PRESENT LAW AND BACKGROUND INFORMATION RELATED TO SELECTED TAX PROCEDURE AND ADMINSTRATION ISSUES

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on April 16, 2013

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

April 15, 2013
JCX-9-13

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INTRODUCTION AND SUMMARY

The Senate Committee on Finance has scheduled a public hearing on "Tax Fraud and Tax ID Theft: Moving Forward with Solutions" for April 16, 2013. This document,[1] prepared by the staff of the Joint Committee on Taxation, reviews three broad aspects of Federal tax administration and practice that are relevant to voluntary compliance: identity theft tax fraud, rules governing paid tax preparers, and civil tax penalties. The first section discusses tax rules under the Internal Revenue Code[2] and other laws that are directly implicated in efforts to prevent identity theft tax fraud and summarizes several proposals aimed at addressing the issue. The second section discusses the tax rules governing paid tax return preparers and the attempt by the Internal Revenue Service ("IRS") to regulate the conduct of paid tax return preparers. The third section discusses the civil assessment process and provides an overview of the civil tax penalty system and summarizes selected issues raised by practitioner groups and others.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Information Related to Selected Tax Procedure and Administration Issues* (JCX-9-13), April 15, 2013. This document can also be found on our website at www.jct.gov.

[2] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the Treasury regulations thereunder.

I. BACKGROUND AND FEDERAL TAX PROVISIONS AND PRACTICES IMPLICATED IN IDENTITY THEFT REFUND CLAIMS

This section describes aspects of present Federal tax law procedure and administration rules and practices, including confidentiality and disclosure protections, that are relevant to schemes currently used by identity thieves. This section also includes a brief summary of the laws governing access to information compiled by the Social Security Administration that is often used to facilitate frauds. This discussion does not attempt to summarize the variety of schemes used to perpetrate identity theft nor does it address the many successful administrative measures that have been taken to date. Rather, this discussion accepts the premise that the fraudulent activity continues[3] and describes several possible statutory remedies that have been proposed.

Identity theft involving fraudulent tax refunds often employs the following scenario. A perpetrator obtains someone else's identifying information and submits an individual income tax return using the name and social security number of the victim. In the return submitted, the perpetrator fabricates information about wages and supposedly withheld taxes, attaches a falsified W-2, and claims a refund. By filing early in the filing season, it is less likely that the victim will have already filed a return, if only because the victim will not yet have received the necessary forms 1099 or W-2. The identity theft victim may learn of the problem when the IRS intercepts the claim for refund and seeks information from the victim to verify the claim, or when the victim later files a legitimate return for the tax year that is rejected by the IRS.

[3] Testimony of J. Russell George, Treasury Inspector General for Tax Administration, Senate Special Committee on Aging, "Tax-Related Identity Theft: An Epidemic Facing Seniors and Taxpayers," April 10, 2013. Mr. George reported that as of December 31, 2012, the IRS identified almost 1.8 million incidents during CY 2012, comprising approximately 280,000 incidents in which taxpayers contacted the IRS alleging that they were victims of identity theft, and more than 1.5 million incidents in which the IRS detected potential identity theft.

A. Federal Tax Provisions and Practices Relevant to Identity Theft Refund Claims

Disparate elements in the tax laws and administration are implicated in identity theft. The aspects of tax law and practice exploited by identity thieves can be grouped generally into two groups: those factors that are relevant to prevention of the fraudulent claims and those that are relevant to investigation and prosecution of identity thieves. In the former category are the information return filing schedule that precludes real-time document matching by the IRS during filing season and the historic lack of uniform standards of practice applicable to return preparers who are neither attorneys nor certified public accountants and do not volunteer to seek qualification to practice before the Department of Treasury.[4] In the latter category are the provisions protecting confidentiality of tax information and the extent to which such information may be used for non-tax criminal matters.[5]

1. Tax provisions and practices relevant to identification and prevention of fraudulent refund claims

Despite extensive information reporting requirements, third-party reporting is limited in its ability to aid early detection and prevention of fraud during the filing season. Through the filing of tax returns, information received from third parties, and its own audits and investigations, the IRS has a significant amount of information about U.S. taxpayers. That information enables the IRS to select and examine the accuracy of income tax returns, but may be unavailable during the filing season to verify accuracy of refund claims as they are received.

The individual income tax filing season is the period beginning in January when the IRS first accepts for filing income tax returns for the preceding calendar year and ending April 15, the due date (absent an extension) for individual income tax returns. Although copies of information reports that payors must provide to individuals are generally due to the individuals no later than January 31 following the close of the calendar year,[6] the person preparing such reports may not be not required to submit the related information return to the IRS until a later date. The due date for information returns that are filed electronically is March 31,[7] but information returns of various types that are filed on paper are due earlier, on the last business day of February in the year after the taxable year in question.[8] There is not a similar disparity in

[4] The efforts to bring paid tax return preparers into the scope of regulatory codes of conduct are considered in Part II of this pamphlet, *infra*.

[5] Sec. 6103.

[6] Sec. 6051.

[7] Sec. 6011(e) and 6071(b); Treas. Reg. sec. 301.6011-2(b), mandates use of magnetic media by persons filing information returns identified in the regulation or subsequent or contemporaneous revenue procedures and permits use of magnetic media for all others.

[8] Treas. Reg. sec. 31.6071(a)-1(a)(3)(i).

filing due dates for individual income tax returns dependent upon whether the returns are filed electronically or on paper.

The most significant information report with respect to identifying fraudulent refund claims may be the information reports on wages paid to, and taxes withheld from, employees. That information is compiled in Form W-3, with copies of all W-2's attached, and submitted directly to the Social Security Administration.[9] The information on the Forms W-3 is not available to the IRS until it has been processed by Social Security Administration, which may not be completed during the filing season. As a result, third-party reporting is limited as a tool to identify and reject fraudulent claims. Delay in processing a refund beyond the filing season presents the possibility that the IRS must pay interest on the refund.[10]

2. Tax provisions and practices relevant to investigation and prosecution of fraudulent refund claims

Both Federal and State law enforcement agencies may have an interest in investigating and prosecuting persons who claim fraudulent identity theft refund claims. In prosecuting any offenses arising from the actions of the thief, questions arise about the extent of the ability of the IRS to cooperate with those law enforcement officials, due to the restrictions on disclosure of tax return information under Code section 6103. For example, if the stolen identity is used by an undocumented worker to obtain employment and file a return reporting his own wages and claiming a refund of taxes withheld from those wages, the IRS must determine whether the return filed should be considered to be that of the victim or of the thief. As a result, questions may arise as to whether the victim may consent to disclosure of information to law enforcement. Such cases require careful examination of the facts and the applicability of exceptions to the general rule against disclosure. A brief history of the nondisclosure rules and the development of the exceptions under which disclosure is permitted for purposes of non-tax criminal prosecution is provided below.

General rule of nondisclosure and historical background[11]

Prior to 1976, pursuant to Treasury regulation, a U.S. Attorney or an attorney of the Justice Department could obtain tax information in any case "where necessary in the performance of his official duties." Tax information obtained by the Justice Department could be used in proceedings conducted by or before any department or establishment of the Federal Government or in which the United States was a party. Tax information obtained by both the Justice Department and U.S. Attorneys was used in investigating and prosecuting criminal activities. In addition, in connection with the enforcement of non-tax criminal statutes, tax information was made available to each executive department and other establishments of the

[9] Treas. Reg. sec. 31.6051-2; IRS, "Filing Information Returns Electronically," Pub. 3609 (Rev. 12-2011); Treas. Reg. sec. 31.6071(a)-1(a)(3)(i).

