanding what the patrolman's reasoning is at the time the ticket is written. The driver is able to contest the ticket in traffic court, where, depending on his pocket book and the seriousness of the matter, he can be represented by a

to the taxpayer. Although willing to listen to taxpayers and their representatives and obviously intending to be fair, the Service is not designed and does not purport to be unprejudiced and unbiased in the judicial sense." *See* ABA Comm. on Ethics and Professional Responsibility, Formal Op. 314 (1965), reprinted in 51 *A.B.A. J.* 671 (1965), as quoted in Prescott, note 67 *supra,* at 716 and n.100. Indeed, in the specific context of penalty administration, at least one commentator has proposed the creation of an independent "Penalty Appeals Board" to hear appeals of negligence penalties, based in part on the perception that the IRS proposes the negligence penalty as a matter of course anytime an understatement is determined, regardless of whether the standards of section 6662 have been met.

[71]*See* Corneel, note 66 *supra,* at 346 ("obviously, in what is basically a self-reporting system, it is exceedingly important for the taxpayer to regard the Service as a fair and impartial administrator of the law rather than as the enemy").

[72]*See* Worsham, "The Effect of Tax Authority Behavior on Taxpayer Compliance: A Procedural Justice Approach," 18 *J. Am. Tax'n Ass'n* 19, 20 (Fall 1996) (in the context of procedural justice, "consistent procedures are those that insure both the equal treatment of individuals and the equal application of rules over time").

[73]Additional elements of procedural justice relate to this notion of administrative consistency, in that procedural justice also requires accuracy and correctibility in penalty administration. The notion of accuracy as an element of procedural justice simply reflects the desirability for the IRS to "get it right" when it comes to sanctioning a taxpayer. Seemingly unjustified or arbitrary penalty assessments, based on perceived incorrect applications of the law, confuse taxpayers seeking to understand what constitutes compliant conduct and, as a result, heighten perceptions of unfairness and increase the risk of enhanced noncompliance. While the IRS must strive for consistent accuracy in its penalty determinations, however, procedural justice also calls for the existence of mechanisms through which to correct the inevitable errors that will be made. This notion of "correctibility" requires meaningful, effective avenues for review or appeal of penalty determinations that the taxpayer believes are erroneous.

[74]*See* Corneel, note 66 *supra,* at 352 ("Tax penalties, generally speaking, indicate not merely an error on the part of the taxpayer or practitioner, but some flaw in character or attitude: insufficient care, intentional violation of the law, [or] an effort to mislead the other side").

lawyer or represent himself; he can question the officer and present other evidence, including whatever excuse he wishes. The judge is independent of the patrolman who wrote the ticket, has the power to strike down the ticket, and may do so unless the government provides proof of its case.

Now consider the imposition of a collection penalty. Generally, no discussion of the collection issue occurs before the issuance of a penalty proposal. Rather, the case normally commences with the receipt of a notice from a service center. The IRS computer is the analogue to the highway patrolman, and thus no human being is present to discuss the nature of the offense or reason for or computation of the penalty. However, human interaction at this point may be more needed both because culpability may be less clear to the taxpayer (the taxpayer may feel that the underpayment resulted from financial hardship or excusable error rather than from a conscious act, such as a lead foot on the accelerator) and because the notice may be hard to understand (while the IRS has made progress in making its notices more understandable, a collection notice is not a model of clarity, and the basis for the penalty computation is somewhat complex). The taxpayer can only place a telephone call to an IRS call site, correspond with Taxpayer Service personnel at the service center, or visit an IRS walk-in site — relatively cumbersome alternatives. Further, these alternatives are less satisfactory because, unlike the patrolman in the speeding situation, the IRS representative will have no personal knowledge of the taxpayer's conduct, will be dealing with a penalty that has already been proposed in the notice, will likely meet the taxpayer's factual representations with skepticism based on experience with other taxpayers rather than on any direct observation of this taxpayer, and will probably not be as thoroughly trained as the patrolman. Taxpayers can make an administrative appeal of a collection penalty, and the rights to such an appeal have been strengthened recently, but the range of defenses that may be proffered are generally limited to procedural issues, and the IRS employee who will hear the case, while not having been involved in it previously, will not be independent in the same sense as the judge who hears the appeal of the speeding ticket.[75] Only if this appeal fails may the taxpayer obtain a hearing before an independent judge, and even then, in most circumstances the penalty must be paid before it can be contested.[76]

All in all, this is a much less satisfactory procedure and is much more likely to leave the taxpayer disappointed, frustrated, and angry. I do not necessarily suggest that the IRS should change its procedural approach to collection penalties, but a comparison of these cumbersome and impersonal procedures to the more streamlined processes of traffic control provides weight to the view that a conservative approach to proposal and imposition of tax penalties is appropriate and encourages IRS pursuit of less burdensome and more transparent ways of dealing with them.

Procedures for accuracy penalties generally do involve more direct interaction with the IRS because they generally arise out of the audit process. Thus, the proponent is generally present or available to discuss the penalty, and the administrative appeals process is probably more effective, due to the need to examine, discuss, and resolve the underlying substantive issue. Further, such a penalty can be contested in the Tax Court before it is paid. The main procedural concerns regarding the administration of accuracy penalties are probably concerns about the taxpayer's ability to understand the reasons for the penalty's assertion and the opportunity to be heard, in the sense of presenting exculpatory evidence. Satisfactory explanation of the reasons for assertion may prove difficult, in view of the relative infrequency of assertion, which leads to a concern that a taxpayer paying an accuracy penalty has been unfairly singled out, and the taxpayer's opportunity to be heard has been undercut in certain circumstances by reason of Congress's enactment of very severe penalties that provide low thresholds for assertion and remove IRS and judicial waiver authority.

In sum, an effective system of penalty administration must incorporate basic elements of procedural justice if it hopes to maximize taxpayer perceptions of fairness and the resulting benefit of voluntary compliance. Against this backdrop of framing principles, I now turn to examine two important categories of penalty provisions in the code.

VI. Collection and Deposit Penalties and Interest

A. Overview of Development of the Law

As noted above, failure to file and collection penalties are assessed far more frequently than other penalties, comprising more than 97 percent in dollar amount of all penalties and more than 99 percent of the number of penalties reported, net of abatements, in 1998.[77] One might reasonably add to these numbers the assessments of interest on delinquent payments. While arguably not a penalty, but rather a charge for the use of the government's money, interest must nevertheless be included in a calculation of the delinquent taxpayer's aggregate liability, and the current interest provisions can be viewed as having some features of a civil sanction. If interest were added to the calculations, it would swamp the pure civil sanction numbers.[78] Collection penalties and interest play the largest part in public

[75] *See generally* section 6320; IRS Pub. 594 (Rev. 1-2000).

[76] Section 6330.

[77] In 1998, delinquency (failure to file), estimated tax, failure to pay, bad check, and miscellaneous penalties generally imposed at the service centers made up about $7.4 billion of the approximately $7.6 billion of penalties assessed and not abated. These penalties actually made up slightly more than the total 29.97 million penalties assessed, net of abatements, because the number of negligence penalties abated was substantially larger than the number asserted. *See* IRS Data Book, *supra* note 2, Table 98db28cp.

[78] *IRS Data Book, supra* note 2, Table 98db15ex, notes that net interest collected from individuals was $4.8 billion and net interest collected from corporations was $10 billion. Presumably, these numbers are simply the excess of collections of interest over payments of interest on tax overpayments, and thus the total interest collected would be much higher. I was not able to identify similar information for the 1998 year.

dissatisfaction with the IRS. Congressional hearings on IRS misconduct revolve, to a very great extent, around collection efforts, and, clearly, a substantial portion of every delinquent account in the IRS's accounts receivable is penalty and interest. Because these penalties and interest are the most prevalent nontax charges incurred by taxpayers, they deserve first place in any discussion.

Understanding how the prevalence of collection penalties developed requires a review of the history of the code's provisions governing the accrual of interest on underpayments of tax. For those who may regard the Internal Revenue Code as a bit on the dry side, the following is an extraordinarily pure dose of alum, but it also seems an unavoidable ante to the succeeding discussion.

From 1935 until the mid-1970s, the interest rate on over and under payments of tax was 6 percent simple interest,[79] and no general failure to pay penalty analogous to that now provided in section 6651(a)(2) or (3) existed. However, the failure to file a return was, as it is today, subject to a 5 percent per month penalty on the unpaid balance due, up to a maximum of 25 percent.[80] If the taxpayer had the obligation to deposit taxes such as wage withholdings, then the failure to make timely deposits was penalized for the period during which this failure occurred at the rate of 1 percent per month, up to a maximum of 6 percent.[81] If the taxpayer paid his taxes by check and the check bounced, a penalty of the greater of $5 or 1 percent of the amount of the check applied. Estimated tax penalties accrued at the 6 percent simple interest rate.[82] Interest accrued on penalties from the date of notice and demand unless they were then paid within 10 days.[83] Interest did not accrue on overpayments if they were refunded within 45 days after the return was filed,[84] and accrual of interest could be terminated up to 30 days before the refund was made.[85]

This comparatively simple regime continued essentially unchanged until 1969, when Congress added to the code a penalty of ½ percent per month, not to exceed 25 percent in total, for failure to timely pay tax.[86] Under the 1969 rules, the failure to pay penalty and the failure to file penalty could not aggregate more than 5 percent per month. The practical import of this rule was to provide that, if the taxpayer had failed to file a return, penalties would accrue at a rate of 5 percent per month for the first 5 months, and then at the rate of ½ percent per month for the next 50 months. The legislative history indicates that, in 1969, commercial interest rates exceeded the statutory 6 percent rate and that the Congress wanted to prevent taxpayers from using the Treasury as a source of cheap borrowings.[87] Because the statutory interest rate continued to be 6 percent simple interest, this change had the practical effect of doubling the interest rate on late payments. The 1969 act also changed the failure to deposit penalty from 1 percent per month for six months to a flat 5 percent.[88] The reasons for this change are not explained separately in the legislative history, though it clearly put a greater premium on timely deposit.

In 1974, Congress replaced the statutory 6 percent rate of interest on underpayments with an annually adjustable simple interest rate equal to 90 percent of the prime rate,[89] explaining that higher commercial rates created an incentive for taxpayers to delay paying their tax liabilities and, perhaps, to understate their tax liabilities on their returns.[90] The immediate practical effect of this change was that the interest rate increased to 9 percent. Over the next four years, it decreased twice — to 7 percent in 1976 and to 6 percent in 1978.[91] Although this change in the law was intended to bring the interest rate into line with commercial rates, and thus, theoretically, the reasoning underlying the introduction of a failure to pay penalty in 1969 was no longer valid, the failure to pay penalty was not repealed. Including the failure to pay penalty as a part of the cost of delinquency, interest-type charges imposed between 1974 and 1980 fluctuated between 12 and 15 percent.

In 1981, Congress increased the interest rate to 100 percent of the prime rate[92] because the rate (then 12 percent) was still viewed as low relative to commercial rates and thus a contributor to the growth in delinquent accounts.[93] Under this new regime, the rate rose to 20 percent in early 1982. The failure to deposit penalty was also amended to add a 25 percent penalty on amounts claimed to have been deposited in excess of the actual deposit.[94]

[79]Section 6601(a), 6611(a) (1954).

[80]Section 6651(a) (1954).

[81]Section 6656(a) (1954).

[82]Sections 6654, 6655 (1954).

[83]Section 6601(f)(3) (1954).

[84]Section 6611(e) (1954).

[85]Section 6611(b)(2) (1954).

[86]Tax Reform Act of 1969, section 943.

[87]"Since the current cost of borrowing money is substantially in excess of the 6 per cent interest rate provided by the code, it is to the advantage of taxpayers in many case[s] to file a return on the due date but not to pay the tax shown as owing on the return. For the period the tax remains unpaid, the taxpayer is borrowing from the Government the amount of the tax at a 6 percent rate of interest. Similar borrowings can result from failure to pay deficiencies or to make deposits of taxes. Although full information is not available, borrowings of this type may be occurring on a substantial scale." S. Rep. 91-552 at 297-98, reprinted in 1969-3 C.B. 611-12.

[88]Tax Reform Act of 1969, Pub. L. No. 91-172, section 943, 83 Stat. 487 (1969).

[89]Pub. L. No. 93-625, section 7, adding section 6621 (Jan. 3, 1975).

[90]S. Rep. No. 93-1357 (Dec. 16, 1974), in *Internal Revenue Acts 1971-75, Text and Legislative History,* at 1139-43 (West 1976).

[91]Rev. Rul. 75-487, 1975-2 C.B. 488; Rev. Rul. 77-411, 1977-2 C.B. 480.

[92]Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, section 711, 95 Stat. 172 (1981).

[93]General Explanation of the Economic Recovery Tax Act of 1981, 328-29, as reprinted in *Internal Revenue Acts 1980-81, Text and Legislative History,* at 1698-99 (West 1982).

[94]ERTA, Pub. L. No. 97-34, section 724 , 95 Stat. 172, 344 (1981).

