The Tax Professional and the New Tax Compliance Environment

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Developments, commencing in 1975 and culminating with the T.E.F.R.A. (Tax Equity and Financial Responsibility Act) legislation of 1982, have created a new tax compliance environment. These developments, discussed herein, have changed significantly the taxpayer's exposure to the Internal Revenue Service with respect to income tax returns that are determined to understate his correct liability. The developments have, more significantly, made the tax professional more accountable to the Internal Revenue Service and to clients for return reporting positions which are not upheld.

Philosophically, in the new environment a tax return is expected to be more nearly a statement of the taxpayer's belief of his correct tax liability than a ticket to the audit lottery and an "opening bid" to commence negotiations.

The Former (Pre-1975) Compliance Picture

In the former (which may be defined as the pre-1975) compliance environment there was, effectively, a built-in incentive for taxpayers and their advisors to take an aggressive (just short of negligent or fraudulent) attitude with regard to tax planning and tax return reporting.

So long as the taxpayer's return was not susceptible to a fraud or negligence penalty, it constituted a "ticket" to the "audit lottery". This lottery was a "no lose" game for the taxpayer. If the return was not selected for audit, the taxpayer won because his liability was only the amount which he had presented on his return. On the other hand, if the return was selected for audit the taxpayer would end up paying only the tax which he properly owed, without penalty absent negligence or fraud. Moreover, in those pre-1975 days, the taxpayers' liability for interest was fixed at 6% (simple) per annum—generally a bargain rate in modern times. Therefore, the taxpayer would actually gain from having the use of his tax money at a simple 6% interest rate during the period between the due date of the return and the time when he was forced to pay the determined tax deficiency.

The principal civil tax penalties upon which the Service relied to enforce compliance were dependent upon the subjective intent of the taxpayer. If any part of an understatement on the subject tax return was due to fraud then the taxpayer was subject to a penalty of 50% of the entire understatement (not just the fraudulent portion).\(^1\) If any

\(^1\) IRC § 6653(b).
part of an understatement on the subject tax return was due to negligence (or the nonfraudulent disregard of rules and regulations) then the taxpayer was subject to a penalty of 5% of the entire understatement (not just the portion attributable to negligence or disregard).\

In order to impose the fraud penalty the Internal Revenue Service had to prove, by "clear and convincing evidence" that the taxpayer intended to evade his tax liability.

With respect to the underlying facts, unless it was established that the taxpayer knew that the facts upon which his return reporting position was based were untrue, the fraud penalty would not be applicable. With respect to the applicable legal principles, the taxpayer would avoid the penalty if there was any rational argument in support of his legal position.

The avoidance of the negligence penalty with respect to positions of law required more, but only slightly more, support for the taxpayer than did the avoidance of the fraud penalty. So long as there was a reasonable basis for the taxpayer's position the penalty would not be applicable. A "reasonable basis" for a legal position can exist even though it is far more likely than not that the taxpayer would lose if the issue were raised by the Internal Revenue Service.

In short, as a practical matter the taxpayer was not liable for the traditional, intent dependent, penalties for fraud or negligence so long as there was virtually any support for the legal positions taken and so long as he exercised a modest degree of care to see that the facts relied upon in return preparation were not incorrect.

Prior to the recent compliance developments the tax professional could effectively provide his client with a virtual guarantee that there would be no penalty exposure with regard to aggressive tax return positions. The professional could give an opinion that there was a "reasonable basis" for a reporting position even if the professional believed that it was most unlikely that the position would be upheld. Except for those egregious situations justifying criminal prosecution or possible referral for professional disciplinary action, the Internal Revenue Service had no effective means to control the tax professional's conduct. Moreover, since it was the taxpayer who was the beneficiary of the professional's opinion by virtue of the virtual immunity to penalty it provided, there was little to inhibit tax professionals from participating in, and often promoting, aggressive tax planning and tax return reporting. Indeed, some have observed that those tax professionals who chose to

\(^2\) IRC § 6653(a).

\(^3\) IRC § 7454(a).


engage in such activities may have built up clientele at the expense of their more restrained professional colleagues.  