[10] Sec. 6611(e).

[11] This background generally is based on Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* (JCS-33-76) December 29, 1976 at 322-323; 1976-3 C.B. 314 (Vol. 2), p. 326.

Federal government in connection with matters officially before them, on the written request of the head of the agency. Tax information so obtained could be used as evidence in proceedings before any "department or establishment" of the United States or any proceedings in which the United States was a party.

Congress enacted section 6103 in 1976 after a comprehensive review of the handling of tax return information. Section 6103 treats returns and return information as confidential. Returns and return information are not to be disclosed unless such disclosure is specifically authorized in section 6103 or other provision of the Code.[12] Criminal and civil sanctions apply to the unauthorized disclosure or inspection of returns and return information (secs. 7213, 7213A, and 7431). In its review of the areas in which returns and return information were subject to disclosure, Congress sought to balance a particular office or agency's need for the information with the citizen's right to privacy and the related impact of the disclosure upon the necessary continuation of voluntary compliance with the Federal tax assessment system.

Thus, present law provides that both returns and return information generally should be treated as confidential and neither may be disclosed except in those limited circumstances in which Congress determined that disclosure was warranted. "Return" means a tax or information return, declaration of estimated tax, or claim for refund which, under the Code, is required (or permitted) to be filed on behalf of, or with respect to, any person. It also includes any amendment, supplemental schedule or attachment filed with the tax return, information return, declaration of estimated tax or claim for refund. For example, Form W-2, Wage and Tax Statement, is an information return, and is the return of both the employer who filed it with the IRS and the employee with respect to whom it was filed. The Code defines "return information" broadly to include a taxpayer's identity.[13]

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[12] See section 6103(c) (disclosure by taxpayer consent); 6103(d) (disclosure to State tax officials); 6103(e) (disclosure to persons having material interest); 6103(f) (disclosure to committees of Congress); 6103(g) (disclosure to the President and certain other persons); 6103(h) (disclosure to Federal officers and employees for tax administration purposes); 6103(i) disclosure to Federal officer and employees for administration of Federal laws not relating to tax administration); 6103(j) (statistical use); 6103(k) (disclosure of certain returns and return information for tax administration purposes); 6103(l) (disclosure for purposes other than tax administration); 6103(m) (disclosure of taxpayer identity information); 6103(n) (tax administration contractors); and 6103(o) (disclosure of return and return information with respect to certain taxes).

[13] Identity refers to the name of the person with respect to whom a return is filed, his mailing address, his taxpayer identifying number (TIN or SSN or a combination thereof). In addition to taxpayer identity, return information includes any information gathered by the IRS with regard to taxpayer's liability under the Code, such as the nature, source or amount of income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments; whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing; any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense; any part of any written determination or any background file document relating to such written determination which is not open to public inspection under section 6110; any advance pricing agreement entered into by a taxpayer and the Secretary and any background information related to the agreement or any application for an advance pricing agreement; and any agreement under section 7121 (relating to closing agreements), and any similar agreement, and any background

"Taxpayer return information" is another defined term for purposes of section 6103 and is a subset of return information. Taxpayer return information means return information that is filed with, or furnished to, the IRS by or on behalf of the taxpayer to whom such return information relates. For example, information filed with the IRS by a taxpayer's attorney or accountant is taxpayer return information. Information transcribed directly from a taxpayer's return is taxpayer return information. The distinction between return information and taxpayer return information is significant for the disclosures non-tax criminal matters for which a court order generally is required to obtain taxpayer return information.

Exception for disclosure for non-tax criminal purposes

In making the access to tax information for non-tax criminal purposes more restrictive, Congress noted that in years before 1977, Federal agencies had almost unfettered access to tax information for non-tax criminal purposes and such non-tax access was inconsistent with the premise that the American citizen's tax information should be afforded a degree of privacy similar to that given to private papers in a private home. The information "that the American citizen is compelled by our tax laws to disclose to the Internal Revenue Service is entitled to essentially the same degree of privacy as those private papers maintained in his home. [Prior] law and practice [did] not afford him that protection -- the Justice Department and other Federal agencies, as a practical matter, being able to obtain that information for nontax purposes almost at their sole discretion."[14]

To afford the taxpayer with the appropriate degree of privacy and balance the need for tax information in the investigation and prosecution of non-tax criminal matters, Congress decided that the Justice Department and any other Federal agency responsible for the enforcement of a non-tax criminal law should be required to obtain court approval for the inspection of a taxpayer's return or return information. Notably, however, Congress did not require the court approval procedure with respect to information which is derived from a source other than the taxpayer or filed on behalf of such taxpayer, such as the information developed by an examining agent from third-parties or public records. A court order by a Federal district court judge or magistrate is generally required to obtain returns and information submitted by the taxpayer or the taxpayer's representative to the IRS (taxpayer return information). The court order process is *ex parte*, meaning that there is no right of notification or participation of the defendant in the proceeding.

The order can be granted upon a determination where (1) there is reasonable cause to believe, based upon information believed to be reliable, that a specific criminal act has been committed, (2) there is reasonable cause to believe that the return or return information is or may be relevant to a matter relating to the commission of such act, and (3) the return or return information is sought exclusively for use in a Federal criminal investigation or proceeding concerning such act and the information sought to be disclosed cannot reasonably be obtained,

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information related to such agreement or request for such agreement (sec. 6103(b)(2)). It does not include data in a form that cannot be associated with or otherwise identify, directly or indirectly, a particular taxpayer.

[14] S. Rep. No. 94-938 (94th Cong. June 10, 1976), p. 328; 1976-3 C.B. (Vol. 3) 49, p. 366.

under the circumstances, from another source. With respect to terrorist activities, since 2001, an order may be granted if there is (1) reasonable cause to believe, based upon information believed to be reliable, that the return or return information may be relevant to a matter relating to a terrorist incident, threat or activity and (2) the return or return information is sought exclusively for use in a Federal investigation, analysis, or proceeding concerning any terrorist incident, threat or activity. Pursuant to ex parte court order, returns and return information may be disclosed for purposes of locating a fugitive from justice.

Because a court order is not required for the disclosure of tax information obtained from a source other than the taxpayer, this authority allows the IRS to disclose return information (other than taxpayer return information) to the appropriate Federal officials of possible violations of Federal criminal law, and to respond to requests from the head of any Federal agency and certain other Federal officials responsible for non-tax Federal criminal purposes. The IRS may also disclose return information to Federal and State law enforcement agencies in cases of imminent danger of death or physical injury.