In 1982, Congress first required that deficiency interest be compounded daily because daily compounding better reflected commercial practice.[95] It also increased from yearly to semi-annually the frequency with which the rate was adjusted to reflect changes in commercial rates.[96] The interest rate continued at 20 percent, dropping to 16 percent in January 1983. A 20 percent annual interest rate compounded daily is the equivalent of an approximately 22.1 percent simple interest rate. Thus, when added to the failure to pay penalty, the total annual time-value, simple interest charge for a delinquent liability would have been approximately 28.1 percent. A minimum failure to file penalty was also added to section 6651(a)(1), calculated as the lesser of $100 or 100 percent of tax liability, if the failure to file continued for more than 60 days.[97]

While earlier adjustments in interest rates could be interpreted in part as a response to concerns about growing accounts receivable, until 1984 Congress had the stated view that the purpose in adjusting interest rates was to bring the rates charged by the federal government into a reasonable relationship with commercial rates. In 1984, however, Congress for the first time began explicitly to look to the interest rate provisions of the code to solve other problems. It increased the interest rate on deficiencies attributable to "tax motivated transactions" to 120 percent of the normal deficiency rate.[98] Additionally, the beginning date for the accrual of interest on accuracy-related penalties was pushed back from notice and demand for payment to the due date of the return, so that the strength of these penalties would not be diluted through delay.[99] The interest rate was 11 percent to 13 percent from June 1983 through the end of 1985.

In 1986, Congress doubled the failure to deposit penalty, making it 10 percent.[100] It did not explain the reason that this increase was necessary, but then-prevalent budget balancing concerns and the high political visibility of an increase in marginal rates were powerful motivators to finding revenues in the nooks and crannies of the code. The rate of accrual of the failure to pay penalty was doubled from ½ of a percent to 1 percent for periods after the taxpayer has been given notice and demand for immediate payment.[101] The base for determining the rate of interest was changed to the federal short term rate, and a differential was introduced, so that overpayments bore a rate of interest 1 percentage point lower than underpayments, and readjustment of the rate to reflect changing market conditions was moved from semi-annually to quarterly.[102] In explaining the need for the differential, Congress noted that financial institutions loan funds at a rate of interest higher than they pay and reasoned that the Treasury's rates, being the same, must therefore be out of line, causing taxpayers "either to delay paying taxes as long as possible to take advantage of an excessively low rate or to overpay to take advantage of an excessively high rate."[103] This explanation did not address the fact that a failure to pay penalty would have been added to the time-value charge on a delinquent payment.

A substantive change in the law had a collateral impact on the after-tax cost of interest on underpayments: For individuals, interest on tax underpayments generally ceased to be deductible.[104] Thus, the real after-tax cost of interest rose substantially in 1986 for many taxpayers. By 1986, higher interest rates had imposed a burden on some taxpayers, and this had created some sympathetic cases for waiver of interest that the IRS indicated could not be dealt with under current law. Accordingly, Congress concurrently enacted section 6404(e), giving the IRS discretion to waive interest that has accrued due to ministerial errors and delays of the IRS.[105] In 1988, the bad check penalty of section 6657 was doubled, to 2 percent of the amount of the check.[106]

In 1989, the increased interest rate on deficiencies attributable to tax motivated transactions was repealed[107] as a part of overall reform of the accuracy-related penalties. The failure to deposit penalty was restructured, with the penalty increasing from 2 percent to 15 percent, depending on the length of time during which the failure to deposit continued.[108] A 10 percent rate applied if the failure continued for more than 15 days, and the maximum rate began after notice and demand by the IRS. The theory underlying this phased-in approach was that the gradual increase in penalty would encourage the delinquent depositor to

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[95]General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 256-59, as reprinted in *Internal Revenue Acts 1982, Text and Legislative History*, at 1205-06 (West 1983).

[96]Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Publ. L. No. 97-248, section 344-46, 96 Stat. 324, 635-38 (1982), adding section 6622 and amending section 6621. These provisions in TEFRA also eliminated a taxpayer's right to interest on overpayments in certain technical ways.

[97]TEFRA.

[98]Deficit Reduction Act of 1984 (DEFRA), Pub. L. No. 98-369, section 144(a), 98 Stat. 494 (1984), section 144(a).

[99]Section 6601(e), as added by DEFRA section 15(a).

[100]Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, section 8001(b) 100 Stat. 1874 (1986).

[101]Tax Reform Act of 1986, Pub. L. No. 99-514, section 1502(a), 100 Stat. 2085 (1986). The legislative history does not explain the reason for this increase, though presumably it was justified on the theory that after notice and demand IRS begins to incur increased collection costs. S. Rep. No. 99-841, at 778-79 (Sept. 18, 1986).

[102]TRA of 1986, section 1511.

[103]S. Rep. No. 99-313, 184-85 (May 29, 1986).

[104]*Id.*, section 511(b).

[105]TRA of 1986, section 1563.

[106]Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, section 5071(a)(1)-(3), 102 Stat. 3342 (1988).

[107]Improved Penalty Administration and Compliance Tax Act (IMPACT), Pub. L. No. 101-239, section 7721, 103 Stat. 2388 (1989).

[108]IMPACT, section 7742, 103 Stat. at 2405.

come into compliance to avoid further penalty accruals.

In 1990, the 1 percent differential between interest rates on over- and underpayments was increased to 3 percent for corporate underpayments that exceeded $100,000, beginning 30 days after the taxpayer was sent a revenue agent's report.[109] The purpose of this change was evidently to place corporations' payments of interest to the IRS, which continued to be deductible after 1986, on a parity with those of individuals, which were no longer deductible.[110]

In 1994, Congress reduced the interest rate payable to corporations on refunds by 1½ percent, thus increasing the differential between the interest rates that the IRS charges and pays to corporations to 4½ percentage points, in some cases.[111] The entire explanation for this change is as follows: "Distortions may result if the rates of interest in the Code differ appreciably from market rates. Reducing the overpayment rate for large corporate overpayments of taxes will reduce the possibility of distortions."[112]

In 1996, the IRS was given authority to waive the failure to deposit penalty for a first-time, inadvertent failure and to abate the penalty the first time that the depositor failed to make the deposit in the correct way.[113] IRS authority to abate interest was expanded to include delays due to certain "managerial" as wells as "ministerial" acts, and the Tax Court was provided jurisdiction over whether the IRS had abused its discretion in failing to waive interest for certain taxpayers.[114]

In 1998, the differential between over and underpayment interest rates was eliminated for individuals and explicit statutory rules were enacted for interest netting.[115]

B. Thoughts on Collection Penalties and Interest

Before the enactment of the failure to pay penalty in 1969, a taxpayer that had failed to pay the taxes reported on his income tax return paid 6 percent simple interest. This interest was deductible; thus, for example, if he was in the 34 percent bracket (single individual with taxable income exceeding $10,000), the after tax rate of interest would have been 3.96 percent.[116] If the delinquency continued for two years — a period not unusual for a taxpayer with solvency problems — the individual would owe a total of 12 percent on the original underpayment (about 7.92 percent[117] after tax if he could take advantage of the deduction). An employer that failed to deposit its withholding taxes paid the 6 percent failure to deposit penalty over the first six months of the delinquency, plus the 6 percent simple interest rate from the date the return was filed. If the employer was a corporation subject to the full 48 percent tax rate, the after-tax cost of a delinquency for one year would have been 9.12 percent of the undeposited amount.[118] Over two years, the cost would have been an aggregate of 18 percent of the undeposited amount before accounting for the deductibility of interest and approximately 12.24 percent after.[119]

It is understandable that the drafters of the 1969 Tax Reform Act thought that this state of affairs provided an insufficient incentive for timely payment of tax, particularly as interest rates rose. They chose to address this problem by introducing a failure to pay penalty that had the effect of raising the interest rate for amounts shown on income, estate, and gift tax returns to 12 percent. For our hypothetical individual taxable in the 34 percent bracket, this raised the simple interest rate from 3.96 to 9.96 percent, after tax, and to an aggregate of 19.92 percent over a two-year delinquency. For our hypothetical corporation, the maximum that could have been collected on a delinquent deposit for a one-year delinquency would have continued to be 12 percent before tax,[120] and 9.12 percent after tax;[121] for a two-year delinquency, it would have continued to be an aggregate of 18 percent before tax, or 12.24 percent[122] on an after-tax basis.

Following the 1969 Tax Reform Act, Congress continued to be concerned about compliance issues and revenue generation. The numerous changes in the collection penalties over the ensuing 30 years can be interpreted in several different ways. Initially, the focus seemed to be on specifying an economically correct interest rate, on the theory that this would improve IRS collections. The first adjustments in the rate were less than the appropriate commercial rate: only 90 percent of the prime rate, and without compounding. Because these early rates continued to be bargains, there was no need to revisit the failure to pay penalty, the original impetus for which had been less oriented toward penalizing taxpayers and more toward raising the effective rates closer to commercial reality.

Later, as Congress continued to tinker with the interest rate and it approached and perhaps exceeded commercial rates, the failure to pay penalty apparently came to be viewed as a legitimate sanction for late payment, and thus its original role was forgotten or ignored. Some of the increase in rates was less than obvious, since it derived from the move from simple

[109] Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, section 1134(a), adding new section 6621(c), 104 Stat. 1388 (1990).

[110] House Conf. Rep. No. 101-964, at 1100-01 (Oct. 27, 1990).

[111] Uruguay Round Agreements Act, Pub. L. No. 103-465, section 713, 108 Stat. 4809 (1994).

[112] House Rep. No. 103-826(I), at 178 (Oct. 3, 1994), as reprinted in *1994 U.S.C.C.&A.N.* 3950.

[113] Taxpayer Bill of Rights 2, Pub. L. No. 104-168, section 304(a).

[114] *Id.*, sections 301-02.

[115] Internal Revenue Service Restructuring and Reform Act, Pub. L. 105-206, sections 3301(a), 3302(a), 112 Stat. 658 (1998).

[116] 6 x 0.66.

[117] 12 x 0.66.

[118] (6 x 0.52) + 6.

[119] (12 x 0.52) + 6.

[120] 6 (deposit penalty) + 6 (interest on underpayment).

[121] 6 + (6 x 0.52).

[122] 6 (deposit penalty) + [12 (interest on underpayment) x 0.52].

to compounded interest and the elimination of the interest deduction for individuals.

More recent changes in the rate structure appear to reflect a need for revenue to balance the budget and a willingness to extract that revenue from taxpayers who have trouble paying their taxes on time — particularly corporations. Such justifications as the legislative history provides for the interest differential, for the increase in the interest differential for corporations, and for the increases in the failure to deposit penalty from 5 to 10 to 15 percent, have a somewhat fluffy feel, as though they were written to justify political decisions taken for reasons not germane to effective administration of the law. As we noted above, little evidence exists that any particular level of collection penalty substantially improves compliance, and accordingly adjustments and increases in interest rates and these penalties are based on little more than conjecture as to what the likely effect will be.

Little evidence exists that any particular level of collection penalty substantially improves compliance, so adjustments and increases in interest rates and penalties are based on little more than conjecture as to their likely effect.

Let us return to our hypothetical taxpayer in 1969 and see how he is affected. Rather than the aggregate 7.92 percent he would have had to pay after tax to clear up a two-year-old underpayment in 1968, or the 19.92 percent he would have had to pay in 1973, today he would have to pay substantially more.[123] If notice and demand has been made, interest accrues on the penalty, and he no longer gets to deduct interest on tax deficiencies. Further, though the failure to pay penalty is still capped at 25 percent in the aggregate, it accrues at the rate of 1 percent per month if final notice and demand for payment has been made — a likely event after several months given the IRS's automated collection system. Thus, while the precise computations are a bit more complex, it is possible to estimate a likely two-year sum at around 33 percent, before taking into account any increase in the failure to pay penalty following final notice and demand.[124] This sum will continue to grow quickly. If the taxpayer fails to file a timely return, the penalty burden increases substantially, due to the 5 percent per month failure to file penalty that has been a fixture in the code for decades.

For our employer who has failed to make a tax deposit, the news is worse, for he must add the now 15 percent failure to deposit penalty to the equation and compute interest at an 11 percent rate. Instead of two-year costs of 12.24 percent before and after the Tax Reform Act of 1969, in 1999 he would have had to pay something on the order of 43 percent[125] before tax and 33 percent after tax,[126] at a time when commercial interest rates were below 8 percent per annum. Further, while outside the scope of this article, it is much more likely that our employer will find himself liable for these penalties today than would have been the case in 1969 because the substantive rules for deposits of withheld taxes have been tightened up substantially. Very specific and unforgiving rules now govern the timing and form of the deposit of withheld tax, with some large employers required to make deposits on virtually a daily basis and with some employment taxes due effectively before the employees have even been paid.