The tax professional now must practice in a new, tougher tax compliance environment. There is no longer the “free lunch” of unrealistically low interest rates. The Internal Revenue Service no longer lacks any civil penalty which can be imposed directly upon the professional. Moreover, there is now a definite “downside risk” to the taxpayer for taking aggressive tax return positions.

**Interest On Deficiencies**

Today, there is no inherent benefit to the deferral of one’s tax payments by virtue of the rate of interest charged on tax deficiencies. To the contrary, at this time, the tax professional must weigh the cost of interest on deficiencies heavily in the scale when advising with regard to debatable tax return reporting positions.

In 1975 the Internal Revenue Code was amended to establish a new rate of interest of 9%, effective July 1, 1975, and to provide for possible adjustments to the interest rate each February 1 (starting with February 1, 1976), depending upon the prime interest rate charged by banks the previous September. The adjustments were to be made no more frequently than every two years. In 1981 the Code was amended to make the interest rates on deficiencies even more responsive to changing market interest rates. Under the Economic Recovery Tax Act of 1981 (“ERTA”), interest rates were to be adjusted each year on January 1 (starting with January 1, 1983) depending upon the prime rates charged by banks the previous September. The interest rates on tax deficiencies for all periods prior to the effectiveness of TEFRA were as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>Rate of Interest (simple)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior to July 1, 1975</td>
<td>6%</td>
</tr>
<tr>
<td>July 1, 1975 to January 31, 1976</td>
<td>9%</td>
</tr>
<tr>
<td>February 1, 1976 to January 31, 1978</td>
<td>7%</td>
</tr>
<tr>
<td>February 1, 1978 to January 31, 1980</td>
<td>6%</td>
</tr>
<tr>
<td>February 1, 1980 to January 31, 1982</td>
<td>12%</td>
</tr>
<tr>
<td>February 1, 1982 to December 31, 1982</td>
<td>20%</td>
</tr>
</tbody>
</table>

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*IRC § 6621. As amended by Section 7(a) (1) of Public Law 93-625, January 3, 1975, effective July 1, 1975.
TEFRA dramatically changed the situation with respect to interest charged on tax deficiencies commencing January 1, 1983. The rate of interest has been made more sensitive to changing market interest rates and is now subject to possible adjustment twice a year, each January 1 and July 1, depending upon the “adjusted prime rate charged by banks” during the six month period ending the previous September 30 (for the January 1 rate) or the previous March (for the July 1 rate). Even more significant was the change from simple interest to interest which is compounded daily (effective for interest accruing on deficiencies after December 31, 1982). As of this writing, the post-1982 interest charged on tax deficiencies is as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 1983 to June 30, 1983</td>
<td>16%</td>
</tr>
<tr>
<td>July 1, 1983 to December 31, 1983</td>
<td>11%</td>
</tr>
<tr>
<td>January 1, 1984 to June 30, 1984</td>
<td>11%</td>
</tr>
</tbody>
</table>

The new structure for interest on tax deficiencies, particularly the relationship to actual market rates and the daily compounding of interest, creates a new downside risk for many taxpayers who are taking aggressive tax return positions. At the least, the interest on a possible tax deficiency is an important factor to be considered.

**The Return Preparer Penalties**

In the Tax Reform Act of 1976 Congress added return preparer penalties to the Internal Revenue Code. In addition to detailed provisions regarding the “mechanical” aspects of return preparation, the new provisions established a $100 per return penalty imposed for an understatement due to negligence or the intentional disregard of rules and regulations and a $500 per return penalty for an understatement due to a willful attempt to understate the liability. The preparer penalties are not restricted in application to those who physically prepare the tax return. One can be a preparer for purposes of the penalties if he, for example, gives advice as to a material entry on the return.

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9 IRC § 6621.
10 IRC § 6622.
12 There are penalties imposed for failure to comply with detailed rules regarding signatures, copies, information returns, etc. which are not pertinent to this discussion. See IRC § 6695.
13 IRC § 6694(a).
14 IRC § 6694(b).
15 See Benjamin, *Definition of a Preparer—Who is He?*, 10 Tax Adviser 516 (1979).
The preparer penalties did not impose any novel standards of conduct for the tax professional, for the penalties pertinent to this discussion were imposed only for fraud or negligence. However, the preparer penalties were of major significance because they injected into the tax compliance system civil penalties which were applicable to those who were not taxpayers. Hence, in the context of a discussion of the new compliance environment, these penalties are of primary importance as a first step in the process of making those who participate in another's understatement of tax liability directly responsible to the Internal Revenue Service.

