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TAX PROCEDURE AND LITIGATION COMMITTEE
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TAXATION SECTION
TAX PROCEDURE AND LITIGATION COMMITTEE¹**

**COMMENTS TO THE PROPOSED TREASURY REGULATIONS
ADDING SECTIONS 1.6664-4(c)(3)(iii) and 1.6664-4(c)(2)**

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¹ The comments contained in this paper are the individual views of the author who prepared them and do not represent the position of the State Bar of California or of the Los Angeles County Bar Association.

² Although the participants on the project might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate in this project.

EXECUTIVE SUMMARY

On December 31, 2002, the Treasury Department released proposed Treasury Regulations that limit the defenses available to the imposition of the accuracy related penalties.

This paper makes comments on proposed additions to Treasury Regulation section 1.6664-4(c) as follows:

“1.6664-4(c)(iii) *Reliance on the invalidity of a regulation.* A taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith unless the taxpayer adequately disclosed, in accordance with § 1.6662-3(c)(2), including the disclosure of the position that the regulation in question is invalid, and, if the position relates to a reportable transaction as defined in § 1.6011-4T(b), the transaction is disclosed in accordance with § 1.6011-4T.”

“1.6664-4(c)(2) *Opinions or advice relating to reportable transactions.* Taxpayers may not reasonably rely on an opinion or advice of a tax advisor if the opinion or advice is disqualified under this paragraph. An opinion or advice is disqualified if it relates to the appropriate tax treatment of a reportable transaction, as defined in § 1.6011-4T(b), and the taxpayer does not disclose the transaction in accordance with § 1.6011-4T.”

It is the authors' recommendation that the proposed Treasury Regulation not be adopted because it is contrary to current case law, Congressional intent and will not promote the fundamental objective for imposing penalties. It will also impose an unrealistic and undue burden on taxpayers.

DISCUSSION

I. OVERVIEW

On December 31, 2002, the Treasury Department released proposed Treasury Regulations that limit the defenses available to the imposition of the accuracy related penalties. The proposed changes to the Treasury Regulations will eliminate the reasonable cause defense for a taxpayer who relied on the advice or opinion of a tax professional that a Treasury Regulation is invalid and the position is not disclosed on a return. This proposed Treasury Regulation should not be adopted because the Treasury Regulation is contrary to current case law, Congressional intent and will not advance the fundamental objective for imposing penalties. In addition, the Treasury Regulations will impose unrealistic and undue burdens on taxpayers.

The objectives for imposing penalties will be met if the current law is not changed. Professionals are retained by taxpayers because taxpayers do not have understanding of the tax laws which include the Internal Revenue Code, Treasury Regulations, Revenue Rulings and court cases.

Imposing an accuracy related penalty on the taxpayer when there is a failure to report a position which is inconsistent with a Treasury Regulation or Revenue Ruling may result in malpractice suits against the tax professional. It would create a system where taxpayers with the financial ability to bring such lawsuits will be able to recover the penalties from tax professionals while those who lack the resources will not be able to do so, resulting in a greater inequity in the tax system.

The negligence penalty, when first enacted, did not exceed five percent of the tax. Congress, in its effort to simplify the penalty sections of the Internal Revenue Code, combined the negligence penalty with the accuracy related penalty. This results in a taxpayer being penalized twenty percent of the underpayment of tax when he/she relies on his/her tax professional who fails to make the appropriate disclosure. This burden should not be imposed on a taxpayer who provides his/her tax preparer with all the necessary information needed to make appropriate disclosures.