Congressional hearings about excesses and insensitivity within the IRS collection function reflect taxpayer unhappiness with the way taxes are collected. Rhetoric about customer service, new appeals rights, and amendments permitting the waiver of interest reflect attempts to deal with the fundamental fact that taxpayer mistakes and delinquencies are simply treated more harshly than taxpayers think is warranted. A part of the issue is surely the total charges assessed on delinquencies, but the IRS's approach to handling particular cases may also exacerbate the problem. As Congress compared interest rates in 1974 to commercial rates, perhaps it would be wise to compare the IRS's treatment of delinquent taxpayers to the way delinquent customers or borrowers are treated in commercial contexts. It seems likely that the burdens placed on delinquent taxpayers and the difficulty of resolving a delinquent account far exceed what is encountered in dealing with most businesses. The involuntary nature of the relationship between taxpayers and the IRS perhaps justifies placing some limited additional costs on taxpayers, but the foregoing suggests that the situation has gotten out of hand.

It is not surprising that Congress has tended to find revenues in the collection area. The IRS's computer systems are effective enough to identify all cases of admitted delinquency and assess the required penalties and interest. Further, the constituency of delinquent taxpayers does not constitute a very effective lobbying group. But the question must be asked whether the harsh penalties are the most efficient way to collect taxes due and owing. Any practitioner who has represented a taxpayer in a difficult collection matter would, I think, agree with the proposition that the current combination of penalties and interest presents a serious impediment to resolution, and, whatever the future holds pending IRS restructuring, this impediment has been compounded for years by the inability of the IRS to effectively use the tools at its disposal to

[123]Assuming that the underpayment rate held steady at 9 percent and that interest compounded.

[124]Estimated as follows: {[6 percent failure to file penalty + 9.416 percent interest (9 percent compounded daily) + 0.282 percent (0.9416 percent interest on average outstanding failure to file penalty] x 2} + [9.416 percent on 1st year's outstanding balance].

[125]Estimated as follows: $[(1 + 0.11/365)^{730} — 1] + 0.15 + [0.15 \times (1 + 0.11/365)^{730}]$.

[126]Same as note 125, except that interest is tax-effected by multiplying it by 0.65.

compromise these additions to tax, so that that IRS and the taxpayer could return to a more normal relationship.

The frequency with which collection sanctions are imposed and the IRS's ability to identify delinquencies through its computer systems suggest a high degree of horizontal equity among delinquents. However, the very significant increases in the amounts of such sanctions over the last several decades, the enactment of the escape valve of section 6404(e), the lower levels of financial penalties for delinquency incurred in commercial situations, and the harsh comments on IRS collection activities expressed in congressional hearings and widely disseminated in the media all indicate that the regime of collection sanctions is perceived as disproportionately severe.

As for the deterrent effect of collection penalties, so long as the costs of delinquency slightly exceed the costs of borrowing from a commercial institution, delinquent conduct is adequately deterred by these costs. I posit this theory because the IRS has no trouble keeping track of admitted delinquencies — the assessment of more than 30 million collection penalties each year shows this. On the other hand, anecdotal evidence indicates that the most common delinquency problem is not the choice not to pay, but rather the absence of the resources to do so. If this is the case, then particularly harsh financial penalties may exacerbate, rather than deter, delinquencies.

Another fact suggesting that collection penalties may in general be too high is that in situations in which they are particularly draconian and particularly inevitable — the federal deposit area — a fairly high level of noncompliance nevertheless exists. This condition is probably more easily explained by the difficulty of complying with a demanding and complex deposit regime rather than from any unwillingness to try to comply. While the penalties are clear, the underlying law apparently presents significant difficulties.

As for IRS administration of collection penalties, IRS computer systems enable such penalties to be asserted in nearly all situations in which they are warranted. Between 10 and 20 percent of the penalties that are generated are waived, but information about the IRS's approach to waivers is not available in any systematic way.

C. Recommendations

In general, collection penalties and interest should encourage the timely filing of returns, making of deposits, and paying of taxes. When a taxpayer has failed to comply with these obligations, sanctions and interest charges should seek to reinforce the importance of payment and filing obligations, but should also seek to return the taxpayer as soon as possible to a compliant condition. Because collection issues are tracked systemically and generally involve reported liabilities, the detection of noncompliance is quite effective, and there seems no need for particularly harsh penalties to prevent risk-taking behavior. Rather, modest sanctions, combined with effective follow-up, should be adequate. In fact, because many delinquent taxpayers have other economic problems, sanctions that are too harsh may make it more difficult to resolve cases. They may also generate negative attitudes about the fairness of the tax system. One set of modifications in the law that would be responsive to these observations is as follows:

1. Failure to file penalty. The 5 percent per month failure to file penalty of section 6651(a) has been a fixture in the code since 1954. Clearly, timely filing of returns is important, and thus imposition of the initial 5 percent penalty for missing the due date of a return seems warranted from the standpoint of reinforcing the importance of timely filing and deterring delinquency. Failures to file have little to do with civil sanctions, however, and the subsequent build up of the penalty is so quick that it tends not to have much impact on taxpayer behavior. Further, at a later point in time, when the delinquent taxpayer is focusing on straightening out his tax affairs, the aggregate 25 percent penalty presents a serious economic impediment to case resolution. Accordingly, the author would reduce the speed with which the penalty accrues and extend the time during which it does so.

One approach might be to impose an initial 5 percent penalty at the time that the return becomes delinquent and then impose the remaining 20 percentage points of the penalty at the rate of 5 percentage points per year for four years, with the penalty accruing on the anniversary of the original due date of the return. This would provide a longer-term incentive to get delinquent returns filed, thus increasing the likelihood that the taxpayer has resolved the original impediment to filing, and it would establish an annual reckoning day for dealing with the delinquent return. Since the penalty would still be reasonably sized, it would adequately support the importance of timely filing, and the decline in the speed with which the penalty grew might lead to better acceptance of the penalty as a fair sanction by those to whom it would apply.

2. Failure to pay penalty. The original reason for the enactment of the half a percent per month failure to file penalty in section 6651(a)(2) and (3) was that the statutory interest rate was too low. Interest rates are now adjusted quarterly to reflect market conditions, and for corporate taxpayers are set at rates that are probably far higher than the rates at which the taxpayer can borrow commercially. Accordingly, it seems proper to regard as now corrected the problem that originally led to the introduction of this penalty. The IRS's computer system provides a high level of ability to identify and pursue tax delinquencies, and thus, there seems little need to establish a heavy sanction in order to take into account the possibility that the failure to pay will not be identified. Given today's rates of interest on underpayments, the addition of the failure to pay penalty, whether at 6 percent or 12 percent per annum, probably engenders strong feelings that it is excessive and unfair. Its quick accrual plays a major role in the compounding of liabilities, making it more difficult for the delinquent taxpayer to get back into compliance. Further, the author surmises that the most common reasons for nonpayment of admitted liability are those, such as insolvency and personal problems, to which civil sanctions are not germane.

The principal compliance objective in a failure to pay situation should be to obtain payment of tax and interest and to return the taxpayer as quickly as possible to a position of compliance. In the author's view, the failure to pay penalty may present a major impediment to this objective, while having little importance in the discouragement of delinquency and engendering strong feelings of unfairness among those who become subject to it.

Accordingly, the author suggests that the accrual of interest be regarded as the principal incentive for timely payment of tax. The failure to pay penalty should be an economically modest adjunct to these interest charges. Accordingly, it is suggested that the enhanced 1 percent rate of the penalty following notice of levy be repealed. Further, the half-a-percent per month penalty should be examined critically. A bold step would be to repeal this portion of the penalty as well. This would place the after-tax cost of delinquency in payment close to the cost that was incurred by a taxpayer immediately after the original enactment of section 6651(a)(2) and (3) in 1969. An adjunct to such an approach might be the addition of a onetime fairly modest late charge on the delinquent amount. The author favors this approach, either with or without the addition of a late charge. An alternative would be to reduce the rate of accrual of the penalty, perhaps by half, to 0.25 percent per month. In the author's view, this would also constitute an improvement in the collection framework.

3. Interest charges. One broad theme of legislative changes to interest rates over the last 30 years is that they should be set in relation to market interest rates, so that taxpayers do not have an incentive to delay payment of acknowledged liabilities. This view seems intuitively correct, and therefore the move toward rates that are compounded and are adjusted quarterly seems sound. Since taxpayers have varying levels of creditworthiness and the rates cannot practically be calibrated to the particular taxpayer's situation, one or two compromise rates must be selected. It seems right, as well, to set this rate toward the higher end of a spectrum of commercially reasonable rates, since too low a rate may encourage delay in payment, and a rate slightly higher than a commercial rate reflects the government's status as an involuntary creditor. The current underpayment rate for corporations with large underpayments (11 percent) probably exceeds a commercially reasonable range for a broad-based rate. The rate for other underpayments (9 percent) likely does not exceed a market rate for many taxpayers, though it is substantially higher than a market rate for others.[127]

The gap between over- and underpayment rates, which has now been repealed for individuals but continues to be 2½ or 4½ percentage points for most corporations, raises two major issues. The first and most important is whether such a disparity in rates will be regarded as fair. The historic approach to interest on refunds and deficiencies was based on parity between the rates, and this and the elimination of the differential for individuals tends, notwithstanding the stated legislative purposes in establishing these disparities, to provide support for the view that the disparity in rates for corporations is unfair and has no legitimate compliance objective.[128]

> ***The principal compliance objective in a failure to pay situation should be to obtain payment of tax and interest and to return the taxpayer as quickly as possible to a position of compliance.***

A second issue is the complexity that such differentials import into the code. An entire industry has grown up to deal with the disparity, the identification of offsetting over- and underpayments, and the general subject of global interest netting. This sort of avoidable complexity is simply not wise unless it achieves an overriding objective. One might argue that an overriding objective is to prevent corporations from using the government as a depository for funds. However, this is likely a modest problem at most, given the fact that a taxpayer has no assurance that the government will agree that an overpayment exists.

In sum, the author's preference would be to eliminate all interest differentials and set both the underpayment and overpayment rates at the current standard rate for underpayments, utilizing the current rate-setting mechanism. If the failure to pay penalty were repealed as suggested above, the interest rate could perhaps be set slightly higher.

4. Failure to deposit penalty. As with the failure to pay penalty and interest, the failure to deposit penalty has increased substantially over time. Originally a 6 percent addition accruing ratably over six months, it was changed to a flat 5 percent, onetime charge in 1969, to a flat 10 percent charge in 1986, and, in 1989, to progressive 2, 5, and 10 percent penalties phased in over the 15 days following the missed payment, with an increase to 15 percent after notice and demand. The penalty can apply in the case of failures to make the payment using the prescribed depository or method of transmittal, as well as the failure to remit the funds at all. Depositors are held to very high standards regarding the timing and form of deposit. The IRS is quite proficient at asserting the failure to deposit penalty, and thus, as is the case with failures to pay reported underpayments, there seems little reason to increase the severity of these penalties to reflect any significant risk that noncompliant behavior will be overlooked.

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[127]Rev. Rul. 2000-57, 2000-50 I.R.B 579, *Doc 2000-30749 (8 original pages), 2000 TNT 230-3.*

[128]The author acknowledges the view that the differential for large corporate underpayments coordinates this rate on an after-tax basis with the nondeductible nature of deficiency interest paid by individuals. However, this synthesis of the disparity is a bit arcane.

The size of the failure to deposit penalty can be very large in relation to the conduct penalized, particularly since the penalty is a percentage of the deposit and the required deposits can be many millions of dollars. The 10 percent penalty for a two-week delay in payment is the equivalent of a 260 percent annual interest rate. A matter as important as the deposit of withheld taxes requires a set of administrative rules calculated to do the best possible job of preserving long-term compliance. However, the existing system is a source of considerable friction between depositors and the IRS. This is unfortunate, in view of the fact that in a sense, the depositors are providing a service to the IRS through the collection and remission of the taxes owed by their employees and by other payees.

One useful focus might be to consider the type of arrangement under which the IRS would proceed if its relationship with depositors were viewed as a commercial one. Under such a circumstance, a late deposit would cause the IRS to incur interest, since it would have to borrow the amount of the deposit during the delay, and reimbursement for this cost would be appropriate. Additionally, if the deposit were made in a form less convenient or less quickly processible, the IRS would incur additional processing costs and additional interest cost until the deposit had been posted. Under this approach, one would think that the accrual of interest at the usual underpayment rate on the amount of the deposit and a service charge for the extra cost of processing a payment in the wrong form would be adequate.

The IRS is quite proficient at asserting the failure to deposit penalty, so there seems little reason to increase the severity of these penalties to reflect any significant risk that noncompliant behavior will be overlooked.

On the other hand, one might take the view that a charge for processing a payment made in the wrong form is inappropriate. Rather, if the form of payment is a matter of convenience to the IRS, one could argue that the IRS should accept payment in many different forms and provide an economic incentive, perhaps in the form of a slight discount, for payments in the preferred form. It might also make sense to examine the substantive rules governing timing and form of payment to determine whether too much is asked of taxpayers. As delinquencies age, they become more difficult to collect, and therefore a late charge keyed to the fact and duration of the delinquency seems appropriate, and perhaps it is appropriate to make this charge somewhat greater than would exist in a commercial setting to reflect the importance of complying with tax obligations.