The Valuation Overstatement Penalty

In ERTA, in 1981, Congress added a totally new penalty to the Internal Revenue Code to create a "downside risk" for those taxpayers who understated their liabilities due to an overstatement of the value (or basis) of property.

The valuation overstatement penalty is applicable if an individual, closely held corporation or personal service corporation has an underpayment of income tax due to a valuation overstatement. An overstatement of value (or adjusted basis) exists if the determined value (or adjusted basis) is less than the amount claimed on the return. The amount of the valuation overstatement penalty is determined by the ratio (expressed as a percentage) that the claimed value (or basis) bears to the determined value (or basis), as follows:

From 150% to 200% the penalty is 10%.
From 200% to 250% the penalty is 20%.
Over 250% the penalty is 30%.

For example, assume a 50% bracket taxpayer donated to a church 1,000 bibles for which he claimed a value of $25 each. Thus he took a deduction of $25,000 and reduced his income tax liability by $12,500. If it is determined that the value of the bibles was only $5 each (perhaps the price paid) then there would have been a $20,000 valuation overstatement. The overstatement would have caused a $10,000 understatement of liability. The applicable ratio of claimed value to actual value is 25,000/5,000 or 500%. Accordingly, the penalty would be 30% of $10,000 or $3,000.

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17 IRC § 6659(f)(2).
18 IRC § 6659(f)(3).
19 IRC § 6653(c)(1). In essence, an underpayment is the same as a deficiency.
20 IRC § 6659(a).
21 IRC § 6659(b).
The valuation overstatement penalty is not applicable to property that was held by the taxpayer for more than five years.\(^\text{22}\) Nor is the penalty applicable if the taxpayer's underpayment for the year attributable to all valuation understatements is less than $1,000.\(^\text{23}\)

The valuation penalty may be waived (in whole or part) upon a showing that there was a reasonable basis for the amount claimed and that the claim was made in good faith.\(^\text{24}\)

The valuation overstatement penalty is not directly applicable to the tax professional. However, it does affect the professional's relationship with the client. It is, certainly, necessary for the practitioner to be sure that the client is aware that the penalty exists and to advise that care should be taken to utilize realistic valuations in tax planning and tax reporting. The tax professional is, further, well advised to be sure to clarify his role (or the absence of any role) in the determination of the valuation of property for tax reporting purposes. An after-the-fact discussion of the allocation of blame for the valuation overstatement penalty is best avoided by clarification of the professional's duty at the time a return reporting position is taken.

Additional Fraud and Negligence Penalties

Additional penalties for negligence and fraud (1982) have been added to the Internal Revenue Code. These penalties are cumulative to the traditional negligence and fraud penalties.

The traditional negligence penalty is 5% of the taxpayer's entire understatement of tax for the year, if any part of the understatement was due to negligence or the intentional disregard of rules and regulations.\(^\text{25}\)

The traditional fraud penalty is 50% of the taxpayer's entire understatement\(^\text{26}\) for the year, if any part of the understatement was due to fraud.

The new additional negligence penalty is applicable to returns originally due after 1981.\(^\text{27}\) The new additional fraud penalty is applicable to returns originally due after September 3, 1982.\(^\text{28}\) The new additional negligence and fraud penalties are both in the amount of 50% of the interest payable on the amount of the underpayment attributable to the penalized conduct.\(^\text{29}\)

The operation of these penalties is best illustrated by an example. Assume a 50% bracket taxpayer who reports taxable income of $50,000

\(^{22}\) IRC § 6659(c).
\(^{23}\) IRC § 6659(d).
\(^{24}\) IRC § 6659(e).
\(^{25}\) IRC § 6653(a)(1).
\(^{26}\) IRC § 6653(b)(1).
\(^{27}\) Sec. 722(b)(1)(2) of Public Law 97-34 Aug. 13, 1981.
\(^{28}\) Sec. 325(a), (b) of Public Law 97-248, Sept. 3, 1982.
\(^{29}\) IRC § 6653(a)(2); 6653(b)(2).
for 1982. Assume further, that the taxpayer is determined to have omitted $20,000 of gross receipts and is also determined to have erroneously (but nonfraudulently and without negligence) accrued a deduction for $80,000 in 1982 which should have been deducted in 1983. The taxpayer would, therefore, have a total 1983 deficiency of $50,000, of which $10,000 was due to the omitted gross receipts and $40,000 was due to the erroneous deduction.