IRS Pilot Program for cooperation with local authorities

On its website, the IRS describes the Identity Theft Victim Disclosure Waiver Process, a strategy developed by the IRS to permit greater cooperation with state and local law enforcement. Under this process, Federal tax returns and return information associated with the accounts of known and suspected victims of identity theft is made available to non-Federal law enforcement officers with the express written consent of those victims. Prior to disclosing any tax information, the IRS requires that victims sign a waiver authorizing the release of information to the designated State or local law enforcement official pursuing the investigation. First launched in Florida in April 2012, the process is now being implemented throughout the United States.[15]

[15] See, http://www.irs.gov/uac/Law-Enforcement-Assistance-Pilot-Program-on-Identity-Theft-Activity-Involving-the-IRS. See also, IRS, “Disclosure Issues Related to Identity Theft,” PMTA 2012-5, available at http://www.irs.gov/uac/Legal-Advice-Issued-to-Program-Managers.

B. Availability of "Death Lists" Maintained by Social Security Administration

One source of information facilitating identity theft that has been used by identity thieves is a list of deceased individuals, known as the Death Master File (DMF). It comprises information obtained by the Social Security Administration (SSA) from a variety of sources other than state governmental bodies. Updated weekly, the DMF contains the full name, Social Security Number (SSN), date of birth, date of death, and the county, state, and zip code of the last address on record for the decedents listed. This information is distributed through the Department of Commerce and is widely available on many websites free or for a nominal fee.

The DMF was first created and published as part of a settlement of a lawsuit under the Freedom of Information Act of 1966 ("FOIA"), in which an individual attempted to determine whether pension benefits were being fraudulently claimed on behalf of individuals who had died.[16] The suit was resolved with a consent judgment entered in 1980, which remains in effect. The scope of the data included on the list was narrowed when data received from states was specifically exempted from FOIA in 1983. Social Security officials maintain that they have no legal grounds on which to depart from continuing to compile and publish the data the agency receives from sources other than states. The agency has not sought modification of the order.[17]

The Freedom of Information Act strongly favors public access to information contained in government files unless the information is covered by one of its several exemptions.[18] The evaluation of the applicability of the exemptions generally is fact intensive and requires balancing of competing interests. Among the competing interests are the privacy rights protected under The Privacy Act of 1974,[19] which favors confidentiality of records held by the government about specific individuals, especially if disclosure would constitute an invasion of personal privacy. The two statutes are thus in tension. Personal privacy interests generally are considered to cease when an individual dies.

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[16] Thomas Hargrove and Isaac Wolf, "Fraud-fighter from Stuart, who won access to master death file, now says it's abused," *Scripps Howard News Service*, available at http://www.tcpalm.com/news/2011/nov/15/fraud-fighter-from-stuart-who-won-access-to-file/?print=1.

[17] Testimony of David F. Black, General Counsel, Social Security Administration before the House Committee on Ways and Means, Subcommittee on Social Security May 8, 2012, available at http://www.ssa.gov/legislation/testimony_050812.html . In his testimony, Mr. Black noted that the Department of Justice had advised SSA that there was no exemption to the FOIA or the Privacy Act that would justify withholding the data covered by the court-approved consent decree. In 1983, Congress added subsection (r) to section 205 of the Social Security Act. This subsection requires collection of death information from States to update program records, provides the circumstances under which certain agencies may receive such information from SSA and exempts the death information obtained from States from FOIA and the Privacy Act.

[18] 5 U.S.C. sec. 552(a).

[19] 5 U.S.C. sec. 552a.

C. Proposals Under Consideration

There have been many measures proposed to address the issues discussed above. The following descriptions reflect a limited sample of those proposals.

1. Expand IRS access to New Hire data for general tax administration purposes

President's Budget proposals for each year since fiscal year 2006, including fiscal 2014, include a request that the Social Security Act be amended to expand IRS access to data in the National Directory of New Hires ("the Directory").[20] The data is collected and maintained by the Office of Child Support Enforcement of the Department of Health and Human Services ("HHS"). The database contains newly-hired employee data from Form W-4, quarterly wage data from State and Federal employment security agencies, and unemployment benefit data from State unemployment insurance agencies. The Directory was created to help State child support enforcement agencies enforce obligations of parents across State lines.

Under the proposal, the IRS could use the data for general tax administration purposes, including data matching, verification of taxpayer claims during return processing, preparation of substitute returns for noncompliant taxpayers, and identification of levy sources. The proposal provides that data obtained by the IRS from the Directory is protected by existing taxpayer privacy law, including civil and criminal sanctions for unauthorized disclosure.

Under present law, the IRS may obtain data from the Directory only for the purpose of administering the earned income tax credit[21] and verifying a taxpayer's employment that is reported on a tax return.[22] The IRS may also negotiate for access to employment data directly from State agencies responsible for such data, to the extent permitted by the laws of the various States. Generally, the IRS obtains such employment data less frequently than quarterly, due to the significant internal costs it incurs in preparing these data for use.

2. Restrict access to the Death Master File and social security numbers.

Several variations of measures to protect the social security numbers of deceased individuals from broad circulation have been proposed. In legislation introduced, as well as in the recently released President's Budget proposal for fiscal year 2014, immediate access to the Death Master File would be limited to those users who legitimately need the information for fraud prevention purposes (such as banks, trust administrators, and the IRS) and general release of the DMF to all other users would be delayed for a specified number of years.[23]

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[20] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals* ("President's Budget FY14"), April 2013, p. 192.

[21] Sec. 32(a)(1).

[22] 42 U.S.C. Secs. 653 and 653a.

[23] Sec. 301, "A bill to protect tax-related identity theft and tax fraud," S. 676, introduced April 9, 2013; President's Budget FY14, p.203.

In addition, several proposals would place limits on the instances in which agencies could require use of a social security number. Use of the number on Medicare cards would be prohibited by bills pending in both the House and Senate; the bill pending in the Senate would also bar publication or display of the numbers generally, and criminalize sale or purchase of such numbers.[24]

3. Enhance civil and criminal penalties when identity theft results in fraudulent tax claims

Several proposals also address perceived shortcomings in the strength of penalties applicable to fraudulent refund claims based on identity theft. Proposals include several measures that would enhance criminal penalties by specifying tax-related offenses under Titles 18 and 26 as predicate offenses to establish aggravation for purposes of prosecution under statutes specifically targeted at identity theft.[25] Others propose new or increased civil penalties, such as the President's Budget FY14 proposal for a penalty of $5,000 for each fraudulent return or refund claim filed by an identity thief,[26] and the proposed increased penalties for return preparers who use or disclose taxpayer information improperly.[27]

Another proposal focuses on the use of stolen taxpayer identifying information in order to circumvent work eligibility requirements. In a recently introduced bill, such use of information would be subject to criminal penalties. Both employees and employers would be held accountable.[28]

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[24] Sec. 302, "A bill to protect tax-related identity theft and tax fraud," S. 676, introduced April 9, 2013; "Medicare Identity Theft Prevention Act of 2013," H.R. 781, introduced February 15, 2013.

[25] See, *e.g.*, "STOP Identity Theft Act" S. 149, introduced January 24, 2013; President's Budget FY14, pp. 211.

[26] President's Budget FY14, p. 212.

[27] Sec. 305, "A bill to protect tax-related identity theft and tax fraud," S. 676, introduced April 9, 2013.

[28] See, "Accountability through Electronic Verification Act," S. 202, introduced January 31, 2013.