Whatever is done with regard to the substantive rules and the idea of rewards, the deposit regime should be supported with a penalty for failure to comply to make clear a failure of timely deposit is not merely a commercial choice. Such a penalty should be sufficiently significant to drive home this point, without being overly burdensome. It is not clear what was unsatisfactory about the 1 percent per month penalty imposed in 1954 or the 5 percent flat rate penalty imposed in 1969. One wonders whether, at bottom, the doubling of the penalty to 10 percent simply reflected a congressional need for additional revenues. The phase-in of the penalty in 1989 seems a reasonable attempt to encourage depositors to make late payments promptly, but the further increase in the penalty to 15 percent seems harsh.

The author suggests that the failure to deposit penalty be capped at 5 percent, and that it keep its present two-week phase-in form, with the penalty building from 1 percent for a 1- to 5-day delay, to 3 percent for a 6 to 15-day delay, and finally 5 percent for a delay of more than 15 days. The 15 percent penalty following notice and demand should be repealed. Further, the IRS and Congress should reexamine the substantive rules governing timing of deposits and method of deposit to see whether a more flexible and user-friendly regime could be established, perhaps providing incentives rather than penalties for taxpayers willing to comply with the more stringent regime.

VII. Accuracy-Related and Preparer Penalties

A. Overview of Recent Developments

In 1954 and for many years thereafter, the penalties governing return accuracy and preparer obligations were two: an untargeted 5 percent penalty for negligent and intentional understatements, and an untargeted 50 percent penalty for fraudulent understatements. The ethical rules promulgated by professional groups and Circular 230 governed preparer conduct. This simple regime endured until 1976, when the Tax Reform Act of 1976 added penalties for negligent or willful conduct by preparers.[129]

In the view of the author, pre-1976 law generally accorded well with the objectives of penalties and their proper place in tax administration. It rested on a simple and unarguable norm — thou shalt not commit negligence or fraud — for which copious defining case law existed. The negligence penalty was generally modest in amount in relation to the proscribed conduct, thus exciting little in the way of concerns that the regime was unfair as applied.[130] The modest size of these penalties may have reflected an overall compliance landscape that included a fairly high audit rate (6 percent in the 1960s) and a fairly active criminal general enforcement program and as a result a reasonable level of comfort that noncompliance would be found out and that noncompliers would receive their just deserts. It also probably reflected a view that the negligence penalty should play primarily a symbolic normative role rather than the economic deterrent role that we have, at least in form, come to expect.

[129]Sections 6694 and 6695 were added by the Tax Reform Act of 1976, Pub. L. No. 94-455, section 1203 (b)(1), (f).

[130]However, the lack of targeting was a problem. *See Asphalt Products Co. v. Comm'r,* 482 U.S. 117 (1987).

Policymakers may have been comfortable with this situation in part because of the perceived absence of major compliance concerns such as the tax shelter problems of the late 1970s and later.

The legislative changes that began in 1976 and continued into the first half of the next decade reflected the very big compliance problem of syndicated tax shelters and other tax avoidance techniques, concerns that the IRS and the Tax Court could not effectively enforce the law,[131] and the belief that higher economic costs in the form of higher and new penalties would change taxpayer conduct. Over these 10 years, Congress subjected preparers to regulation by the IRS, increased negligence penalties in various ways, singled out certain specific conduct for penalty, and increased interest rates several times.[132] Congress introduced section 6661, the substantial understatement penalty, in 1982 to encourage disclosure of tax shelter issues.

The substantial understatement penalty reflected one very big idea — that aggressive but nonnegligent return positions should be disclosed. This idea grew out of two themes: (1) that the IRS should be put on notice of aggressive reporting positions because the absence of such notice, when combined with the relatively low frequency of audits, effectively resolved uncertain issues in the taxpayer's favor,[133] and (2) that the "reasonable basis" standard of the negligence penalty had been interpreted in too loose a way and was no longer a satisfactory way of stating the standard for return positions and professional advice, particularly in the context of syndicated tax shelter transactions.[134]

The deposit regime should be supported with a penalty for failure to comply to make clear a failure of timely deposit is not merely a commercial choice.

Thus, its supporters intended the substantial understatement penalty to render aggressive positions more readily identifiable and to elevate the reporting conduct of taxpayers above what had come to be seen as a too-low norm. While the mechanical operation and definitional rules of the substantial understatement penalty have generated a rich and soporific literature, not much disagreement is now heard on the general proposition that a disclosure penalty is a sound idea.

By the time of enactment of the Tax Reform Act of 1986, the tax shelter wars had continued for some time. A voluminous patchwork of sanctions had grown up and great complexity had been added to the code to address specific tax-reduction techniques. The IRS was proving its ability to identify shelters and successfully litigate them and had developed a substantial compliance program to do so, and many investors had discovered that investing in a syndicated tax shelter was no more profitable, and less fun, than an unsuccessful trip to Las Vegas. The addition of the restrictions on passive activity losses to the code in 1986[135] was the *coup de grace* for most tax shelters for individuals. These rules prohibited the use of passive losses by individuals in most situations and turned what had previously been the issues of judgment on which many tax shelter products were based into a simple criminal issue because use of passive losses

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[131]Tax shelter cases under examination grew from 195,000 in 1980 to 331,000 in 1984 and Tax Court inventories grew from 34,865 in 1980 to 63,598 in 1984. *See General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (Jt. Comm. Print), at 485 (Dec. 31, 1984).

[132]In 1976, Congress attempted to curb tax shelters through changes in the substantive law and identified a need for regulation of preparers, based on IRS data regarding the growth in, and lack of regulation of, the commercial return preparation business. *See* TRA 1976 sections 201-209; 1203. The substantive attack on tax shelters continued in the Revenue Act of 1978 sections 201-12 and subsequent acts. Changes in the penalty provisions did not begin until 1981, when ERTA increased the interest rate on deficiencies by 11 percent, increased interest rates an additional 50 percent for negligent understatements, added a valuation overstatement penalty, and increased penalties for false withholding allowance certificates, information returns, and overstated tax deposits. *See* ERTA, sections 721-24. In addition to the enactment of section 6661, TEFRA sections 323-30 (1982) added penalties for promoting abusive tax shelters and aiding and abetting the understatement of tax (sections 6700-01); increased the interest rate in fraud situations by 50 percent; and introduced a $500 penalty for filing a frivolous return (section 6702). DEFRA sections 141-44 added requirements that tax shelters be registered and that promoters keep a list of purchasers of them (sections 6111 and 6112), increased penalties for promotion of tax shelters (section 6700) and participation in tax motivated transactions (the increase in the section 6621 interest rate by 20 percent repealed by OBRA 1989), and specifically targeted certain tax avoidance conduct (e.g., fraudulent withholding information) for penalty (section 7205).

[133]J. Kurtz and Panel, "Discussion on 'Questionable Positions,'" 32 *Tax Lawyer* 13 (1978).

[134]*See, e.g.*, J. Mundheim, "Remarks Before the Securities Regulation Institute," *reprinted in* 15 *BNA Daily Tax Report*, J-1, J-2 (Jan. 22, 1980):

> Is the lawyer's role in advising a single client with respect to a transaction already consummated to be governed by the same standards as the lawyer's role in helping set up and promote a tax shelter to be offered to numerous investors? A substantial number of thoughtful tax practitioners take the view that it is unprofessional conduct for an attorney to give a "reasonable basis" opinion that he knows will be used to lead many people to assert tax positions that he believes are not sustainable. In its recently published Guidelines for Tax Practice, the Committee on Standards of Tax Practice of the ABA Section of Taxation warned that in the circumstances of promoting a tax shelter, the giving of an opinion "may be taken by the public as our endorsement of the program." Accordingly, the Guidelines take the view that tax attorneys should not assist in the offering of tax shelters which are without economic substance and without a substantial likelihood of legal validity.

[135]Section 469.

would have constituted tax evasion for most individuals.

Penalty reform in 1989 focused on whether the compliance detritus left from the pre-1986 period was still needed. It sought to dismantle portions of the code's Maginot Line against tax shelters and to restructure and coordinate the patchwork of penalties that had grown up encouraging taxpayers and preparers to accurately report tax liabilities and to disclose aggressive positions. Congress integrated the patchwork of negligence, valuation, and substantial understatement penalties, which overlapped and could have applied concurrently before 1989, and converted them to a single 20 percent penalty.[136] It restructured the preparer penalty to place more focus on the strength of the positions taken rather than the conduct of the preparer,[137] and it clarified through legislative history some nonstatutory interpretive issues, such as the definition of "authority" in the substantial understatement penalty, which the Treasury Department later addressed in regulations projects.[138] Congress also added a single reasonable cause exception to the code, applicable to all of these penalties.[139] And it repealed numerous penalties targeting specific acts with enhanced, special, or no-fault penalties.[140] The basic changes made in IMPACT were largely noncontroversial and seem generally to have been regarded as appropriate. The reduction in the number of situations in which multiple penalties could apply concurrently (referred to as "stacking" at the time), the targeting of the negligence penalty to the negligent portion of the understatement, the move to a single 20 percent rate, and the improved consistency of waiver criteria were all viewed as significant improvements.

Shortly after IMPACT, its simplifications began to erode. In 1991, the IRS promulgated regulations under sections 6662 and 6694 defining when either penalty could be applied. These regulations took the position that the minimum strength for a disclosed return position was that it not be "patently improper,"[141] a concept that was not otherwise defined. They broadened and clarified the definition of substantial authority, but they failed to seize the opportunity to coordinate this minimum standard for disclosure with the preparer standard of "realistic possibility of being sustained on its merits." Instead, they substituted a numerical standard of a 33 percent chance of success as the standard, with the existence of substantial authority treated only as one factor for consideration.[142]

The Taxpayer Relief Act of 1997[143] changed the minimum standard for a disclosed position in the section 6662 regulations from not "patently improper" to a "reasonable basis." But it made no similar change in section 6694. As a practical matter, the failure to define "reasonable basis" other than to say that it was "a relatively high standard" simply further confused the negligence standard under section 6662 and further distanced the taxpayer's expected behavior from that of the preparer. Thus, the preparer could continue to comply with the requirements of section 6694 by assuring that a disclosed position was not patently improper, while the taxpayer for whom the return was prepared could be subjected to penalty unless the position rose to a higher, though ill-defined standard of reasonable basis.[144]

The extent to which the courts have been willing to excuse taxpayer conduct based on professional advice raises some question as to whether the substantial authority penalty plays its originally envisioned role.

IMPACT continued to single tax shelters out for punitive treatment; under section 6662, only disclosure could protect against imposition of the penalty, and then only if the taxpayer "reasonably believed" that success was "more likely than not." Section 6662 defined a tax shelter as an arrangement having "the principal" purpose of tax avoidance or evasion.[145] These rules have been substantially tightened over the years, notably through the introduction of a strict liability standard for corporations in 1994,[146] and, in 1997, the broadening of the term "tax shelter" to include any arrangement having tax avoidance as "a significant" purpose.[147] The latter change potentially sweeps within the definition any transaction with significant tax aspects and arguably eliminates the opportunity for corporations to use disclosure to avoid penalties on any position having material tax impact. Arguably, the only defense in such a situation is to cast oneself on the mercy of the IRS by pleading the applicability of reasonable cause waiver criteria.

As these amendments suggest, a high level of concern exists within both the bar and the government regarding tailored "products" based on aggressive, technical interpretations of the law that many practitioners doubt would pass judicial scrutiny. For such products, which are marketed primarily to large and perhaps medium-sized corporations, there exist strong

[136]Section 6662.

[137]Section 6694(a).

[138]House Conf. Rep. No. 101-386, at 653 (Nov. 21, 1989).

[139]Section 6664(c).

[140]Sections 6621(c), 6653(f) and (g), and 6656(b) (1989).

[141]Treas. reg. sections 1.6662-3(b)(3) and 1.6694-2(c)(2) (Dec. 31, 1991).

[142]Treas. reg. section 1.6694-2(b)(1).

[143]Taxpayer Relief Act of 1997, Pub. L. 105-34, 111 Stat. 788 (1997).

[144]Regulations make clear that a reasonable basis is "significantly higher than . . . not patently improper" but give little additional definition to the standard. Treas. reg. section 1.6662-3(b)(3) (Nov. 17, 1998).

[145]*See* section 6661(b)(2)(C), as added by TEFRA section 323 (1982).

[146]Uruguay Rounds Agreement Act, Pub. L. No. 103-465, section 744(b)(1), 108 Stat. 4809 (1994).

[147]TRA of 1997, section 1028(c)(2).

doubts regarding the efficacy of the current penalty regime and confusion and debate about what, if any, modifications in the penalty structure are desirable.[148]

Finally, in 1990 and 1993, Congress added a special category of penalty for transfer pricing adjustments.[149] This penalty functions as a no-fault penalty that can be avoided only through compliance with detailed rules governing contemporaneous documentation for the questioned pricing and the timing of its production on audit.