If the $20,000 income omission was due to fraud there would be a traditional fraud penalty of $25,000, which is 50% of the $50,000 total deficiency for the year, even though only $10,000 of the deficiency was due to fraud. Similarly, if the $20,000 income omission was due to negligence there would be a traditional negligence penalty of $2,500, being 5% of the total understatement for the year.

In addition to the traditional fraud or negligence penalty there would be added a new cumulative penalty equal to 50% of the interest payable on the understatement due to the penalized conduct. If it is assumed that at the time the penalty is assessed the interest payable with respect to the understatement would be 40%, the additional penalty would be 20% of the understatement due to the penalized conduct. In the example, the understatement due to the penalized conduct (be it fraud or negligence) would be $10,000 (50% of the omitted receipts). Accordingly, the additional penalty would be $2,000.

Therefore, under the assumed facts, if there were a fraud penalty imposed it would be in the amount of $27,000. If there were a negligence penalty imposed it would be in the amount of $4,500.

### Penalty for Promotion of Abusive Tax Shelters and Injunctions

The penalty for the promotion of an “abusive” tax shelter is potentially applicable to any person who organizes (or assists in organizing) or who participates in the sale of an interest in any entity, plan or arrangement.\(^\text{30}\)

The penalty will be imposed if any such person makes or furnishes a statement with respect to the securing of any tax benefit resulting from the holding of an interest in an entity or participating in a plan or arrangement which the person knows, or has reason to know, is false or fraudulent as to a material matter.\(^\text{31}\)

The penalty also will be imposed if any such person makes a “gross valuation overstatement” as to any material matter.\(^\text{32}\) There is a “gross valuation statement” if there is a statement as to the value of any property or services which is directly related to the amount of any allowable deduction or credit, and the stated value exceeds 200% of the amount

\(^\text{30}\) IRC § 6700(a)(1).
\(^\text{31}\) IRC § 6700(a)(2)(A).
\(^\text{32}\) IRC § 6700(a)(2)(B).
determined to be the correct value. The I.R.S. may waive the gross valuation overstatement penalty on a showing that the stated value had a reasonable basis and was made in good faith.

The amount of the penalty for promotion of an abusive tax shelter is (in addition to any other applicable penalty) the greater of $1,000 or ten percent of the gross income derived or to be derived from the activity of organizing or participating in the sale of interests in the pertinent entity, plan or arrangement. Certainly, there is going to be ample room for debate as to the correct amount of the penalty in many cases.

In addition to the ability to impose civil penalties, the Service has been empowered to seek injunctions to prohibit any person from engaging in conduct subject to the penalty for promoting abusive tax shelters. An action seeking an injunction can be commenced in the United States District Court for the district in which the defendant either resides, has his principal place of business or engaged in conduct violative of Section 6700. If the court finds that the defendant has violated the section and that an injunction is appropriate to prevent recurrence, the court may enjoin the defendant from engaging in activities which are violative of Section 6700.

The Service in October, 1983, issued Revenue Procedure 83-78 establishing a procedure for potential actions against promoters of “abusive” tax shelters, including the assertion of penalties, the seeking of injunctions and the possible issuance of pre-filing letters to the promoter’s investors. These letters are, in effect, warnings to the investor not to claim the tax benefits promised by the promoter.