II. AUTHORITY TO REGULATE THE CONDUCT OF PAID TAX RETURN PREPARERS

A. Tax Return Preparers Under the Treasury Regulations

Tax assessment and collection in the United States depends heavily on the voluntary compliance of taxpayers. In recent years, a steadily increasing numbers of taxpayers discharge their duty to prepare accurate and timely tax returns by seeking the advice and assistance of a paid tax return preparer.[29] Thus, an important element in achieving voluntary taxpayer compliance is in turn dependent on the competence and professionalism of the advisers whose assistance taxpayers seek in preparing a tax return. Nevertheless, before 2011, the vast majority of paid tax return preparers were not subject to the standards of practice and conduct applicable to persons appearing before the Internal Revenue Service. In 2011, new regulations were issued to require paid tax return preparers to comply with these standards by obtaining a registration number and meeting certain education and testing requirements by January 2014. A court enjoined the Secretary of the Treasury from attempting to enforce the educational and testing components of the regulations on the grounds that the Secretary's general authority to regulate practitioners is insufficient to permit regulation of return preparers, who, according to the court, do not practice before an office of the Department of Treasury.[30]

<u>History of the Department of Treasury Authority</u>

The Department of Treasury has authority to regulate conduct of persons representing others before any office or agency of the Secretary.[31] The original grant of authority to regulate persons appearing before the Secretary was added to an 1884 appropriations measure to allay concerns that potentially fraudulent compensation claims were being presented to and approved by the Secretary. The claims in question related to compensation for property lost in military service during the Civil War. The claims had been presented to the War Department for review, reviewed by an auditor under the aegis of the Treasury, and forwarded to Congress after approval with recommendations that they be paid. Congress then decided whether to fund payment of the claims. In section 3 of the General Deficiency Act of July 7, 1884, under the heading "War Department," Congress authorized appropriation of $125,787.03 for "horses and other property lost in the military service prior to July 1, 1881," with the following proviso:

> *Provided*, That the Secretary of the Treasury may prescribe rules and regulations governing the recognition of agents, attorneys, or other persons representing claimants before his Department, and may require of such persons, agents and attorneys, before being recognized as representatives of claimants, that they shall show that they are of good character and in good repute, possessed of the

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[29] See generally, IRS Publication 4832, "Return Preparer Review," December 2009.

[30] *Loving v. Internal Revenue Service*, 2013 U.S. Dist. LEXIS 7980 (D.D.C. 2013) (*Loving I*), modified by 2013 U.S. Dist. LEXIS 13878 (D.D.C. 2013), (*Loving II*) *appeal pending*, D.C.C. Dkt. No. 13-0561 (February 20, 2013).

[31] 31 U.S.C. sec. 330 et seq.

> necessary qualifications to enable them to render such claimants valuable service, and otherwise competent to advise and assist such claimants in the presentation of their cases. And such Secretary may after due notice and opportunity for hearing suspend, and disbar from further practice before his Department any such person, agent, or attorney shown to be incompetent, disreputable, or who refuses to comply with the said rules and regulations, or who shall with intent to defraud, in any manner willfully and knowingly deceive, mislead, or threaten any claimant or prospective claimant, by word, circular, letter, or by advertisement.[32]

This proviso was included to address concerns that military veterans were being cheated by disreputable agents, who represented large numbers of veterans and charged contingency fees. Despite the fact that some of the agents were charging unfair fees or misleading their clients, the Secretary lacked authority to declare an agent ineligible to represent a soldier.[33] This provision provided that authority and has remained substantively unchanged. It is now codified in Title 31, the first sentence as subsection 330(a), and the second sentence as subsection 330(b).[34]

Circular 230

In addition to the authority in Title 31, regulations provided in Treasury Department Circular No. 230 ("Circular 230")[35] establish standards that identify criteria to be eligible to appear before an official of the Department of Treasury as a representative. The original publication of Circular 230 in 1921[36] combined several other legislative measures that established ethical standards for conduct before an executive agency and established a template for a standard of practice.[37] A committee on enrollment and disbarment was established. An applications process was prescribed for enrollment of all persons wishing to appear before the Department of Treasury. The only persons eligible to appear before the Department of Treasury would be the party whose claim was pending, an enrolled attorney or an enrolled agent. The publication also established procedures for complaints and hearings on disbarment, included a nonexclusive list of causes warranting disbarment and prescribed procedures for substituting

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[32] Act of July 7, 1884, ch. 334, 23 Stat. 236, 258-59.

[33] For example, on the House floor, Mr. Townsend of Illinois stated, "Let a word be now said on behalf of the soldiers victimized by the sharks that lie around this city and who make their living by practicing deception on soldiers living hundreds--in some instances thousands--of miles away. … The officers of the Department have done their duty in endeavoring to guard the interests of claimants against these claim agents, but they have been unable to do so because no law authorized them to disbar the disreputable claim agents from practice. I know there are honest and upright men engaged in the business, and they can not [*sic*] object to a law which will protect the soldier from the disreputable class of attorneys to whom I have referred." 15 Cong. Rec., 1884, p. H5222.

[34] 31 U.S.C. secs. 330(a) and 330(b).

[35] 31 C.F.R. part 10.

[36] Circular 230, 1921 C.B. 4-1600A, February 15, 1921.

[37] The circular required agents take an oath similar to that prescribed in Act of May 13, 1884 (23 Stat. 22), and banned government employees from appearing before the Secretary other than in their official capacity, citing proscriptions of the Act of March 4, 1909, 35 Stat. 1107.

representatives or revocation of authorization to an agent. A supplement to Circular 230 published later the same year bars a former Department of Treasury employee from appearing in a matter as to which the employee had personal knowledge or responsibility in an official capacity, thus establishing post-employment conflict of interest as a basis for disbarment.[38]

Since its introduction, Circular 230 has been revised on a number of occasions, although regulating return preparation was not generally the subject of the amendments. However, in 1937, a sentence was added to the requirement in the regulations that required a specific disclosure of contingent fees on executed powers of attorney to state that "This requirement shall not be applicable to powers of attorney wherein the authority granted is limited to the filing of tax or information returns."[39] One may infer from this revision that return preparation was within the contemplation of services to be performed by persons subject to Circular 230.

Under Circular 230, certain persons, such as attorneys or certified public accountants, are qualified on the basis of maintaining licenses or professional credentials issued by a state or governmental entity. The regulations also provide that persons may qualify on the basis of successful completion of educational requirements and testing prescribed by the Department of Treasury. Circular 230 was revised in 2011 to specify three classes of representation that are authorized on the basis of testing: enrolled agents, registered tax return preparers and qualified appraisers. The inclusion of registered tax return preparers in the sweep of these regulations establishes standards of conduct for previously unenrolled tax return preparers, including minimum educational and competence requirements, in order to be eligible to prepare and sign a return as a paid tax return preparer. The regulations now include a definition of "tax return preparer" that is consistent with use of that term in the Code (see discussion in section B of this part, below). The regulations require all preparers to obtain a "preparer tax identification number" ("PTIN") and to use such number on all returns with respect to which the person is considered a tax return preparer.[40]

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[38] 1921 C.B. 4-1600B 414, June 7, 1921.

[39] F.R. Doc. 37-2747; Fed. Reg. 1842, September 15, 1937

[40] The use of a preparer tax identification number was specifically authorized in section 6109(a)(4), which provides that such number must be included on all returns or claims for refund, when required by regulations prescribed by the Secretary.