In the 11 years since IMPACT, a fairly large number of cases dealing with section 6662 have been handed down. Most deal with the application of section 6662 only cursorily, but a few do develop the law in interesting ways. Of particular note are the success some taxpayers have had obtaining reasonable cause waivers through reliance on the advice of advisors.[150] The extent to which the courts have been willing to excuse taxpayer conduct based on professional advice raises some question as to whether the substantial authority penalty plays its originally envisioned role in the conduct of a well-advised taxpayer. The courts are also in the early stages of sorting out how to define "substantial authority" to take factual disputes into account.[151]

So far as can be determined from computerized research techniques, there have been fewer than 10 cases litigated under the preparer penalty of section 6694 since 1989, and none of those has involved the section in its post-IMPACT form. The statistics for section 6695 are even less impressive — only four cases have been reported since 1989. Thus, insofar as is evident, while the existence and proposal of these penalties may or may not be important, the actual application of them plays no serious role in tax administration.

[148]*See generally* Sheppard, "What Should We Do About Corporate Tax Shelters?" *Tax Notes*, Dec. 14, 1998, p. 1431; Ezrati, Comments of TEI on the Definition of a Corporate Tax Shelter Under Sections 6662 and 6111, *Doc 98-34304 (13 pages), 98 TNT 229-65*; "N.Y. Banks Concerned About Administration's Tax Shelter Proposals," *Doc 1999-11981 (4 original pages), 1999 TNT 63-11*; Statement of Stefan F. Tucker on behalf of the Section of Taxation American Bar Association before the Committee on Finance, *Doc 1999-15321 (13 original pages), 1999 TNT 81-28*; James P. Holden, Buyer Beware of Aggressive Corporate Tax Shelters, *Doc 1999-4482 (7 original pages), 1999 TNT 20-137*; "NYSBA Tax Section Applauds Some Anti-Corporate Tax Shelter Proposals, Rejects Others," *Doc 1999-15300 (83 original pages), 1999 TNT 82-29;* Johnson, "Corporate Tax Shelters, 1997 and 1998," *Tax Notes*, Sept. 28, 1998, p. 1603; Kies, "A Critical Look at the Administration's 'Corporate Tax Shelter' Proposals," *Tax Notes*, June 7, 1999, p. 1463.

[149]Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508 section 11312(a), adding new section 6621(c), 104 Stat. 1388 (1990); OBRA 1993, Pub. L. No. 103-66, section 13236(a), 107 Stat. 312 (1993).

[150]*E.g., Streber v. Comm'r,* 138 F.3d 216, *Doc 98-12699 (15 pages)* (5th Cir. 1998).

[151]For a general review of the status of this issue, see Raby and Raby, "Facts Can Control in 'Substantial Authority' Cases," *Tax Notes*, Sept. 21, 1998, p. 1465.

B. What the Statistics Tell Us

The *sturm und drang* of recent discussions on strengthening accuracy penalties against tax shelters suggests that existing accuracy-related penalties have been tried by the IRS and found wanting; thus a harsher regime is required. Little statistical information exists, but such statistics as do exist cast serious doubt on this view. Rather, they suggest that the IRS pursues the imposition of existing accuracy-related penalties only sporadically and that when the penalties are contested, it mostly gives up despite fairly consistent support from the courts.

> ***Statistics suggest that the IRS pursues the imposition of existing accuracy-related penalties only sporadically and that when the penalties are contested, it mostly gives up.***

The IRS does not publish information regarding the proposal of accuracy penalties. We cannot, therefore, determine the frequency with which revenue agents assert that a taxpayer should pay an accuracy-related penalty. Nor can we determine the frequency with which the IRS Appeals Office concedes them. The IRS does publish information regarding the assessment and abatement of these penalties, but these statistics reflect only what happens at and after the statutory notice of deficiency is issued. Even these statistics are rudimentary because the IRS does not stratify section 6662 assessments and abatements by the specific statutory subsection asserted. Thus, it is not possible to determine how many assessments are made for negligence rather than a failure to comply with the substantial understatement or tax shelter prongs of section 6662. The IRS does divide accuracy-related penalties between individual and corporate taxpayers, however.

The picture that emerges is one of a penalty administration process having severe problems. Let us look first at the statistics for impositions of accuracy-related penalties on the income tax returns of individuals. See Table 1.

Over the years 1995 through 1998, the four years reported at the IRS's Web site, the annual number of accuracy-related penalties assessed has declined by approximately 88 percent, while abatements have exceeded assessments by a four-to-one ratio, presumably because the IRS is abating accuracy penalties assessed in prior years. Because negligence penalties are assessed only after completion of the examination and appeals processes, when large numbers of proposed negligence and substantial understatement penalties are dropped, these figures greatly understate the number of cases in which the IRS has asserted and then conceded a penalty.

These statistics clearly deserve greater investigation and explanation, but the basic picture that emerges is

Table 1
Assessments and Abatements of Accuracy Penalties
On Individual Income Tax Returns
(Dollar Amounts in Thousands)[152]

	Assessed		Reasonable Cause		Other Abatements		Net Assessments	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount
1995	12,730	102,592	1,290	1,840	44,655	85,644	-33,215	15,108
1996	8,210	104,104	958	1,876	28,467	52,365	-21,215	49,863
1997	3,676	104,798	779	2,178	19,225	46,789	-16,328	55,831
1998	1,465	38,818	892	1,548	13,264	27,265	-11,799	11,553
Total	26,081	350,312	3,919	7,442	105,611	212,063	-82,557	132,355

one of virtually inevitable administrative reversal of proposed accuracy-related penalties. One might reasonably ask whether the 1,465 accuracy penalties assessed against individuals during 1998 — a bit more than one for every 1,000 individual returns that the IRS says it looked at and a bit more than one for every 100,000 income tax returns filed — constitutes a healthy picture, particularly when abatements were nearly 10 times these numbers.[153]

The IRS assesses and abates accuracy penalties against corporations in a similarly sparse but less strange pattern. As Table 2 shows, the IRS assessed 1,387 accuracy penalties in corporate examinations during the years 1995 through 1998, with the annual number assessed declining by about 80 percent over that period. About 15 percent of these penalties were abated.

Table 2
Assessments and Abatements of Accuracy Penalties
On Corporate Income Tax Returns
(Dollar Amounts in Thousands)[154]

	Assessed		Reasonable Cause		Other Abatements		Net Assessments	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount
1995	629	227,598	0	0	73	1,308	556	226,290
1996	367	123,758	1	5	40	507	326	123,247
1997	265	64,727	2	11	46	11,458	217	53,259
1998	126	46,559	5	141	21	27,784	100	18,634
Total	1,387	462,642	8	157	180	41,057	1,199	421,430

Thus, for example, in 1998, 100 net assessments of accuracy penalties occurred, or about one for every 550 corporate income tax returns that the IRS says it looked at and a bit less than 1 for every 25,000 corporate returns filed.[155] We do not know how many accuracy-related penalties the IRS proposed against corporations, but any practitioner would, I think, believe that it is many multiples of the total of 100 net penalties ultimately assessed.

The IRS's reluctance to assess accuracy-related penalties does not reflect judicial hostility. A cursory review of cases decided under section 6662 shows that the Tax Court commonly sustains these penalties in individual cases. Nor do the courts have much reluctance to impose such penalties on corporations. Recent opinions such as *UPS*, *Compaq*, and *CM Holdings* show that the existing substantial understatement and negligence prongs of section 6662 will be applied when the courts find them warranted[156] and that the courts are willing to find penalties warranted when aggressive tax planning fails to pass judicial muster.

Why, then, does the IRS decline to pursue accuracy-related penalties in all but a few situations? This is not

[152]In 1998, the number of civil penalties assessed, decreased for reasonable cause and other abatements, does not net to the (11,799) figure shown; however, these are the statistics provided in Table 28, Civil Penalties Assessed and Abated, Table 98db28cp, at www.irs.gov.

[153]Statistics for returns filed and returns audited are taken from IRS Data Book, *supra* note 2, Table 98db15ex.

[154]*Id.*, Table 98db28cp.

[155]*Id.*, Table 98db15ex.

[156]*See In re CM Holdings, Inc.*, Civ. No. 97-695 MMS *Doc 2000-26945 (15 original pages), 2000 TNT 203-5* (D. Del. Oct. 16, 2000) (Slip opinion); *Compaq Computer Corp. v. Comm'r,* 113 T.C. 363 (No. 25), *Doc 1999-36977 (22 original pages), 1999 TNT 223-8* (Nov. 18, 1999); *United Parcel Service v. Comm'r,* T.C. Memo. 1999-268, *Doc 1999-26528 (114 original pages), 1999 TNT 153-11* (Aug. 9, 1999).

an idle question, when both the Treasury Department and the Joint Committee Staff are suggesting substantial tightening of the accuracy-related penalty regime for so-called corporate tax shelters, presumably on the theory that the existing regime does not give the IRS the practical power to take the firm actions that are warranted. Perhaps the IRS views persistence in the assertion of penalties as an impediment to settling audits or values resolution of cases in Appeals more highly than successful litigation of penalties. If so, the introduction of a new penalty regime, adding new legal standards that would presumably need to be articulated judicially, seems unlikely to alter administrative experience much.

Alternatively, the IRS's examiners may have standards for supporting and documenting accuracy-related penalties that surpass those required in court. Or, perhaps very few taxpayers really meet the criteria for imposition of accuracy-related penalties. Or perhaps the IRS's examination function is not able, in the first instance, to determine which cases merit accuracy-related penalties and which do not. Whichever, or however many, of these circumstances apply, and whether or not one thinks more accuracy-related penalties should be assessed and collected, fundamental problems exist in their administration.

The IRS's reluctance to assess accuracy-related penalties does not reflect judicial hostility to the penalties on the books.

The above numbers are particularly striking because the basic criteria for assertion of accuracy-related penalties are relatively straightforward. Whether an audited taxpayer was negligent requires only a straightforward, common-sense assessment of the care with which the taxpayer undertook its filing obligations. Whether a substantial understatement penalty is due requires an assessment only a bit more complex. The tools are there. The rules for using them are clear. The low net numbers of penalties assessed and the IRS's success in recent major cases indicate that the IRS could seriously attempt imposition much more frequently than it does. But whether the IRS's choice not to rely on penalties is a smart one rather than an institutionally neurotic avoidance of conflict with taxpayers is not clear. The evidence either way has simply not been developed. We simply do not know what is going on. Thus, comments and suggestions on accuracy-related penalties, including much that has been written about the issue *du jour*, corporate tax shelter penalties, tend to be based on assumption and supposition.

C. Thoughts on These Penalties

The IRS will not have a credible program for penalizing taxpayers in appropriate situations for erroneous return positions until it begins to provide meaningful information about when it chooses to assert, compromise, assess, and abate these penalties. Such information would provide the foundation for important decisions regarding the training of its personnel and amendment of existing statutes and regulations. The absence of such information was noted in 1989 in the study leading to IMPACT,[157] but it appears that essentially no progress has been made in developing meaningful additional information over the last 11 years. At best, this dearth of information evidences missed opportunities to improve tax administration. At worst, it permits the bollixing of statutes and regulations, as the collective tax policy imagination creates technical solutions to issues that are fundamentally administrative in nature. The IRS should analyze its actual experience with these penalties; it should determine whether appropriate decisions are being made, whether the penalties asserted are having an appropriate compliance impact, and whether technical barriers to appropriate treatment of noncompliant taxpayers — such as an excessive rate or an inability to prevail with overly aggressive taxpayers — exist.

Despite the need for better information, the philosophical observations that have been stated elsewhere in this article do provide a framework for observations on how the existing statutory and regulatory regime might be simplified and improved. The following comments constitute observations that the author believes could be usefully pursued even in the absence of needed information regarding actual IRS experience. They are tentative, in the sense that better information, if it were available, would lead to a close and critical examination, and perhaps alteration, of them.

1. The reasonable cause defense. As enacted by IMPACT, section 6664(c) provides that no accuracy-related penalty shall be imposed if it is shown that there was reasonable cause for the underpayment and that the taxpayer acted in good faith. In principle, such a waiver provision seems consistent with the underpinnings of penalties discussed above. It seeks to treat similarly situated taxpayers — those with a good reason for their behavior to be excused — in a similar way, and thus advances the principle of fairness. It also assists in sound administration of the penalty by providing a legal basis for the hearing of taxpayers' reasons that their conduct should be excused and for leniency by the IRS in deserving situations. Unfortunately, the pursuit of other policies through the definition of reasonable cause, the prohibition of its application in certain situations, and a misunderstanding of its proper scope substantially undermine the utility of the reasonable cause waiver as it is currently implemented.