A. Application of Accuracy Related Penalties under Current Law.

An understatement of income tax on a return can result in the imposition of accuracy related penalties.³ The penalties will not be imposed if the taxpayer can prove that the understatement was due to reasonable cause.⁴ A taxpayer can prove reasonable cause if the understatement is the result of the taxpayer's reasonable reliance on the advice or opinion of a tax professional.⁵ Reasonable reliance is based on all the facts and circumstances of the taxpayer's situation.⁶

Reliance is reasonable when the taxpayer furnishes all necessary information to the professional, the professional does not lack knowledge in the field in which the advice is given and the professional gives the advice or opinion based on the professional's understanding of the tax law.⁷

1. Case Law.

Under current case law, a taxpayer will not be held liable for an accuracy related penalty when the taxpayer proves that reliance on the advice of a tax professional was reasonable. This result would occur regardless of the validity or invalidity of a Treasury Regulation as long as

³ Internal Revenue Code section 6662.

⁴ Internal Revenue Code section 6664(c). "No penalty shall be imposed under this part with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion."

⁵ Reg. Section 1.6664-4(b)

"No penalty may be imposed under section 6662 with respect to any portion of an underpayment upon a showing by the taxpayer that there was reasonable cause for, and the taxpayer acted in good faith with respect to such portion." See also Reg. Section 1.6664-4(b). "The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances." "Reliance on... professional advice... constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith."

⁶ Id.

⁷ See Kikalos v. Commissioner, T.C. Memo 1998-92, the taxpayer did not keep adequate books, as a result the taxpayer could not furnish the professional with all relevant information. See also, Ahadpour v. Commissioner, 32 Fed Appx. 319 (9th Cir), taxpayer did not disclose all relevant information to accountant. See also, Mordkin v. Commissioner T.C. Memo 1996-187, the taxpayer did not offer the testimony of the accountant to show what advice the taxpayer relied on).

the taxpayer can establish that the underpayment is the result of the taxpayer's reasonable reliance on the advice of a tax professional.⁸

B. Proposed Regulations

Proposed Treasury Regulation Section 1.6664-4(c)(iii) states:

“Reliance on the invalidity of a regulation. A taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith unless the taxpayer adequately disclosed, in accordance with section 1.6662-3(c)(2), including the disclosure of the position that the regulation in question is invalid, and, if the position relates to a reportable transaction as defined in section 1.6011-4T(b), the transaction is disclosed in accordance with section 1.6011-4T.”⁹

Proposed Treasury Regulation Section 1.6664(c)(2) states:

“(2) *Opinions or advice relating to reportable transactions.* Taxpayers may not reasonably rely on an opinion or advice of a tax advisor if the opinion or advice is disqualified under this paragraph. An opinion or advice is disqualified if it relates to the appropriate tax treatment of a reportable transaction, as defined in § 1.6011-4T(b), and the taxpayer does not disclose the transaction in accordance with § 1.6011-4T.”

⁸ See, Schwalbach v. Commissioner, T.C. 215 (1998). The taxpayer took the position that Income Tax Reg. Section 1.469-1(f)(6) was invalid. While the court found the regulation to be valid and the taxpayer liable for underpayment of tax, the taxpayer was not held liable for the accuracy related penalty. The taxpayer established that the underpayment of tax was a result of the taxpayer's reasonable reliance on a C.P.A. The taxpayer established that the C.P.A. was presented with all the relevant information needed to prepare the return and the C.P.A. prepared the return based on his understanding of the tax laws. See also, Shaw v. Commissioner, T.C. Memo 2002-35, the taxpayer took the position that Income Tax Reg. Section 1.469-2f)(6), was invalid. The court found the regulation to be valid, but once again did not hold the taxpayer liable for the accuracy related penalty because the taxpayer established reasonable reliance on the advice of his accountant.

⁹ Regardless of when a transaction was entered into, the IRS, in appropriate circumstances, may consider a taxpayer's failure to disclose a position that a regulation is invalid as a factor in determining whether the taxpayer has satisfied the reasonable cause and good faith exception under section 6664(c) to the accuracy related penalty. (26 CFR Part 1, RIN 1545-AY97, December 31, 2002, [4830-01-p]), 2003 TNT 3-69.