The new penalty for the promotion of abusive tax shelters requires the tax professional engaged in any way in a “promotion” to take precautions to avoid the possibility of a controversy regarding his liability for the penalty. Obviously, the professional should not knowingly participate in any fraudulent promotion. However, it must be recognized that where there is discovered to have been a fraudulent statement made, there can be substantial issues raised as to whether the professional knew (or had reason to know) of the misstatement. Accordingly, the professional should do all possible to be beyond accusation. There should be contemporaneous documentation of the scope of the professionals’ duties with respect to the promotion. The professional should

38 IRC § 6700(b)(1).
39 IRC § 6700(b)(2).
40 IRC § 6700(a).
41 IRC § 7408(a).
42 IRC § 7408(a). See also IRC § 7408(c).
also take reasonable steps to insure that the statements made regarding
the promotion are correct. Regrettfully, since there will always be some
uncertainty as to the degree of investigation required, the professional
can rarely, if ever, be perfectly sure of his position. At a minimum, the
professional should raise questions if he suspects that there might be a
fraud. He must also consider the difficult question of what steps are
appropriate if an ongoing fraud is discovered. Unfortunately, it is im-
possible to present universally applicable guidance as to the proper
steps to take, particularly in the context of an ongoing professional
relationship, where there is a suspicion of fraud. For the present it is
probably necessary to conclude that any participation in a promotion
which turns out to be fraudulent will place the professional in jeopardy
of a penalty proceeding. On the other hand, a failure to meet one’s
professional obligation to a client will also create potential liability.
Hence, the professional may well find himself in a possible dilemma in
which the tax law, professional ethical standards, potential civil liability
and even pertinent criminal exposure may all be relevant. The new
compliance environment is a very difficult one for promoters of abusive
tax shelters and, as well, for those who assist them.

The Penalty for Aiding and Abetting An Understatement

Until the enactment of T.E.F.R.A., the Internal Revenue Service had
a criminal, but no civil, sanction available against one who knowingly
aided and abetted the understatement of the tax liability of another.
Now the Service can, in appropriate cases, impose civil sanctions on
such persons.

The penalty for aiding and abetting the understatement of tax is ap-
plicable if a person who aids or assists, procures or advises with respect
to the preparation of a return or other document in connection with a
tax matter. The document (or a portion) will be used in a material
matter arising under the tax laws and will result in the understatement
of another person’s liability.

The penalty can be applicable to a person by virtue of the acts of a
subordinate. This derivative liability can result by virtue of one’s order-
ing a subordinate to act in violation of the statute or by knowing of,
and not attempting to prevent, the subordinate from so acting. However,
one is not liable for the penalty merely for rendering mechanical
assistance (e.g., typing) in connection with the preparation of the per-
tinent document. As in the analogous criminal statute, the applicability

39 IRC § 7206(2).
40 IRC § 6701(a)(1).
41 IRC § 6701(a)(2)(3).
42 IRC § 6701(c).
43 IRC § 6701(e).
of the civil penalty is not dependent upon knowledge by the taxpayer that the subject tax return is false.\textsuperscript{44}

The amount of the penalty is determined by the number of documents, taxpayers and taxable periods concerned. Basically, the penalty is $1,000 ($10,000 if it relates to a corporation's tax liability) with respect to each document, limited by the restriction that there will be only one penalty per taxpayer per taxable period.\textsuperscript{45} Thus, if two penalized documents are provided to a single taxpayer for a given taxable year, there would be only a single penalty of $1,000 (or $10,000 for a corporation). If a given taxpayer is provided with two documents which relate to two taxable years the total penalty would be $2,000 (or $20,000 for a corporation). The providing of penalized Forms K-1 to each of 50 partners for a given year would result in penalties of $50,000 (or more if there are corporate partners). It can be anticipated that the I.R.S. will take the position that a single penalized document which pertains to the tax liabilities of two taxpayers will be subject to a $2,000 penalty (or $20,000 if corporate taxpayers are involved).

The penalty imposed by Section 6701 is in addition to any other penalty which may be imposed.\textsuperscript{46} Hence, it is possible that this penalty could be imposed, in appropriate circumstances, together with the penalty for promotion of an abusive tax shelter.

The tax professional should, clearly, avoid the knowing participation in the preparation of a document which would subject him to this penalty. This is obvious. However, it is sometimes less obvious to a third party (particularly the I.R.S.) that a professional who had anything whatsoever to do with the preparation of a false document did not know of the falsity. Hence, in every aspect of tax practice the professional must take precautions to avoid involvement or even apparent involvement in improper actions. Here again, the tax professional who prepares any document in connection with a tax matter must take precautions to define the scope of his responsibility for the accuracy of the document. He should also not overlook obvious indications that any document material to a tax matter is not accurate.