The regulations define reasonable cause and good faith to include "an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer" and state that consideration of whether the taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts

[157] Commissioner's Penalty Study, at X-32 (1989).

and circumstances.[158] The regulations go on to note as circumstances supporting waiver an honest misunderstanding of fact or law that is reasonable under the circumstances and note that, while reliance on the advice of a professional tax adviser or appraiser does not necessarily demonstrate reasonable cause and good faith, such reliance may do so if adequate factual disclosures were made to the adviser and the adviser is knowledgeable and takes relevant facts, such as the taxpayer's purpose, into account.[159] A somewhat more stringent rule applies in the case of tax shelters, but the regulations clearly contemplate that a waiver can be made even in the case of a corporate tax shelter if the corporation "reasonably relies in good faith on the opinion of a professional tax advisor." For the corporation to meet this standard, the opinion must analyze the facts and authorities, concluding that there is a greater than 50 percent likelihood that the tax treatment will be upheld if challenged.[160]

> ***The IRS will not have a credible program for penalizing erroneous return positions until it begins to provide meaningful information about when it chooses to assert, compromise, assess, and abate these penalties.***

When the IRS asserts the negligence prong of the accuracy-related penalty, the central question is whether the taxpayer has acted with due care. The code and regulations define "negligence" as a failure to make "a reasonable attempt" to comply with the law or "to exercise ordinary and reasonable care" in preparing a return. Similarly, "disregard of rules or regulations" is defined to mean "careless, reckless or intentional disregard" of such authorities. In either case, the fundamental question addressed is that of the taxpayer's prudence,[161] and it seems quite clear that the taxpayer should be able to advance adequate consultation with a tax professional as a defense to the penalty. While an adviser may interpret the taxpayer's facts and law in a fashion most favorable to the taxpayer, an adviser who advises the taxpayer to take a position that would otherwise constitute negligence may have violated Circular 230, professional standards of responsibility, and the standards of section 6694.[162] Further, and perhaps more importantly, a preparer who fails to meet minimum professional standards may have some malpractice liability to his client. Thus, while the symmetry of the negligence and disregard prongs of the accuracy-related penalty and the strictures of professional standards is not perfect, the various rules seem close enough to one another — and the preparer's potential liability for malpractice significant enough — to assure that the preparer's advice is likely to discourage overly aggressive conduct by the taxpayer.

The behavioral norm that the substantial understatement prong of the accuracy-related penalty seeks to establish is one that requires disclosure of positions not supported by substantial authority.[163] The penalty selects only understatements over a certain threshold amount (the greater of 10 percent of tax or $5,000[164]) and asks a more objective question: whether the items giving rise to the adjustment were either disclosed or supported by "substantial authority." In concept, if the taxpayer is not sure whether an item is supported by substantial authority, the intent of the provision is to require the taxpayer to make a conscious choice either to disclose the item or to risk imposition of the penalty.

In advising a taxpayer with a somewhat risky position supported by some authority, it is often difficult to state with certainty whether a court would find that substantial authority exists. In such a case, the potential availability of a reasonable cause waiver (as currently conceived under section 6664) can function in a way that is inconsistent with the objectives of the penalty. If the adviser is prepared to provide an opinion that substantial authority exists, the taxpayer may be able to avoid the statute's intended choice, neither disclosing the position nor incurring the penalty, because the opinion provides the basis for a waiver. Further, the adviser does not have the constraints that would arise in the context of the negligence penalty, since, presumably, the preparer would have some support for the view that substantial authority did exist and the underlying position would neither lack a reasonable basis nor be patently improper. Accordingly, while the substantive rule of the penalty seeks to put the taxpayer to an election (disclosure or risk of penalty), the ability to rely on professional advice for a waiver eliminates much of the objectivity in the issue raised by substituting a question similar to that addressed by the negligence penalty (did the taxpayer act reasonably in the circumstances). If application of the substantial understatement penalty depended simply on the objective question, to be answered in court, as to whether substantial authority existed, opinions on the subject would likely be more impartial and careful, and the taxpayer would be more likely to disclose positions for which the existence of substantial authority was unclear.

While the idea that there should be a single uniform set of criteria for waiving an accuracy-related penalty

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[158]Reg. section 1.6664-4(b)(1).

[159]Reg. section 1.6664-4(b), (c).

[160]Reg. section 1.6664-4(e)(2).

[161]Section 6662(b)(1) imposes the penalty on "[n]egligence or disregard of rules or regulations." Section 6662(c) defines "negligence" to include "any failure to make a reasonable attempt to comply" with the code and "disregard" to include any "careless, reckless, or intentional" disregard. *See also* reg. section 1.6662-3(b).

[162]*E.g.*, Circular 230, sections 10.22 and 10.34; ABA Opinion 85-352.

[163]In the case of a noncorporate tax shelter, the standard would be "more likely than not."

[164]Section 6662(d)(1)(A). Increased to $10,000 in the case of certain corporations. Section 6662(d)(1)(B).

seems, from today's vantage point, a simplistic and utopian perspective given the existing structure of section 6662, the availability of such a waiver keyed to the particular criteria of each prong of the accuracy-related penalty seems nevertheless a sound concept. A particular case in point is the rule governing contemporaneous documentation of transfer prices, which imposes a penalty for underpayments attributable to transfer-pricing adjustments unless contemporaneous documentation of such prices exists and is produced within 30 days of a request. The statute eliminates the possibility of waiver for reasonable cause,[165] perhaps because the uniform criteria of section 6664 would have undercut the specific documentation rules. However, it is not hard to imagine circumstances, such as slightly missing the deadline for production, in which the inability to waive a penalty would most likely be viewed as unfair, given its huge size and the inconsequentiality of the conduct resulting in imposition. More generally, in the case of the substantial understatement penalty, while a waiver should probably not be available based on an opinion intended to protect a taxpayer's intentional nondisclosure from uncertainty as to whether substantial authority exists, there may be other circumstances in which waiver would be appropriate. For example, the regulations note that an isolated computational or transcriptional error may be subject to waiver. Further, where a potential issue is completely overlooked for understandable reasons, it may be appropriate to consider a waiver of the substantial understatement penalty.

When a penalty applies in a broad range of situations, is high in amount, and operates without a showing of fault, a particular need exists for a safety valve that the IRS and the courts can apply to avoid excessively harsh operation. In the context of strict liability penalties, the absence of waiver authority effectively restricts a taxpayer's opportunity to be heard, and the absence of a forum in which an excuse could be heard and accepted if warranted creates conditions for claims of over-reaching and ill treatment. Existing debates regarding the definition of "corporate tax shelter" for penalty purposes establish the exceeding difficulty of defining such a term. As the definition is broadened, and the penalty is increased, the risk heightens that some positions would receive an unwaivable penalty, even though most would view the situation with some leniency. It would take only a few ill-conceived penalties to produce a huge amount of pressure to repeal such a provision. To leave the IRS and the courts without the tools to avoid such situations is a mistake.

Nor should Congress, the IRS, or the Treasury Department be concerned that a sound and soundly administered reasonable cause waiver provision could gut an underlying statute. Any waiver should be defined by reference to the implementation of the underlying objectives of the statute, and a careful articulation of a waiver provision within such a context should actually assist in sound administration. The IRS may not be able to get it right in every case, but it is 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. Thus, rather than making a waiver for reasonable cause and good faith completely unavailable for any particular prong of the accuracy-related penalty, and thus risking unwaivable imposition of the penalty in circumstances in which it may be viewed as unduly harsh, a sounder approach would be to provide a definition of reasonable cause for each prong of the penalty, with each reflecting the particular structure and function of the particular provision.

It is 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.

2. The penalty rates. The rates at which the accuracy-related penalty is applied also raise the fairness issue of how harshly particular conduct should be penalized. When the substantial understatement penalty was first enacted, the rate was a targeted 10 percent of the understatement. This was raised briefly to 25 percent before settling at the 20 percent rate we see today. The increase in rates came in 1986, fairly shortly after the introduction of the penalty in 1982, and seems to have been part of the response to continuing problems with syndicated tax shelters sold principally to individuals. While the 20 percent rate was preserved in 1989 and extended to the negligence penalty, no quantitative evidence provided support for maintaining the penalty at this rate rather than any other. It is worth noting that this rate is four times the rate of the negligence penalty in the original 1954 code and applies to conduct that would have passed muster under a negligence standard.

While no particular empirical basis exists for setting the rate either lower or higher or leaving it the same, the tendency over the last two decades toward heavier penalties may be one reason for the particularly harsh views expressed about IRS administration of the law over the last few years. While one may argue that the higher 20 percent penalty has some *in terrorem* deterrent effect that would not be present at a lower rate, one may also argue that the higher rate helps make application of the penalty less consistent, as revenue agents and the courts import concerns about the size of the penalties into their decisions about whether taxpayer conduct failed to meet the standards set forth in section 6662.

The infrequency with which the IRS asserts that taxpayers should be penalized for negligence or a failure to disclose suggests a reluctance to impose a 20 percent penalty in situations in which many taxpayers have presumably engaged in culpable conduct. One reasonable conclusion is that the very size of these penalties leads to infrequent and inconsistent assertion of them, as IRS employees themselves neutralize what

[165]Section 6662(e)(3)(D).

they see as penalties that are disproportionate to the conduct that should, theoretically, receive a penalty.

A substantial decrease in the size of accuracy-related penalties might actually lead to more consistent application of them, as a modestly sized sanction more akin to a toll charge for underpayment could be more broadly applied and might be more easily accepted — both by taxpayers and IRS employees — as proportionate to culpability. A very substantial reduction in amount might conceivably also reduce the need for administrative waivers except in compassionate situations, and broader application might provide better horizontal equity among those who have underpaid their liability.

3. Factual misunderstandings as a defense to the accuracy-related penalty. When a taxpayer has lost a substantive tax issue, an underpayment of tax has been established, and a penalty under section 6662 has been asserted, the taxpayer has a reasonably small number of defenses to the penalty. The two major defenses originally envisioned were disclosure and the existence of substantial authority, the idea being that, with respect to an identified questionable position, the potential applicability of the penalty would have adequately encouraged the taxpayer either to disclose the position or to determine in an objective way that a reasonably strong basis — substantial authority — existed for the position.

If the taxpayer has a factually oriented issue and has misinterpreted those facts, it was originally thought that the penalty must apply because, based on a correct understanding of the facts, no authority would support the taxpayer's position. This view placed these taxpayers in a position of strict liability for the penalty, even though the proper interpretation of facts is often no clearer than the proper interpretation of the law. A few cases have now begun the development of more forgiving principles regarding a taxpayer's erroneous interpretations of facts.

For example, in *Estate of Kluener v. Comm'r*,[166] the taxpayer took the position that he was operating a horse farm for profit. While this was one reasonable interpretation of the facts, the trial court held for the IRS and imposed the substantial understatement penalty on the basis that, since the taxpayer was not engaged in the venture for profit, those cases permitting the utilization of losses from horse farms that were profit seeking were not substantial authority for the taxpayer's position. The appeals court affirmed on the substantive issue, but reversed on the penalty, holding that the facts of the case themselves could be "authority" for the taxpayer's position. It then found that the weight of facts favoring the taxpayer's view was "substantial."

Other cases have also grappled with this issue, and several have supported some version of the Sixth Circuit's view, although it is too early to conclude what outcome is likely. The Tax Court appears to hold to the view that the facts of the case itself cannot constitute "authority," while the appeals courts are divided both on this question, and, among those who think that facts can constitute "authority," on what constitutes substantiality.[167] One might argue that such questions are more appropriately considered under the reasonable cause waiver provisions of section 6664(c) and that some tendency exists to place the bar too low.[168]

At present, the direction in which the law will develop regarding the taxpayer's factual position is not clear. In principle, an objective standard for treating taxpayer-favorable facts as substantial authority has some merit and would provide a more evenhanded way of equating the consequences of mistakes in factual and legal interpetation. On the other hand, if the taxpayer in the end has too much leeway to "misunderstand" his facts, the impact of the developing rule could undercut the concept of the objective "election" to which the substantial understatement penalty puts the taxpayer. In sum, whether the law in *Kluener* and similar cases fills a needed place in our understanding of section 6662 appropriately developed in the case law or undercuts the election of disclosure or sanction contemplated is not clear. It may make sense for now, however, to defer legislating in this area and allow the law to develop further.

4. Number of reporting standards. Another serious problem in this area is the number of different reporting standards. At present, sections 6662, 6664, and 6694, Circular 230, and professional responsibility rules for lawyers, accountants, and others provide a plethora of standards that return positions, with and without disclosure, should meet. While one cannot completely reconcile these through revisions to penalty provisions, such revisions would nevertheless be a good start. At present, one can identify at least the following standards for return positions in these penalty provisions: (1) reasonable cause (section 6664(c)), (2) nonfrivolous (not patently improper) (section 6694(a)(3)), (3) negligence or disregard of rules and regulations (section 6662(b)(1)), (4) reasonable basis (section 6662(d)(2)(B)(ii)(II)), (5) substantial authority (section 6662(d)(2)(B)(i)), (6) realistic possibility of being sustained on its merits (section 6694(a)(1)), (7) more likely than not (section 6662(d)(2)(C)), and (8) strict liability (6662(d)(2)(C)(ii)). One might quibble with the inclusion of "reasonable cause" as a reporting standard, since it is meant to function as a pressure valve in situations in which a penalty seems undeserved; however, the use of legal opinions in corpo-

[166]82 AFTR2d par. 98-5273, *Doc 98-27692 (11 pages), 98 TNT 176-9* (6th Cir. 1998)

[167]*Estate of Kluener v. Commissioner*, 72 T.C.M. 1326, *Doc 96-30888 (25 pages), 96 TNT 230-8* (1996); *Antonides v. Comm'r*, 89 F.2d 656 (4th Cir. 1990) (inability to prove profit motive prevented application of reasonable cause waiver). *But see Osteen v. Comm'r*, 62 F.3d 356, *Doc 95-8128 (9 pages), 95 TNT 168-46* (11th Cir. 1995) (if case could be affirmed in favor of the taxpayer under the "clearly erroneous" standard, then factual substantial authority exists); *see also Streber v. Comm'r*, 81 AFTR2d para. 98-610, *Doc 98-12699 (15 pages), 98 TNT 74-11* (5th Cir. 1998); *Norgaard v. Comm'r*, 939 F.2d 874 (9th Cir. 1991). For discussions, see Raby and Raby, note 151 *supra*.