1. *These proposed Treasury Regulations are contrary to current law.*

Under current law, disclosure is not required to establish reasonable cause. Disclosure is a defense to an understatement of income tax under Internal Revenue Code section 6662(d)(2)(B) however, this defense is independent of the reasonable cause defense under section 6664(c).

As discussed above, case law allows taxpayers to establish reasonable reliance on the advice of a tax professional regarding the validity of a Treasury Regulation, without disclosure.

2. *The proposed Treasury Regulations are contrary to Congressional intent.*

In 1989, Congress revised the accuracy related penalties. One of the primary goals of the revision was to make the application of penalties more equitable. The accuracy related penalties were redesigned to impose the penalty against taxpayers who intentionally disregarded the rules and Treasury Regulations, but allow less culpable taxpayers, who made a mistake, to avoid unreasonable penalties.¹⁰

Before the revision, reasonable cause was only explicitly available for substantial understatement. The IRS had the discretion to decide if the accuracy related penalty would be waived. The taxpayer had no standard upon which to base his or her argument that a penalty should not be imposed.

Congress extended the reach of the reasonable cause exception to all accuracy related penalties imposed in section 6662. The exception was created as a means to protect taxpayers that did not intend to violate the tax laws.

The policy that the amount of the penalty should be proportional to the culpability of the taxpayer is what the revision of the

¹⁰ 135 Cong. Rec. § 13898, October 24, 1989 (Vol. 135 No. 145)

accuracy related penalty was based on.¹¹ If a taxpayer relies on the advice or opinion of a tax professional and the reliance is reasonable, the culpability of the taxpayer is minor. A taxpayer should not be held responsible for the advice, or lack thereof, regarding the validity of a Treasury Regulation and the need to disclose any position that is contrary to a Treasury Regulation.

3. *The proposed Treasury Regulations are contrary to public policy.*

The proposed Treasury Regulations are contrary to public policy because they will put a burden on the lay taxpayer to investigate and understand the content and meaning of the Treasury Regulations, which under most circumstances would be difficult for the taxpayer.

Taxpayers who have complicated issues in their tax returns often retain tax professionals for the purpose of receiving advice as to how their tax matters should be treated and what information must be disclosed on a return because the content of the Internal Revenue Code, Treasury Regulations and Revenue Ruling is not common knowledge.

The IRS, under the proposed Treasury Regulations, requires a taxpayer to disclose a position taken on his or her tax return that is inconsistent with any Revenue Ruling or Treasury Regulation. Does the proposed Treasury Regulation expect the taxpayer to know whether a position taken on his/her return is inconsistent with a Treasury Regulation or Revenue Ruling? If the taxpayer goes over his/her return with a tax professional on a line by line basis, how is the taxpayer going to know if the advice is correct?

Although the disclosure requirement certainly assists in the fair administration of the laws, to place this burden solely upon the taxpayer by imposing a twenty percent accuracy related penalty is anything but “fair” to the taxpayer. A taxpayer cannot be expected to disclose a position on a return when he/she does not have the knowledge that the advice received from a tax professional is based on the professional’s opinion that a Treasury Regulation is invalid.

¹¹ 135 Cong. Rec. § 13898. October 24, 1989 (Vol. 135 No. 145).

The taxpayer should not be subject to the accuracy related penalty when the tax preparer has knowledge that the position taken is that a Treasury Regulation is invalid and not inform the taxpayer, or advises the taxpayer that he/she does not have to disclose the position taken.

Taxpayers should not be expected to second guess the advice of the professional they hire. Also, they should not be expected to research the accuracy of the advice they were given before relying on a professional, provided such advice seemed reasonable at the time it was given.

4. The proposed Treasury Regulations are contrary to the policy set forth in the adoption of the final Treasury Regulations, for section 6664, issued on accuracy related penalties in 1991.