B. Tax Return Preparers Under the Internal Revenue Code

Under the Code, the term "tax return preparer" is broadly defined as any person who prepares for compensation, or who employs other people to prepare for compensation, all or a substantial portion of a tax return or claim for refund.[41] When first enacted in 1976,[42] the term was "income tax return preparer," but has since been amended to include persons preparing non-income tax returns, such as estate and gift, excise, or employment tax returns, as well as income tax returns. Preparation of a substantial portion of a return is treated as if it were the preparation of such return, regardless of whether or not the person signs the return.[43] There are no specific educational or professional credentials required to be subject to the rules applicable to tax return preparers.[44] Persons whose duties are merely mechanical or clerical (such as keying in data, typing schedules, or printing or producing copies) are excepted from the definition of tax return preparers, as are IRS officials in the course of their official duties and certain volunteers.

The status as tax return preparer triggers certain duties for tax return preparers and persons who employ tax return preparers and potential sanctions for failure to conform to those duties. For example, depending on the volume of a preparers' business, the preparer may be required to submit returns electronically.[45] Also, a tax return preparer must furnish copies of the completed return or statement to the client and retain copies for his own records,[46] and provide the identification number required by the IRS.[47] In addition, persons who employ tax return preparers are subject to specific recordkeeping requirements.[48] Tax return preparers are subject to civil penalties for failure to comply with the foregoing duties, negotiation of a check payable to a client, or failure to exercise diligence in determining eligibility for an earned income credit.[49] Tax return preparers may also be subject to civil or criminal penalties for the disclosure or use of a client's tax return information.[50]

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[41] Sec. 7701(a)(36)(A).

[42] The term as originally added in 1976 was "income tax return preparer," and thus did not encompass those persons who prepared other statements or returns required by the Code. Tax Reform Act, Pub. L. No. 94-455, sec. 1203(a), October 4, 1976. The prefatory word "income" was deleted from the term in 2007. The Small Business and Work Opportunity Tax Act of 2007," Pub. L. No. 110-28, sec. 8246(a)(1)(A), May 25, 2007.

[43] Treas. Reg. sec. 301.7701-15(b).

[44] Treas. Reg. sec. 301.7701-15(d).

[45] Sec. 6011(e)(3).

[46] Sec. 6107.

[47] Sec. 6109.

[48] Sec. 6060.

[49] Sec. 6695.

[50] Sec. 7216.

Tax return preparers are also subject to a penalty for preparation of a return or refund claim with respect to which an understatement of tax liability results. If the understatement is due to an "unreasonable position," the penalty is the greater of $1,000 or 50 percent of the income derived by the return preparer with respect to that return.[51] Any position that a return preparer does not reasonably believe is more likely than not to be sustained on its merits is an "unreasonable position" unless the position is disclosed on the return or there is "substantial authority" for the position.[52] There is a substantial authority for a position if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. If the position taken meets the definition of a tax shelter (as defined in section 6662(d)(2)(B)(ii)(I)) or a listed or reportable transaction (as referenced in 6662A), the preparer must have a reasonable belief that the position would more likely than not be sustained on its merits. If the understatement is due to willful or reckless conduct, the penalty increases to the greater of $5,000 or 50 percent of the income derived by the return preparer with respect to that return.[53]

[51] Sec. 6694(a)(1)

[52] Sec. 6694(a)(2).

[53] Sec. 6694(b)

C. Controversies in Applying Circular 230 to Tax Return Preparers

The inclusion of tax return preparers in the revisions to Circular 230 issued in 2011 was greeted by criticism from the previously unregulated preparer community, who questioned its necessity, its cost and its ability to achieve the stated goal of limiting fraud and malfeasance that is aided and/or committed by preparers.[54] Challenges to the enforcement of the regulations followed, with mixed results. In *Brannen v. the United States,*[55] the government successfully defended the imposition of user fees. In *Loving v. Internal Revenue Service,*[56] the IRS was enjoined from enforcing its education and testing requirements. Both courts focused on the authority of the Secretary of the Treasury and the deference due such regulations. The two cases challenging the regulations are discussed below.

In *Brannen v. the United States,*[57] a certified public accountant unsuccessfully challenged the user fee required to be paid to obtain the preparer taxpayer identification number. The plaintiff argued that there was no explicit authorization for imposition of a user fee, although, he conceded the existence of the Department of Treasury's authority to require registration and use of a unique identification number referred to as a PTIN.[58] In rejecting the challenge and upholding imposition of the user fee, the Eleventh Circuit noted the general authorization for user fees in Title 31 and the standards under which such fees may be imposed. The court also pointed to the explicit regulations under the Code requiring use of a PTIN in order to be eligible to prepare tax returns for compensation.[59]

In *Loving I,* a U.S. district court held that the general authority of the Secretary to regulate conduct before the Department of Treasury was unambiguous and could not be construed to include tax return preparation within its scope. The court entered a preliminary injunction against enforcement of Circular 230 with respect to paid tax return preparers.

The court rejected arguments on behalf of the IRS that the statute is silent as to return preparation, and that regulations promulgated thereunder are accordingly entitled to deference as a permissible interpretation that is not contrary to the statutory intent, under the two-step analysis

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[54] Patrick E. Tolan, Jr., "It's About Time: Registration and Regulation Will Boost Competence and Accountability of Paid Tax Preparers," *Virginia Tax Review*, vol. 31, Winter, 2012, p. 471.

[55] 682 F.3d 1316 (11th Cir. 2012).

[56] *Loving v. Internal Revenue Service*, 2013 U.S. Dist. LEXIS 7980 (D.D.C. 2013) (*Loving I*), modified by 2013 U.S. Dist. LEXIS 13878 (D.D.C. 2013), (*Loving II*) *appeal pending*, D.C.C. Dkt. No. 13-0561 (February 20, 2013).

[57] 682 F.3d 1316 (11th Cir. 2012).

[58] Since 1976, Code sec. 6109(a)(4) has authorized the Secretary to require preparers to use of a number other than a social security number, although until 2010, it did not.

[59] See 31 U.S.C. 9107; Treas. Reg. sec. 1.6109-2(d).

outlined by the U.S. Supreme Court.[60] The text of the statute, based on a statute that preceded the Federal income tax, is necessarily silent as to any aspect of income tax return preparation, but the court concluded that the use of the term "representation" and "in the presentation of their cases" could not be construed to encompass return preparation or the practice of tax return preparers. As construed by the court, the grant of authority is clearly limited to regulating persons who act in a representative capacity on controversies before an office of Treasury. In concluding that the text unambiguously precluded the regulation of return preparers, the court determined that the statute is not silent as to the issue to be decided, rendering moot consideration of whether the regulation presented a permissible interpretation of the statute.[61]

The Court also reviewed the various specific measures that impose duties and regulation on tax return preparers in the Code as part of its analysis of a broader statutory context. It concluded that the various duties, sanctions and penalties applicable to return preparers under the Code provide support for the textual analysis of section 330 of Title 31. In determining that return preparation is excluded from the scope of Title 31 regulatory authority, the court specifically refrained from evaluating the policy reasons underlying the effort to regulate tax return preparers, noting that "At *Chevron* step one, … such policy arguments have no relevance."[62]

In *Loving II,* the court addressed the government's motion for stay of the injunction. The court modified the injunction to clarify that the IRS need not suspend its PTIN program entirely, nor is it required to close testing and continuing education centers. However, the IRS cannot require attendance or collect fees with respect to the testing and education programs, nor can it impose penalties for failure to participate.