\textit{The Penalty for a Substantial Understatement of Liability}

In T.E.F.R.A. Congress created a new standard of tax return reporting which must be met in order to avoid a civil tax penalty. The "no

\textsuperscript{44} IRC § 6701(d).
\textsuperscript{45} IRC § 6701(b).
\textsuperscript{46} IRC § 6701(f)(1). If a person is penalized under this provision with respect to a document, he cannot also be penalized under the return preparer penalties for the negligent and willful understatement of liability with respect to the same document, IRC § 6701(f)(2).
fault” penalty for a substantial understatement of liability$^{47}$ may be applicable even though a taxpayer is neither negligent nor fraudulent.

The penalty may be imposed for any “substantial understatement” of income tax, in an amount equal to 10% of the underpayment due to the “substantial understatement.” The penalty is a “no fault” penalty in the sense that it may be applicable without regard to the taxpayer’s intent. If there is a “substantial understatement” the penalty is imposed unless one of the criteria for escaping it is met.

An “understatement” is defined as the excess of the amount required to be shown due on a return over the amount shown due on the return less any permissible reduction.$^{48}$ Thus, if a taxpayer reports a $20,000 liability and it is determined that the tax liability which should have been shown on the return was $45,000, there would be a $25,000 “understatement,” subject to possible reduction for penalty purposes.

A “substantial” understatement adequate to trigger the penalty is one which exceeds the greater of 10% of the amount required to be shown due on the return or $5,000$^{50}$ (for a corporation other than an S corporation or personal holding company, $10,000).$^{51}$ Therefore, if for an individual it was determined that the correct tax liability was $45,000 and the tax liability shown due on the return was $20,000, the threshold amount to trigger liability for the penalty would be $5,000, since 10% of the amount required to be shown on the return would be only $4,500. On the other hand, if for an individual the correct determined tax liability was $90,000, then the threshold amount to trigger the penalty would be an understatement of $9,000, since 10% of the $90,000 required to be shown on the return is greater than $5,000.

If there is an understatement initially large enough to meet the threshold for application of the penalty, consideration must be given to whether the understatement is subject to reduction for penalty purposes. An understatement will, of course, result from one or more items of adjustment to the tax return as filed. Hence, each item of adjustment contributing to the understatement must be analyzed to see whether it can qualify for reduction, i.e., escape from penalty.

The relevant standards to be met in order for an item to qualify for a reduction of the understatement penalty depend upon whether the item is attributable to a “tax shelter.” Hence, as to each item of adjustment one must first determine whether the item in question is a “tax shelter” item.

A “tax shelter” is defined in the statute as a partnership or other entity, plan or arrangement which has as its principal purpose the

$^{47}$ IRC § 6661.

$^{48}$ IRC § 6661(a).

$^{49}$ IRC § 6661(b)(2).

$^{50}$ IRC § 6661(b)(1)(A).

$^{51}$ IRC § 6661(b)(1)(B).
avoidance or evasion of federal income tax.\textsuperscript{52} There can be considerable
debate as to whether a given entity, plan or arrangement is a "tax shel-
ter" under the statutory definition. In Proposed Regulations the Internal
Revenue Service has indicated its view that:

"Typical of tax shelters are transactions structured with little
or no motive for the realization of economic gain, which utilize
the mismatching of income and deductions, overvalued assets,
or assets with values subject to substantial uncertainty, non-
recourse financing, financing techniques which do not conform
to standard commercial business practices, or the mischarac-
terization of the substance of the transaction." \textsuperscript{53}

On the other hand the Service takes the position that:

"[T]he principal purpose of an entity or arrangement is not
the avoidance or evasion of Federal income tax if the entity,
plan, or arrangement has (sic) its purpose, the claiming of
exclusions from income, accelerated deductions or other tax
benefits in a manner consistent with the Congressional
purpose." \textsuperscript{54}

It can be difficult, obviously, to predict with certainty whether a given
item is or is not a tax shelter item.

If an understatement is attributable to an item which is not a tax
shelter item, then for penalty purposes the understatement is reduced
with respect to that item if there exists or existed "substantial authority"
for the taxpayer's reporting,\textsuperscript{55} or the "relevant facts" were adequately
disclosed on or with the return.\textsuperscript{56}

"Substantial authority" is a new term. It is not defined in the statute
and was designed to be an entirely new standard. The definition of this
new and important phrase will have to be discerned from future
developments.