“A facts and circumstances approach to determining reasonable cause and good faith provides the greatest degree of flexibility in evaluating a taxpayer’s situation. Special rules and presumptions, to the extent that they require that certain facts and circumstances be disregarded, are inconsistent with this flexible approach.”¹²

The proposed Treasury Regulations restrict the reasonable cause defense to the point that a court’s ability to evaluate a taxpayer’s situation is entirely eliminated. The proposed Treasury Regulations completely disregard the concept of “reasonableness on the part of the taxpayer” in relying on the advice or opinion of a tax professional.

5. The proposed Treasury Regulations are contrary to policies set forth under existing case law.

Under existing case law, the IRS has abated accuracy related penalties when the taxpayer has argued that a Treasury Regulation is invalid, and the position was not disclosed on a return.¹³ In addition, courts

¹² IRS Final Regulations (RTD), 91 TNT 264-2 Final Regs on Accuracy Related Penalties.

¹³ See Krukowski v. Commissioner, 114 T.C. 366 (2000); Sidell v. Commissioner, T.C. Memo 1999-301; Michael v. Commissioner, T.C. Memo 1996-466. In all three cases, the taxpayer claimed a

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do not impose accuracy related penalties on taxpayers who misinterpret Treasury Regulations based upon the advice of tax professionals when the taxpayer proves the reliance was reasonable.¹⁴

6. *The proposed Treasury Regulations do not define what constitutes professional advice or opinion.*

By not defining what constitutes professional advice or opinion, the Treasury Regulations leave unanswered whether the preparation of a return is professional advice or opinion.

It is unfair for a taxpayer to be held liable for the accuracy related penalty if the understatement of tax liability resulted because the tax preparer took a position without the knowledge of the taxpayer. For example, if a partnership prepares a tax return, taking the position that a Treasury Regulation is invalid, but does not disclose it on the K-1 issued to the taxpayer, will the taxpayer be subject to the accuracy related penalty?

If “professional advice or opinion” requires the taxpayer to be explicitly informed by the tax professional and that advice is based on the position that the Treasury Regulation is invalid, there are two possible situations where the taxpayer may be penalized, assuming the tax preparer has the knowledge of the transaction.

When the taxpayer is informed by the tax preparer that the advice given is based on the position that a Treasury Regulation is invalid, but the tax professional does not inform the taxpayer of the need to disclose or that the taxpayer does not need to disclose this, the penalty should not be imposed on the taxpayer.

regulation was invalid. The courts found the regulations to be valid and the IRS conceded the accuracy related penalty.

¹⁴ See, Drummond v. Commissioner, 1998 U.S. App. Lexis 16311, (taxpayer misinterpreted the definitions in a regulation. The court found the taxpayer as not liable for the accuracy related penalty that arose from the misinterpretation because the taxpayer acted reasonably when he consulted a C.P.A. and discussed with the C.P.A. the definitions under the regulation.) See also, Fowler v. Commissioner, T.C. Memo 2002-223. (The taxpayer misinterpreted a regulation. The court held the taxpayer was not liable for an accuracy related penalty because the taxpayer reasonably relied on the advice of a tax professional.)

However, if the taxpayer is informed of the need to disclose, and the taxpayer instructs the tax professional not to disclose, then under current law, the taxpayer would not be able to avoid the accuracy related penalties, since they would not be relying on professional advice since he/she would not be relying on professional advice.

Congress has provided for a penalty against tax preparers who prepare a return which is contrary to a Revenue Ruling or Treasury Regulation. Section 6694(b) provides as follows:

“(b) Willful or reckless conduct. If any understatement of liability with respect to any return or claim for refund is due (1) to a willful attempt in any manner to understate the liability for tax by a person who is an income tax preparer with respect to such return or claim, or (2) to any reckless or intentional disregard of rules or regulations by any such person, such person shall pay a penalty of \$1,000 with respect to such return or claim.”