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[60] See, *Chevron U.S.A. Inc. v. Natural Res. Def. Council Inc.*, 467 U.S. 837 (1984) and *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011).

[61] See, *Chevron U.S.A. Inc. v. Natural Res. Def. Council Inc.*, 467 U.S. 837 (1984) and *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011).

[62] *Loving I*, p. 31.

III. CIVIL TAX PENALTIES AS A FACTOR IN VOLUNTARY COMPLIANCE

The civil penalty regime is one of the staples of tax administration. An understanding of the strengths and weaknesses of the penalty system requires a basic understanding of civil tax administration generally. Accordingly, below is an explanation of the Federal civil assessment process and an overview of Federal civil tax penalties.

A. Civil Assessment Process

The Federal income tax system relies upon self-reporting and assessment. A taxpayer is expected to prepare a report of his liability[63] and submit it to the IRS with any payment due. The Code provides general authority for the IRS to assess all taxes shown on returns,[64] other than certain Federal unemployment tax and estimated income taxes.[65] The assessment is required to be made by recording the liability in the "office of the Secretary" in a manner determined under regulations.[66] If the IRS determines that the assessment was materially incorrect, additional tax must be assessed within the limitations period.[67]

The authority to assess the additional tax may be subject to certain restrictions on assessment known as the deficiency procedures.[68] These deficiency procedures generally assure a taxpayer access to administrative review and a pre-payment judicial forum (i.e., the U.S. Tax Court) for reviewing disputed adjustments proposed by the IRS. A deficiency of tax occurs if the amount of certain taxes[69] assessed for a period, after reduction for any rebates of tax, is less than the liability determined under the Code. If the IRS determines that a taxpayer has not met his or her tax liability, the IRS generally first informs the taxpayer by letter. Most discrepancies in liability identified by the IRS are resolved through such "correspondence audits." In fiscal year 2012, for example, the IRS completed examinations of 1,657,698 returns, of which 1,155,518 were correspondence audits.

If the taxpayer does not comply after receipt of such a correspondence audit, an examining agent reviews the return and determines whether an adjustment in tax owed is required. The determination by the examining agent that an adjustment to the return is required results in a notice sent to the taxpayer known as the "30 day letter," which provides an

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[63] Sec. 6011 and 6012.

[64] See section 6201(a), which authorizes assessment of tax computed by the taxpayer as well as amounts computed by the IRS at the election of the taxpayer, under section 6014.

[65] Sec. 6201(b).

[66] Sec. 6203.

[67] Secs. 6204.

[68] Secs. 6211 through 6215.

[69] The taxes to which deficiency procedures apply are income, estate and gift and excise taxes arising under chapters 41, 42, or 44. Secs. 6211 and 6213.

opportunity for the taxpayer to invoke rights to an administrative appeal or to agree to the adjustments within 30 days.

The notice is informally referred to as a 30 day letter, because the letter informs the taxpayer that if a response is not provided within 30 days, the case proceeds to the next stage, i.e., either immediate assessment or the issuance of a notice of deficiency. Many cases conclude at this stage because the taxpayer agrees with the adjustments proposed. If the taxpayer responds and disputes the adjustments, the case is referred to an independent administrative appeals officer for review. In most cases, the taxpayer and the IRS agree on the merit or lack of merit of the adjustments proposed, and the cases are closed without issuance of a notice of deficiency. If the parties do not reach agreement administratively, the IRS must issue a formal notice of deficiency to a taxpayer,[70] which begins a period within which a taxpayer may petition the U.S. Tax Court. During that period, as well as during the pendency of any proceeding in Tax Court, assessment of the deficiency is not permitted.[71]

There are several exceptions to the restrictions on assessment of taxes that are generally subject to the deficiency procedures.[72] One of the principal exceptions is the authority to assess without issuance of a notice of deficiency if the error is a result of a mathematical or clerical error, generally referred to as math error authority. If the mistake on the return is of a type that is within the meaning of mathematical or clerical error, the IRS assesses the tax and sends notice of the math error to the taxpayer. Purely mathematical or clerical issues are often identified early in the processing of a return, prior to issuance of any refund; they are not typically identified as a result of an examination of a return.[73]

Assessments made in reliance on math error authority bypass taxpayer access to administrative review and a pre-payment judicial review unless the taxpayer requests abatement of the assessment within 60 days. The extent to which this relief from the summary assessment is understood is not clear. According to TIGTA, taxpayers seldom challenge math error assessments but those who do generally prevail. Few cases remain to be referred to examination.[74] These data support the contention that math error authority is efficient, and operates without prejudice to rights of taxpayers. Information developed by the National

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[70] Sec. 6212.

[71] Sec. 6213(a). If a taxpayer wishes to contest the merits in a different court, the taxpayer may agree to assessment of the tax, reserving his or her rights to contest the merits, pay the disputed amount, and pursue a claim for refund reviewable in a suit in Federal district court or Court of Federal Claims.

[72] Section 6213 provides that a taxpayer may waive the restrictions on assessment, permits immediate assessment to reflect payments of tax remitted to the IRS and to correct amounts credited or applied as a result of claims for carrybacks under section 1341(b), and requires assessment of amounts ordered as criminal restitution. Assessment is also permitted in certain circumstances in which collection of the tax would be in jeopardy. Secs. 6851, 6852 or 6861.

[73] See Inspector General for Tax Administration, Department of Treasury, *Some Taxpayer Responses to Math Error Adjustments Were Not Worked Timely and Accurately* (TIGTA 2011-40-059), July 7, 2011.

[74] Ibid.

Taxpayer Advocate, however, suggests the contrary. The failure to challenge a math error adjustment may not signify agreement with the adjustment, but may instead be a result of taxpayers' failure to understand and timely exercise their rights. After reviewing numerous examples of explanatory paragraphs included in IRS notices sent to taxpayers to inform them that math error adjustments had been made to their income tax returns, the National Taxpayer Advocate office determined that many were inadequate. Lack of clarity in the notices, whether as to the substance of the adjustment or the availability of any means of recourse may lead the recipient to allow his or her rights to lapse, and should not be equated with agreement with the adjustment.

Although most math errors identified by the IRS resulted in the assessment of additional tax, over 2.6 million of the 6.6 million math errors identified in fiscal year 2011[75] involved adjustments in taxpayers' favor for credits to which taxpayers were entitled but had failed to claim, mostly commonly the "Making Work Pay Credit" for taxable year 2010. In fiscal year 2012, after the expiration (in calendar year 2010) of the Making Work Pay Credit, the IRS identified only 2.7 million math errors.[76]

[75] 2011 IRS Data Book, Table 15, Math Errors on Individual Income Tax Returns, by Type of Error.

[76] 2012 IRS Data Book, Table 15, Math Errors on Individual Income Tax Returns, by Type of Error.