[168]*See Osteen* and *Streber*, note 167 *supra*.

rate tax shelters suggests that taxpayers are using it affirmatively, attempting to "plan into" a reasonable cause defense.

> ***We do not need all of these different standards, and to the extent that some of the standards are indistinguishable from one another as a practical matter, we do not need the different formulations of them.***

Let us answer, rather than ask, the obvious question: We do not need all of these different standards, and to the extent that some of the standards are indistinguishable from one another as a practical matter, we do not need the different formulations of them. Laying aside for the moment certain activities singled out for harsh treatment, which will be addressed separately below, we need, at most, three, and perhaps only two standards. They are, in ascending bar height, as follows:

(1) A standard for the filing of a refund return that permits a taxpayer to assert any claim that would meet the minimum standard for a complaint in federal court. This would accord most closely with the nonfrivolous or not patently improper standard found in section 6694, though it might be better said by reference to the standards for bringing suit, which are found in Rule 11 of the Federal Rules of Civil Procedure.[169]

(2) A standard for a disclosed position on a tax return. At present, for taxpayers this is the reasonable basis standard in section 6662 and for preparers this is the nonfrivolous standard in section 6694. These standards are, at present, clearly intended to be different, with the result that a taxpayer can, at least theoretically, run afoul of the section 6662 standard, while the preparer does not run afoul of the section 6694 standard. The standards, which serve a single purpose in the context of an original return, should be conformed. There are many different formulations that might be used, including the nonfrivolous, complaint-filing standard described above; the "realistic possibility of success" language in ABA Opinion 85-352 or in section 6694; and the reasonable basis standard found in section 6662. The particular formulation is, in the judgment of the author, not all that important because, in the end, the standard should be defined in case law, with reference to a negligence concept, so that it will not vary greatly from taxpayers' perceptions of what the standard "should" be and thus will be perceived as fair. A formulation keyed in some fashion to the complaint-filing standard is the author's preference, since this provides the maximum simplicity and since the requirement of disclosure makes the precise calibration of the standard (which seems, in any event, illusory) less important. However, if this is not possible, there should nevertheless be a single standard applicable to original returns and to both taxpayers and preparers, and the standard should be formulated using negligence concepts that will resonate with traditional concepts of responsibility. This would support the norm-setting function of the penalties and assist in the further articulation of the standard through litigation. The temptation to attempt detailed definition of the standard through legislation or regulation should be resisted. This standard is inherently a facts-and-circumstances test, relying for its force on the knowledge that an agent or court will test the conduct of the taxpayer or preparer against a common-sense yardstick. Over-definition simply exhausts the normative value of the rule while moving filing behavior only infinitesimally at most.

(3) A standard for undisclosed return positions. At present, undisclosed return positions are generally not subject to penalty under section 6662 if supported by substantial authority and are not subject to penalty under section 6694 if supported by a realistic possibility of being sustained on the merits. With the expansion in the regulations under section 6662 of the materials that count as authority, little reason exists to continue to be concerned that the substantial authority standard is not viable for purposes of section 6694. It may make sense to expand slightly the types of materials that can be relied on as authorities to include authoritative secondary sources, but aside from this change the existing section 6662 standard should work quite well for purposes of section 6694 as well.

5. Valuation and transfer-pricing penalties. The current language of section 6662 singles out several categories of understatement for harsher treatment, including valuation misstatements for income and estate tax purposes, overstatements of pension liabilities, and transfer-pricing adjustments. The penalties for valuation misstatements and overstatement of pension liabilities apply if the correct position is missed by 100 percent, and the penalty for transfer-pricing misstatements applies if the correct position is missed by the lesser of $5 million or 10 percent of gross receipts. If the error is significantly larger, the penalty is doubled from 20 to 40 percent. Oddly, in the case of the first two penalties, neither disclosure nor documentation excuses the penalty but the reasonable cause provision of section 6664(c) can apply, while, for transfer-pricing problems, detailed documentation and disclosure protects from the penalty, but the reasonable cause provision does not apply. One can perhaps spin out a rationale for these differences, arguing that each penalty is nicely calibrated to the circumstances because the 100 percent error threshold for the general valuation penalties presents enough leeway for it to function in a more no-fault way, without regard to disclosure, while the lower threshold for and complexity of transfer-pricing issues requires a sturdier but more mechanical escape valve. In the author's view, however, little

[169]FRCP 11 reads in part as follows: "The signature of an attorney or party constitutes a certificate by the signer that . . . to the best of the signer's knowledge, information, and belief formed after reasonable inquiry it [the paper signed] is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law, and that it is not interposed for any improper purpose, such as . . . to cause unnecessary delay or needless increase in the cost of litigation. . . ."

would be lost and much gained by rethinking some of the unique aspects of these penalties.

Little reason exists not to encourage the disclosure of valuation issues, since this would encourage taxpayers to better think through the supportability of their positions and document them and provide the IRS at least some basis for selecting valuation issues for audit. Providing a formal disclosure option for general valuation issues would also better coordinate the treatment of valuation problems with other reporting issues, treating the legal issues inherent in many valuation problems in a fashion similar to questions of substantial authority. Moving as close as possible to a single penalty regime simplifies reporting expectations and enhances their normative nature.

Little reason exists not to encourage the disclosure of valuation issues, since this would encourage taxpayers to better think through the supportability of their positions and document them.

Further, there seems little reason to eliminate any reasonable cause defense for transfer-pricing errors. Doubtless, the contemporaneous documentation requirement has increased the care with which cross-border prices have been set over the last several years, but it seems odd that, while the IRS has the discretion to take into account all the facts and circumstances of a taxpayer's position in determining the appropriateness of a substantial understatement penalty in all other situations, it is prevented from doing so in the one category of issues constituting the mother of all facts-and-circumstances situations. This congressional distrust of the IRS's capability to administer the penalty in a strict but fair way is most troubling; it should not be difficult to establish an approach including both an effective contemporaneous documentation requirement and the flexibility to take into account appropriately taxpayer efforts to comply with these rules even when the taxpayer is not totally successful. As discussed above, such an extension of the potential for a reasonable cause waiver should not include as an independent basis for waiver reliance on professional advice; any such advice is presumably already taken into account in the required contemporaneous documentation.

Finally, the 40 percent valuation penalty for gross misvaluations appears grounded historically in the graduated misvaluation penalties first enacted in 1981 when syndicated tax shelters were a significant problem. Many shelters were based on grossly inflated valuations of property, such as master recordings, books, and computer equipment for which little or no real factual support existed, and the 40 percent penalty was intended to make participation in such an "investment" hurt. Today, these shelter concerns have largely waned. Valuation issues can involve major uncertainties, and real differences of opinion can exist that can lead to widely disparate views of reality. For truly insupportable valuations, the civil fraud penalty exists. For others, the 40 percent penalty seems a vestige of a particularly troubling time and could be reduced.

The 40 percent rate is particularly troubling in the case of transfer-pricing adjustments because the threshold for application of the 40 percent rate (a $20 million adjustment)[170] is one that any large corporation with cross-border transactions can easily pass without in any way functioning in an aggressive way and because, as described above, no reasonable cause waiver is available.

Few valuation misstatement penalties have been imposed in litigated cases, and it is not clear why this one particular category of issue, particularly such a factual issue, should continue to be singled out for such harsh treatment.

6. Threshold for substantial understatement. A substantial understatement exists only if the understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 in the case of corporations other than S corporations and personal holding companies).[171] It might be worthwhile to reexamine these thresholds. Clearly, the original intent of the penalty was to encourage the disclosure of only larger issues. Perhaps the $5,000 threshold should be increased to reflect the inflation that has occurred over the nearly 20 years since enactment. Similarly, if the substantial understatement prong of the penalty continues to play a role in dealing with tax shelters of extraordinarily wealthy or large taxpayers, perhaps the 10 percent threshold should be reexamined. It might make sense to adjust the percentage downward or substitute for it the lesser of a percentage and a dollar amount (e.g., the lesser of 10 percent or $50 million).

D. A Word About Corporate Tax Shelter Penalties

1. In general. As noted above, taxpayers' compliance is based in large part on the perception that compliance with the law occurs and is enforced in a broadbased and evenhanded way. Broadly shared perceptions of fairness are the most precious of attitudes in encouraging voluntary compliance and must be preserved with effective compliance programs, sound substantive responses to avoidance techniques, and, if necessary, changes in sanctions. When reports of broadly sold and questionable tax avoidance schemes begin to be reported in the national press, major professional firms are acknowledging that they are actively marketing such schemes, and major professional associations agree on the seriousness and scope of the problem, one must become concerned about the ability to preserve and create positive attitudes regarding the fairness of our tax system and potential responses must be identified and evaluated.

Monetary sanctions deserve at best third place in a list of possible responses. The lessons of the 1970s and 1980s tell us that an unambiguous and unassailable

[170]Section 6662(h).

[171]Section 6662(d)(1).

substantive technical response to creative and overly aggressive tax planning is the most effective way to deal with it because it eliminates the substrate of real or imagined substantive ambiguity within which such planning prospers. If a technical response can be accomplished simply, as was done with the passive activity loss rules in 1986, this is desirable. But more complex and targeted responses may be necessary.

More effective compliance programs are the second line of response. The IRS's proven ability to find and contest a large number, and perhaps a high percentage, of questionable shelters in the 1970s and 1980s was a far more important contributor to compliance in the early 1980s than were the enhancements to the system of civil sanctions in the law. While these two components are outside the scope of this article, they constitute, in the author's view, the brushing and dental floss for the tax shelter problem. Penalties are simply the mouthwash — a valuable contribution to our country's tax hygiene, but of value only in the context of a broader program.

2. Existing tax shelter penalties. Under current law, the accuracy-related penalty applies to a "tax shelter," defined as "* * * any * * * plan or arrangement if a significant purpose * * * is the avoidance or evasion of Federal income tax." Subject to the reasonable cause exception in section 6664(c) and in the absence of more precise regulatory definition, these words may sweep within their bounds all the tax-related events of corporate life. If a significant purpose to avoid federal tax exists, then the penalty is imposed unless the taxpayer is not a corporation and reasonably believed that the relevant tax position was more likely than not correct. It is not possible to avoid the tax shelter penalty by disclosure, though, oddly, the reasonable cause and good faith waiver provisions of section 6664(c) nevertheless apply to both corporate and noncorporate taxpayers.

Some have suggested that the expansive definition and the absence of a disclosure option are appropriate.[172] This conclusion seems based on a view that corporate understatements should be subject to a substantial no-fault penalty and that economic deterrence is the only effective tool for dealing with corporate noncompliance. An alternative view supporting such a broad definition is that any situation not deserving of penalty can, in the case of a noncorporate taxpayer, be avoided by disclosure, and, in the case of all taxpayers, through the reasonable cause criteria of section 6664.

Two obvious concerns exist. One is practical: taxpayers involved in transactions with a "significant purpose" of tax avoidance have no incentive to file disclosures, and the likelihood that the IRS will be able to identify such arrangements on audit cannot be high, in view of the low audit coverage rates and the absence of reported instances of the assertion of the penalty. The second is conceptual: the imposition of substantial penalties without a showing of fault is inconsistent with the concept that a penalty should be proportional to the offense, and the broad expanse of the "significant purpose" net makes it inevitable that the penalty will be inconsistently imposed, as revenue agents and appeals officers excuse a taxpayer's reasonable actions by choosing not to impose or uphold the penalty.

Contrary to various proposals, the author is of the view that the existing tax shelter rule should be regarded as an ineffective and ill-thought out rule and should be repealed.

In fact, a computer search of regular and memorandum Tax Court cases[173] indicates that, in the 10 years since 1989, the tax shelter prong of section 6662 has not been used by the Tax Court, although some usage of the pre-1989 version of the provision has been made, and it is too early to know whether the expanded "significant purpose" test would cause this penalty to play a larger role in the future. In the author's view, it seems likely that the most significant effect of the existing tax shelter penalty is to discourage disclosure by removing or weakening the incentives for disclosure, thus making identification of aggressive investments more difficult. Widening the definition to include all arrangements with a significant purpose of tax avoidance will most likely decrease disclosure rather than increase penalties. Thus, contrary to the views of the American Bar Association Section of Taxation and administration and legislative proposals, the author is of the view that the existing tax shelter rule should be regarded as an ineffective and ill-thought out rule and should be repealed.