A preparer who adopts a position on a return that is contrary to a Revenue Ruling or Treasury Regulation is deemed under this Internal Revenue Code Section and the Treasury Regulations promulgated thereunder to have acted either with reckless or intentional disregard of a rule or Treasury Regulation, and, as such, the preparer is subject to a penalty under these provisions. The preparer who, in most cases, should have knowledge of the tax laws may avoid the penalty for reckless or intentional disregard of a rule or Treasury Regulation by disclosing the position and identifying the rule or Treasury Regulation that is being challenged.¹⁵ The Internal Revenue Service already has the right to impose a penalty for this infraction upon the person who should have knowledge and should not be permitted to impose an additional penalty for the same act upon the taxpayer. However, if the taxpayer took some affirmative action which indicated that he/she knew of the tax law in question and the disclosure requirements and failed to disclose his/her contrary position, then the taxpayer should be liable for the accuracy related penalty.

Current case law already provides enough guidance as to whether this penalty should be imposed upon the taxpayer or the tax return

¹⁵ See Treasury Regulation Section 1.6694-3(e)(1).

preparer. In most circumstances, the tax return preparer is in a much better position to know whether any item on the tax return is inconsistent with a Treasury Regulation or Revenue Ruling and is also better able to know the disclosure requirement. Yet, if the Treasury Regulations are not clarified regarding when a taxpayer has actually received an opinion or advice that his or her return is inconsistent with a Treasury Regulation or Revenue Ruling, it is conceivable that strict liability for the accuracy related penalty will attach to a taxpayer, if he/she merely signed the return. As a result, the Internal Revenue Service will be allowed to penalize the taxpayer, up to twenty percent of the understatement, regardless of his or her culpability, which is inconsistent with any standard of “fairness and equity.”

C. The Proposed Change.

There is no justification for amending the current Treasury Regulations dealing with disclosure unless the IRS wants to shift this burden to the professional, which will create more problems than will be solved. Current Treasury Regulation section 1.6664-4(b) and the progeny of case law thereunder, have resulted in fairness to the taxpayer and the IRS. In almost all circumstances, a taxpayer will not be aware that a position is contrary to any Treasury Regulation or Revenue Ruling and the need to disclose this position, unless the taxpayer is informed by a tax professional.

To the extent that the IRS requires disclosure, the burden should, in most cases, be on the professional advisor, including any penalties associated therewith. Due to the vast number of Revenue Rulings and Treasury Regulations, the cost for preparing a simple tax return could be astronomical. However, if the IRS believes that this will result in a fairer application of the tax laws, a tax preparer penalty should be imposed for a failure to disclose. In no event however, should the taxpayer be burdened with this responsibility, provided he/she has disclosed all pertinent facts and received what a reasonable person would believe to be competent advice.

1. *The proposed change will increase disclosure.*

The fundamental objective for imposing accuracy related penalties is to encourage self-compliance. Requiring disclosure is one way the IRS can advance the self-compliance objective. However, the only way a disclosure requirement can be an effective tool for self-compliance is to place the responsibility where it belongs, namely with the tax professional, who is in a much better position to have an understanding of those laws. In almost all circumstances, a taxpayer will not be aware that a position is contrary to any Treasury Regulation or Revenue Ruling, unless the taxpayer is informed by a tax professional.

2. *The proposed change will punish the informed party.*

The tax professional, offering advice or opinion to a taxpayer, is the party who knows the basis of his/her advice or opinion. If the advice is based on the opinion that a Treasury Regulation is invalid, the professional will know of the need to disclose the basis for the positions taken by a taxpayer.

II. CONCLUSION

The objective of the Department of Treasury to limit the defenses to the imposition of the accuracy-related penalty by implementing the proposed Treasury Regulations is contrary to current case law and Congressional intent, and will only increase litigation. It is recommended that the Treasury Regulation not be adopted. Such fundamental changes should be addressed through legislation, not Treasury Regulations.