B. Civil Tax Penalties

Overview of penalties

The Code provides for both civil and criminal penalties to ensure complete and accurate reporting of tax liability and to discourage fraudulent attempts to defeat or evade tax. Civil and criminal penalties are applied separately. Thus, a taxpayer convicted of a criminal tax offense may be subject to both criminal and civil penalties, and a taxpayer acquitted of a criminal tax offense may nonetheless be subject to civil tax penalties. In cases involving both criminal and civil penalties, the IRS generally does not pursue both simultaneously, but delays pursuit of civil penalties until the criminal proceedings have concluded.

The majority of delinquent taxes and penalties are collected through the civil process. In determining whether a penalty applies along with an adjustment to a tax return, the examining agent is constrained not only by the applicable statutory provisions, but also by the written policy of the IRS not to treat penalties as bargaining points but instead to develop facts sufficient to support the decision to assert or not to assert a penalty.[77] The goal is to ensure consistency, fairness and predictability in administration of penalties.

Civil penalties are provided in Chapter 68 of the Code (sections 6651-6751). In general, there is a penalty for (i) fraud, (ii) failure to pay or file (referred to as delinquency penalties), (iii) failure to deposit estimated tax amounts, (iv) negligence, substantial understatement, substantial valuation misstatements, substantial overstatement of pension liabilities, substantial estate or gift tax valuation understatement, lack of economic substance, and undisclosed foreign financial asset understatements, and understatements with respect to reportable transactions (all of the items in this list are referred to as accuracy related penalties), (v) not filing or filing incorrect information returns, and (vi) aiding and abetting understatements, taking unreasonable return positions (applied to return preparers), promoting abusive tax shelters, and failing to furnish information regarding tax shelters (referred to collectively as the preparer, promoter, and protestor penalties).

These penalties are categorized into two types: additions to the tax and additional amounts (herein "additions to tax"), and assessable penalties. The additions to tax penalties are generally subject to deficiency proceedings and include delinquency penalties (section 6651), failure by individuals to pay estimated income tax (section 6654), failure by corporations to pay estimated income tax (section 6655), failure to make deposit of taxes (section 6656), accuracy-related penalties (sections 6662 and 6662A), and the fraud penalty (section 6663). Some of these penalties may be waived under certain circumstances, including a showing of reasonable cause under section 6664.

Assessable penalties can be assessed without restrictions (such as the opportunity for preassessment judicial review) applicable in deficiency cases. These penalties are imposed for failure to pay over collected taxes and to file information returns reporting specified information and transactions (section 6671 through 6720C), for failure to comply with certain information

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[77] Policy Statement 20-1, Internal Revenue Manual, sec. 1.2.20.1.1.

reporting requirements, such as failure to file correct information returns (Section 6721), failure to furnish correct payee statements (section 6722), and failure to comply with other information reporting requirements (sections 6723 and 6725). These penalties may also be waived under certain circumstances, including a showing of reasonable cause under section 6724.

The number and amount of penalties imposed has grown rapidly. For example, in fiscal year 1978, the IRS assessed 15.4 million penalties, for a total of $1.3 billion with $300 million of penalties abated in that year.[78] However, in fiscal year 2012, the IRS assessed 37.9 million penalties for a total of $26.9 billion, with 5 million abated totaling $11.3 billion.[79] The following is a breakdown by type of tax of the total penalties assessed and amounts assessed.[80]

Civil Penalties Assessed, by Type of Tax and Type of Penalty, Fiscal Year 2012

Type of return	Number assessed	Amount assessed (000)
Individual income taxes (incl. estate and trust)	28,502,399	$13,639,029
Business income taxes	995,533	$1,990,879
Employment taxes	7,288,193	$5,080,845
Excise taxes	580,536	$381,095
Estate and gift	7,673	$208,577
Non-return penalties[1]	536,159	$5,564,568
Total	37,910,493	$26,864,993

[1] Represents various penalties assessed and abated for a wide range of noncompliant behaviors, such as noncompliance related to tax return preparers and to information returns (e.g., Forms 1099, W–2, 3520–A, 8027, and 8300), as well as aiding and abetting; frivolous return filings; and misuse of dyed fuel. Also includes trust fund recovery penalties.

The most frequently assessed civil penalty in fiscal year 2012 was failure to pay, representing approximately 57 percent of the number of assessed return penalties.

[78] Alan J. Tarr and Pamela Jensen Drucker, "Civil Tax Penalties," *Tax Management Portfolio (BNA)*, vol. 634-3rd, 2012, p. A-1 (citing Letter from House Ways and Means Subcommittee on Oversight, Chairman J.J. Pickle to House Ways and Means Committee Chairman Dan Rostenkowski, dated June 16, 1989, transmitting the Subcommittee's recommendation on penalty reform; IRS Executive Task Force, *Report on Civil Tax Penalties*, February 22, 1989 (herein "IRS Task Force Report").

[79] 2012 IRS Data Book, Table 17, Civil Penalties Assessed and Abated, by Type of Tax and Type of Penalty. The penalties included in the table are those that were recorded in fiscal year 2012 regardless of the tax year to which they may relate.

[80] Ibid.

Legislative and other history

In November 1987, the Commissioner of Internal Revenue created a task force of IRS and Treasury employees to study civil tax penalties and develop a philosophy of penalties. That group published a report in February 1989 that provided several recommendations that were implemented.[81] For example, the IRS adopted a single penalty policy statement recognizing the primary purpose of civil tax penalties as a means of increasing voluntary compliance. The IRS also developed a comprehensive penalty handbook, revised its training programs, and increased communication with taxpayers regarding penalties.

Following the release of the IRS report, Congress undertook a major review of the penalty provisions resulting in the enactment in 1989 of the Improved Penalty Administration and Compliance Tax Act ("IMPACT").[82] The legislation provided changes to Code in an effort to simplify accuracy-related penalties and information reporting penalties. Specifically, Congress rationalized the penalty structure by reorganizing all accuracy-related penalties into a single Code section (section 6662) with a single rate (except for gross valuation misstatements). The legislation also introduced a reasonable cause exception and created a uniform definition of underpayment.

Since the enactment of IMPACT, Congress has added numerous penalty provision to the Code.[83] Due to the proliferation of penalties and increase in their complexity, there have been many penalty studies and suggestions provided for possible reform. The studies include reports prepared by Joint Committee on Taxation[84]and the Treasury Department[85] (both of which were mandated by the IRS Restructuring Act of 1998[86]), the National Taxpayer Advocate,[87] the Government Accountability Office,[88] Treasury Inspector General for Tax Administration,[89] and two practitioner

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[81] IRS Task Force Report.

[82] Subtitle G of the Omnibus Budget Reconciliation Act of 1989, the Improved Penalty Administration and Compliance Tax Act, December 19, 1989.

[83] National Taxpayer Advocate, *A Framework for Reforming the Penalty Regime," Annual Report to Congress*, vol. 2, December 2008, p. 7 (over 130 penalties in 2008) (herein "NTA Report").

[84] Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99), vols. I and II, July 22, 1999.

[85] Department of the Treasury, Office of Tax Policy, *Report to the Congress on Penalty and Interest Provisions of the Internal Revenue Code*, October 1999.

[86] IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, section 3801, July 22, 1998.

[87] NTA Report, p. 2.