For there to be "substantial authority", first there must be "authority."  
"Authority" in the view of the I.R.S. would include the Code, Regulations,
judicial decisions, official administrative announcements such as
published Revenue Rulings and Revenue Procedures, official statements
of Congressional intent and the like.\textsuperscript{57} "Authority" would not include

\textsuperscript{52} IRC § 6661(b)(2)(C)(ii).
\textsuperscript{53} Proposed Regs. § 1.6661-5(b)(1).
\textsuperscript{54} Proposed Reg. § 1.6661-5(b)(2).
\textsuperscript{55} IRC § 6661(b)(2)(B)(1). The I.R.S. view is that "substantial authority"
must exist with respect to the issues of fact as well as law. Proposed Regs.
§ 1.6661-3(d).
\textsuperscript{56} IRC § 6661(b)(2)(B)(ii).
\textsuperscript{57} Proposed Regs. § 1.6661-3(b)(2).
conclusions reached in the opinions of tax professionals, treatises, legal periodicals, and even Internal Revenue actions of less than published Ruling or Revenue Procedure statute; for example, a private letter ruling. A document which does not, in the view of the Service, rise to the level of “authority” may nevertheless be relevant in determining whether there is “authority” because of its inherent persuasiveness or because of the fact that it, itself, is based upon authority.

If there is some “authority” for the taxpayer’s reporting position, the question whether there exists “substantial” authority requires a weighing process. The bottom line is whether the authority in favor of the taxpayer’s position is “substantial” when weighed against the authority opposed to it. This does not mean that the taxpayer’s position must be more likely than not correct, but it does mean that it must be something more than a “reasonable basis” position sufficient to avoid the traditional negligence penalty. As stated in the Proposed Regulations:

“The taxpayer’s position must be stronger than one which is arguably but fairly unlikely to prevail in court.”

The understatement as to which the penalty may be imposed may be reduced for a non-tax shelter item (even absent substantial authority) if the taxpayer makes an “adequate disclosure” of the “relevant facts.” The disclosure may be on, or with, the tax return in question. The Service has taken a position in Proposed Regulations with regard to what will constitute adequate disclosure. In general terms, an adequate disclosure is made if there is an attachment to the tax return which is clearly labeled as a Section 6661 disclosure, which identifies the item, the amount of the item and the facts affecting the tax treatment of the item that reasonably may be expected to apprise the Internal Revenue Service of the nature of the potential controversy regarding the tax treatment of the item. More detailed rules regarding what is, and what is not, an adequate disclosure are in the process of development at this writing.

If an item is classified as a “tax shelter” item there will be no reduc-
tion of the understatement by virtue of any disclosure.\textsuperscript{66} In order to obtain a reduction of the understatement due to a tax shelter item, there must not only exist substantial authority but also a reasonable belief that the reported tax treatment was "more likely than not" correct.\textsuperscript{67} As a result, for a tax shelter item, it is necessary as a practical matter for most taxpayers to have the opinion of a professional upon whom they can reasonably rely, which states that the tax return reporting position is more likely than not correct.\textsuperscript{68} It should be noted that the Internal Revenue Service has taken the position, in Proposed Regulations, that with respect to a tax shelter item attributable to a pass-through entity (partnership, S corporation or a trust), the entity (not the taxpayer who would be subject to penalty) must have a reasonable "more likely than not" belief.\textsuperscript{69} Thus, in the I.R.S. view, the reasonable belief of the taxpayer on whom the penalty would be imposed is not relevant.\textsuperscript{70}

The penalty for a substantial understatement may be waived (in whole or part) by the Internal Revenue Service on a showing that there was reasonable cause for the understatement and that the taxpayer acted in good faith.\textsuperscript{71} The I.R.S. has taken the position in Proposed Regulations that:

\ldots [R]eliance on an information return or on the advice of a professional (such as an appraiser, an attorney or accountant) will not of itself constitute a showing of a reasonable cause or good faith. Rather, circumstances which may indicate reasonable cause and good faith include, for example, an honest misunderstanding of the facts or law that is reasonable in light of the experience and education of the taxpayer. Thus, an inadvertent error as to a matter of fact that is reasonable under all the circumstances would, in general, indicate reasonable cause and good faith.\textsuperscript{72}