Such a repeal will encourage disclosure of auditable issues, thus improving the ability of the IRS to intelligently select returns; will eliminate some complexity in the penalties; and will still leave the IRS with the ability to penalize negligent and nondisclosed aggressive positions not supported by substantial authority when such positions are discovered. Further, if section 6664(c) is amended along the lines suggested above, neither an adviser's erroneous opinion nor a taxpayer's erroneous belief that substantial authority exists will provide an independent basis for a reasonable cause waiver of the penalty.

3. The need for a special accuracy penalty. The existing accuracy-related penalties are largely based on the proposition that nonnegligent behavior and disclosure

[172]Johnson, "Corporate Tax Shelters, 1997 and 1998," note 148 *supra.*

[173]The Tax Court and Tax Court memorandum decisions on LEXIS were searched for the term "6662(d)(2)(C)." No case was found in which the applicability of a substantial understatement penalty turned on whether the item in question was a part of a "tax shelter." Thus, apparently, for years after 1989, the tax shelter rule has been unimportant as a practical matter.

of aggressive positions is expected of all taxpayers. The breadth of these normative propositions, their grounding in simple common-sense principles, and their applicability across the entire return-filing spectrum give them weight. We should not lightly cast aside the simplicity and normative force of this regime.

As noted above, the courts appear to have no trouble applying existing penalties to failed corporate tax planning. While overly aggressive corporate tax planning doubtless exists and may be a serious problem, it is not, in the author's view, at all clear that a targeted accuracy-related penalty heightening reporting standards for corporate tax shelters is needed for an effective response. In the author's view, a paucity of penalty assessments derives primarily from the IRS's choice not to persist in pursuing existing penalties in appropriate situations rather than a technical failure in the scope of the rules. However, we do not know why the IRS is making this choice. If this is an administrative failing, it is best corrected within the IRS itself; if it is an intelligent way of dealing administratively with particular compliance cases, statutory intervention is not warranted.

Although the articulation and implementation of existing waiver criteria should be closely examined in light of existing compliance issues, an abolition of reasonable cause waivers in the tax shelter context does not seem wise, either. The best point at which to make a judgment regarding the compliance effect of a penalty assertion is within the context of the taxpayer's case itself. For this reason, adequate waiver authority within the IRS is important. Statutory enactments should not eliminate IRS discretion and should not prevent the taxpayer from presenting a common-sense defense to its culpability for an underpayment based on the general principles presently expressed in section 6662. 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. The existing debate about whether, or how, to define the economic substance doctrine in statute foreshadows this.

Removing waiver authority creates a Procrustean bed that can and will deflect energy from regulating overly aggressive conduct.

The basic negligence and disclosure penalties are, in the author's view, a sound way of dealing with aggressive return positions, and failure or issues in the administration of them are best resolved within the context of the existing structure. If an additional and higher accuracy-related penalty must nevertheless be enacted, the best way of thinking of it is probably as a somewhat milder adjunct to the civil fraud penalty. Conceiving of a special tax shelter penalty in this way would permit a higher penalty to be viewed as proportional to the aggressiveness of the conduct because it would be tested by reference to the 75 percent fraud penalty, but it would also require a careful delineation of the particular conduct to be sanctioned, since the proposed analogy implies a stronger element of intent and knowledge and a more remote prospect of success. The existing bipartisan bill put forward by the Senate Finance Committee staff appears to be headed in this direction by proposing a 40 percent penalty for an "abusive tax shelter device," though its definition of this term lacks the clarity needed in a quasi-fraud penalty.[174] Given the broadening use of principles of economic substance and business purpose, it does not seem wise to ground the imposition of a 40 percent super penalty in such quicksand. A more focused and careful definition is essential.

4. Return information. Although the need for an accuracy penalty targeted at tax shelters is questionable, a need within the IRS for better information regarding aggressive transactions may well exist, particularly in view of the perverse disincentives to disclosure presently created by section 6662(d)(2)(C). Section 6011(a) delegates to the IRS the power to specify what information may be required on a return, and section 7203 imposes criminal penalties on the willful failure to provide required information. Information regarding a particular class of transactions of importance to tax administration seems a subject well within the province of this structure. The IRS has exercised its power to specify the content of returns by requiring the disclosure on corporate income tax returns of a set of information described as "reportable transactions" and intended to encompass activities that it views as corporate tax shelters.[175] While further definitional effort seems merited,[176] the approach is a useful one. Further, the addition of a civil penalty of fixed dollar amount for a failure to report a transaction seems consistent with underlying principles, so long as the amount of the penalty is in reasonable proportion to other civil penalties for information reporting failures.[177] Since the definitional problem is particularly knotty, initial conservatism in the assertion of such a penalty, initial leniency in waiver policies, and continued issuance of definitional guidance seem necessary to correct substantive decisions in the application of the penalty and to perceptions that it is being implemented in a procedurally just way.

5. Organizers, promoters, and listing requirements. While not within the scope of this article, the concepts

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[174]"Finance Releases Revised Draft of Tax Shelter Legislation," *Doc 2000-25409 (18 original pages), 2000 TNT 195-8.*

[175]Temp. reg. section 1.6011-4T, promulgated by T.D. 8877 (Feb. 28, 2000).

[176]*See* American Bar Association Tax Section, Comments Concerning Temporary and Proposed Regulations under Section 6011, 6111, and 6112 of the Internal Revenue Code of 1996, T.D. 8875, 8876, and 8877, *Doc 2000-25587 (17 original pages), 2000 TNT 195-23.*

[177]The American Bar Association Section of Taxation has suggested $50,000. *See* ABA Tax Section Remarks at Hearing on Code Penalty and Interest Provisions, *Doc 2000-7088 (20 original pages), 2000 TNT 48-18.*

that reporting obligations may be imposed on nontaxpayer participants in tax-focused transactions and that they should come within the ambit of the IRS's civil penalty schemes are hardly novel ideas. Support for such a proposition flows in part from IRS authority to regulate and penalize return preparers, in part from existing penalties enacted in 1982 by TEFRA,[178] and in part by a recognition that such participants play a role in sustaining the market for such transactions. The principles propounded in this article should be applied in designing such sanctions, but the proposition itself seems a sound one.

E. Recommendations

The following changes in the accuracy-related and preparer penalties are suggested.

1. Reasonable cause. The reasonable cause rules of section 6664 should be modified to provide that reasonable cause and good faith must be interpreted in light of the provisions of the particular prong of the accuracy-related penalty at issue. With respect to the negligence and intentional disregard penalties, reliance on professional advice as presently described in the regulations under section 6664(c) may constitute reasonable cause. For purposes of the substantial understatement prong of the penalty, neither reliance on professional advice nor the taxpayer's belief as to the existence of substantial authority should be taken into account because any uncertainty with regard to the existence of substantial authority may be dealt with through disclosure. Reasonable cause could still be established with respect to the substantial understatement prong of the penalty by, for example, establishing that the taxpayer's failure to identify the existence of an issue did not reflect a lack of care, or that the error or failure to disclose was the result of an isolated administrative error. With respect to the transfer-pricing penalty, the taxpayer should be entitled to seek to establish the existence of reasonable cause and good faith, particularly for minor procedural lapses, though such a defense should perhaps not be available to excuse the failure to prepare contemporaneous documentation that satisfied the general objectives of this requirement.

The reasonable cause rules of section 6664 should be modified to provide that reasonable cause and good faith must be interpreted in light of the provisions of the particular prong of the accuracy-related penalty at issue.

2. Penalty rates. The rate of the accuracy-related penalty should be reduced from 20 to 10 percent to bring it between the historic rate of the negligence penalty before the difficulties with individual tax shelters and the current 20 percent rate. This reduction in the penalty is needed to encourage more consistent imposition of the penalty by reducing its size, to decrease feelings that the penalty is unfair when applied, and to acknowledge the reduced opportunity for a waiver for reasonable cause and good faith. The enhanced 40 percent rate for gross misvaluations and gross transfer-pricing adjustments should be repealed.

3. Reporting standards. The standards for disclosed and undisclosed return positions on original returns should be simplified by conforming sections 6662 and 6694 so that both penalties apply to undisclosed return positions that are not supported by substantial authority and both penalties apply to disclosed positions lacking a realistic possibility of success on the merits if litigated. The definition of substantial authority should be expanded to include authoritative secondary sources.

4. Disclosure for valuation issues. A disclosure exception should be created for valuation penalties, with appropriate safeguards to assure that the taxpayer's reported valuation figure is supported by appropriate documentation.

5. Substantiality thresholds. The definition of a substantial understatement should be amended so that a substantial understatement exists if the understatement exceeds the greater of (a) $50,000 ($100,000 in the case of a corporation other than an S corporation or a personal holding company), or (b) the lesser of 5 percent of tax liability or $25 million.

6. Repeal of existing tax shelter provision. The existing tax shelter provisions in section 6662 should be repealed. Thus, for transactions and positions under a certain threshold amount, the normal rules for substantial understatements would apply, even though the taxpayer may have had a tax avoidance objective in entering into them. These rules would impose a 10 percent penalty on substantial understatements based on an objective conclusion as to whether substantial authority supported the taxpayer's position. Neither the taxpayer's belief as to likelihood of success nor an adviser's opinion regarding legal support for the taxpayer's provision would be relevant in determining whether the penalty could be waived pursuant to the reasonable cause provision of section 6664(c).

7. Penalty administration and the need for a new accuracy penalty for tax shelters. No new accuracy-related penalty for tax shelters appears to be needed at present. The IRS should analyze its recent history in the application and abatement of accuracy-related penalties and consider whether its existing pattern of penalty proposals, assessments, and abatements is appropriate, and it should in the future seek to impose the existing negligence and substantial understatement penalties (as enhanced by revisions to the waiver rules suggested above) in circumstances in which it thinks such penalties are warranted. If the results of such a compliance effort show that such penalties fail to provide meaningful sanctions in deserving situations, then this subject should be revisited.

8. Return information. Requiring more information regarding aggressive transactions is an appropriate subject for IRS regulation and its current efforts to

[178] Sections 6111, 6112, 6700, and 6701.

define the information needed should continue. A reasonably sized fixed dollar penalty for a failure to provide needed information is consistent with the existing penalty structure and would be a reasonable addition to the code. Such an approach to aggressive transactions is more consistent with a principled approach to penalties than an enhanced and targeted accuracy penalty.

VIII. Conclusion

The collection and accuracy-related penalties in the Internal Revenue Code reflect a three-cornered relationship among taxpayers, the IRS, and the Congress. If Congress gets the design of penalties about right and the IRS administers them well, taxpayer compliance should be maximized. The consequences of failure in design or administration should be detectable in compliance results and taxpayer attitudes toward the IRS. In the case of collection penalties, the author thinks that harsh criticism of the IRS arises in part because the stiffening of these penalties over a period of decades has resulted in a regime that is much more harsh than it needs to be. IRS assessment of these penalties is mechanical, and, on the whole, appropriate. However, the sheer efficiency of application of them provides a major reason for reductions in amounts.

In the case of accuracy-related penalties, the IRS's choice not to seek to assess them in meaningful numbers is highly important. However, the dearth of explanation for the small number of assessments greatly inhibits meaningful analysis. IRS analysis of this issue is of the greatest importance. Because the IRS so seldom seeks to assess these penalties despite apparent judicial support for their application, there is little reason to think that an enhanced accuracy-related penalty for corporate tax shelters is needed.

One reason for the failure of the IRS to assert accuracy-related penalties more frequently may be the relatively large amount of such penalties. A reduction in amount would do little damage in view of the low numbers of assessments and may help in making the penalty a more credible tool.

Despite the low number of assertions of the accuracy-related penalty, significant technical improvements could be made in it. The most important would restrict the ability of taxpayers to rely on the advice of advisers to excuse the failure to disclose positions lacking substantial authority, simplify and coordinate the reporting standards applicable to taxpayers and advisers, and recalibrate the thresholds for the substantial understatement to better reflect its purpose.

Obtaining more information on aggressive transactions through the definition of return-filing obligations is within the scope of the IRS's authority and a civil penalty of reasonable size would be a reasonable adjunct to the development of such an obligation. Because the definition of what may be required of taxpayers is difficult, substantial initial administrative leniency and modesty in the amount of any supporting penalty are appropriate.

Most discussions of tax policy on penalties are unsatisfactory because the necessary underpinnings are missing. In part, these underpinnings are missing here as well, due to limitations in the data available and the substitution of personal, but I hope not too arbitrary, views. Given the dryness of the topic, I have taken pains to serve the reader a piece of wedding cake in the form of concrete proposals. But I hope that the more important message — that a principled discussion of these issues within the context of their place in the larger subject of tax compliance is needed and possible — has not been altogether lost.