[88] Government Accountability Office, *Inflation Has Significantly Decreased the Real Value of Some Penalties* (GAO-07-1062), August 2007 and Government Accountability Office, *IRS Should Evaluate Penalties and Develop a Plan to Focus its Efforts* (GAO-09-567), June 2009.

groups, the American Institute of Certified Public Accountants,[90] and the American Bar Association, Tax Section.[91] In addition to these reports, there have been many articles written about the current shortcomings of the penalty regime and suggestions for reform.[92]

Selected Issues Raised by Practitioner Groups and Others

Whether penalties encourage voluntary compliance

One criticism of the current regime is that many of the penalties which have been enacted, particularly over the past decade, seem to be designed for the purpose of raising revenue or punishing taxpayers rather than encouraging voluntary compliance.[93] To support this assertion, practitioner groups and others have pointed to the strict liability penalty created under section 6662(b)(6) which imposes a penalty on transactions which lack economic substance and the strict liability penalty provided under section 6707A for failure to disclose reportable transactions. They argue that the lack of a reasonable cause defense under these provisions eliminates the opportunity, and the incentives, to remediate and to become compliant. Under section 6707A, for example, the penalty may be imposed even if the failure to disclose the transaction is not willful but instead inadvertent (perhaps because the taxpayer could not identify whether a transaction was a reportable transaction).[94]

On the other hand, the fact that revenue increases due to penalties is not dispositive of this point and Congressional intent in enacting penalty legislation has generally been to improve compliance.[95] Thus, if a penalty is effective it will raise revenue though the penalty is never in fact assessed.

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[89] Inspector General for Tax Administration, Department of the Treasury, *Accuracy-Related Penalties Are Seldom Considered Properly During Correspondence Audits* (TIGTA 2010-30-059), June 4, 2010; Inspector General for Tax Administration, Department of the Treasury, *Significant Revenue Continues to Be Lost Because of Unassessed Failure to Pay Tax Penalties* (TIGTA 2009-30-052), March 24, 2009.

[90] American Institute of Certified Public Accountants, Penalty Reform Task Force, "Report on Civil Tax Penalties: The Need For Reform," April 11, 2013, p. 4 ("Penalties should treat similarly situated taxpayers similarly and have sufficient flexibility to account for differences in the particular facts and circumstances of each case.") (herein "AICPA report").

[91] American Bar Association, Section of Taxation, "Statement of Policy Favoring Reform of Federal Civil Tax Penalties," April 21, 2009 (herein "ABA Report").

[92] For a summary of the background, problems, and ideas for reform, see Jeremiah Coder, "Achieving Meaningful Civil Tax Penalty Reform and Making it Stick," *Akron Tax Journal*, vol. 27, 2012, pp. 153-186.

[93] NTA Report, p. 11 (noting that the philosophy for penalties has transitioned from voluntary compliance to economic deterrence); ABA Report, p. 10 (stating that some penalties, such as sections 6707 and 6707A on reportable transactions are designed to punish instead of to encourage compliance); AICPA Report, p. 4-5 (suggesting that new penalties are being proposed and existing penalties are being enhanced for the purpose of raising revenue and not for the purpose of increasing voluntary compliance).

[94] ABA Report, p. 10.

[95] See, *e.g.*, House Report to accompany H.R. 3080, United States-Korea Free Trade Agreement Implementation Act, H.R. Rep. No. 112-239, October 6, 2011, p. 21 (Congress believes it is appropriate to increase

Whether standards in some penalties are sufficiently clear

Practitioners point out that penalties relating to potentially abusive transactions has made this area inconsistent and confusing with respect to disclosure and reasonableness of questionable positions.[96] For example, if a substantial understatement penalty imposed on an individual is attributable to a transaction with a significant purpose of tax avoidance that is not a reportable transaction and that has economic substance, that individual can raise a defense to the penalty by relying in good faith on the opinion of a professional tax advisor, without disclosure and without establishing that the position had a "more likely than not" level of confidence.[97]

On the other hand, for listed transactions (and transactions substantially similar to listed transactions) and other reportable transactions having a significant purpose of tax avoidance, disclosure, substantial authority and a reasonable belief that the treatment was more likely than not the proper treatment and the presence of economic substance are prerequisites to a reasonable cause and good faith defense,[98] and special rules apply to determine whether the tax advisor or tax opinion is "disqualified."[99] For the same reportable transaction, if a taxpayer is able to demonstrate a lack of a significant purpose of tax avoidance or evasion, and that the transaction is not a listed transaction or substantially similar to a listed transaction, no penalty will apply if the taxpayer discloses the relevant facts relating to the questionable position and can demonstrate a reasonable basis for the tax treatment.[100]

Perception that automatic assessment of penalties lacks procedural fairness

The IRS automatically assesses penalties through the application of its automated matching system under section 6038(b)(1) for failures to file Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, and under section 6651(a)(1), for failures to file.

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the penalty for paid preparers who fail to comply with earned income tax credit due diligence requirements to deter non-compliance and for budgetary offset purposes.).

[96] ABA Report, pp. 6-7; AICPA Report, pp. 5-8.

[97] Sec. 6664(c)(1), (2); Treas. Reg. sec. 1.6664-4(c)(1).

[98] Sec. 6664(d)(2), (d)(3).

[99] Sec. 6664(d)(4)(B) provides that reliance on an opinion of a disqualified tax advisor or a disqualified opinion does not establish reasonable cause with respect to the section 6662A accuracy-related penalty on understatements attributable to reportable avoidance transactions. A tax advisor is disqualified if the tax advisor (1) is a material advisor who participates in the organization,, management, promotion, or sale of the transaction or is a person related to a material advisor who participates; (2) is compensated directly or indirectly by a material advisor with respect to the transaction; (3) has a fee arrangement that is contingent on all or part of the intended tax benefits from the transaction; or (4) has a disqualifying interest with respect to the transaction as determined under the regulations. Sec. 6664(d)(4)(B)(ii). A disqualified opinion is an opinion that (i) is based on unreasonable factual or legal assumptions; (2) unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person; (3) does not identify and consider all the relevant facts; or (4) fails to meet any other requirement prescribed by the Service. Sec. 6664(d)(4)(B)(iii).

[100] Sec. 6662(d)(2)(B).

Practitioners and others have noted that when penalties are imposed automatically, there is no mechanism in place to first determine whether the taxpayer's error was the result of particular conduct of a type that merits a penalty.[101] Though such penalties may later be abated, one group has argued that in many cases, taxpayers pay penalties even if they are unwarranted because of the difficulty and expense involved in challenging an assessed penalty.[102]

Whether penalties are disproportionate

Some penalties are not in proportion to each taxpayer's degree of non-compliance. For example, the failure to file penalty under section 6651 of the Code is five percent per month with a maximum penalty of 25 percent. Thus, although a taxpayer who files five months late is penalized more severely than a person whose delinquency is cured after 30 days, he is penalized the same as a person who files one year late or a person that never files.[103] Another example that has been noted as presenting the possibility of being disproportionate is the penalty for failure to maintain lists of advised clients with respect to reportable transactions under section 6708. That penalty is $10,000 per day with no cap if the IRS determines that efforts to timely produce documents are not sufficient, without regard to the number of persons omitted.[104]

[101] ABA Report, p. 8; NTA Report, p. 16.

[102] AICPA Report, p. 12.

[103] NTA Report, p. 25.

[104] AICPA Report, p. 8.