The I.R.S. has announced a "voluntary disclosure" policy with respect to the substantial understatement penalty. In essence, a "qualified amended return" which reports additional tax or makes an adequate disclosure will be treated as if it had been the originally filed return.\textsuperscript{73} A qualified amended return must be filed before the taxpayer is first

\textsuperscript{66} IRC § 6661(b)(2)(C)(i)(I).
\textsuperscript{67} IRC § 6661(b)(2)(C)(i)(II).
\textsuperscript{68} ProposedRegs. § 1.6661-5(d). The opinion of a professional is not, however, absolutely required. \textit{Id.}
\textsuperscript{69} ProposedRegs. § 1.6661-5(e).
\textsuperscript{70} \textit{Id.}
\textsuperscript{71} IRC § 6661(c).
\textsuperscript{72} ProposedRegs. § 1.6661-6(a).
\textsuperscript{73} ProposedRegs. § 1.6661-6(c)(1).
contacted concerning examination of the return and before any person potentially liable for the Section 6700 penalty (for promotion of abusive tax shelters) is first contacted regarding an action which affects the taxpayer's return.\(^7\)

The Service will also provide an automatic waiver with respect to pass-through non-tax shelter items if the taxpayer makes a prescribed type of disclosure which, in effect, constitutes a surrogate disclosure "on behalf of" the entity.\(^7\)

The substantial understatement penalty has substantially changed the relationship between the I.R.S., the taxpayer and the tax professional. Taxpayers may well tend to look to the tax professional, whether in the role of advisor or of tax return preparer, as responsible for the avoidance of the penalty. Certainly, it is important for the professional to clarify to the client the extent to which a plan or tax return reporting position may be vulnerable to the penalty. Where the professional cannot assure the client that a tax return will not be subject to penalty, the client should be warned. If not, there can be recriminations (or worse) if the penalty is imposed. In view of the many uncertainties inherent in regard to any tax return of even modest complexity and the I.R.S. view that an "innocent" taxpayer can be penalized for an error on a pass-thru entity return, there are few situations in which a client can be assured that his return will not be subject to a penalty in the event of a substantial (10%) adjustment on examination.

Some Observations for the Tax Professional

As noted herein, there is a new tax compliance environment. The tax professional is far more vulnerable to the I.R.S. and taxpayers than previously. There can no longer be aggressive planning and reporting without concern for penalty exposure for the taxpayer and/or the professional. Indeed, the substantial increase in the I.R.S. civil penalty arsenal renders it likely that penalty considerations will be a part of many tax examinations involving what the I.R.S. perceives to be aggressive reporting or "abusive" tax shelter planning.

One can, at this juncture, provide little general guidance to the tax professional functioning in the new environment. However, one can observe that the best solution to a problem is the avoidance of the problem in the first place. Obviously, the professional must in fact not commit improper actions. However, in order to avoid controversy he must do what he can to make it clear that he is not responsible for any improprieties which may be committed by others.

The life of the tax professional in the new compliance environment is not an easy one. The professional is subject to duties to the client,

\(^7\) ProposedRegs. § 1.6661-6(c)(2).
\(^7\) ProposedRegs. § 1.6661-6(b).
the Internal Revenue Service, the accounting and/or legal profession and occasionally to others as well. These duties are, sometimes, inconsistent. Moreover, when the practitioner finds himself (albeit innocently) in any way connected with an improper activity there may be difficult choices to make regarding the correct course of action.

Regretfully, one must conclude that the new compliance environment presents problems for which there may be no perfectly correct solution for the taxpayer and/or the tax professional. It may well be that the professional must now devote a portion (in some cases a substantial portion) of his efforts to the avoidance of potential liability for a possible penalty.

In conclusion, it can be noted that it remains to be seen whether the new tax compliance environment will promote greater taxpayer compliance. Certainly, it should promote greater self protective efforts on the part of tax professionals. For better, or worse, in this new environment, the tax professional must consider the Garbis Law of Survival: "If you can't completely solve a tax compliance problem, at least make it someone else's."