

New Penalty Provisions And Their Effect On Aggressive Tax Planning

By **RANDALL W. ROTH**

According to the author, beginning in 1983, the taxpayer and tax advisor have new and potentially burdensome penalty provisions hanging overhead; the effect must be determined on a situation-by-situation basis.



Randall W. Roth is an associate professor of law at the University of Hawaii.

All things being equal, practitioners would always recommend conservative, rather than aggressive, tax planning strategies. But, of course, all things are seldom equal. Many factors in addition to the certainty of one's position must be considered, and after such consideration aggressive approaches sometimes look pretty good.

Prior to enactment of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), taxpayers and tax practitioners clearly had a considerable amount of leeway in planning aggressively without risk of penalties. All that was required to avoid taxpayer negligence penalties and preparer penalties was a "good faith reasonable argument." TEFRA discourages aggressive tax planning by introducing new penalty provisions that sometimes hold the taxpayer and perhaps tax practitioners, to a higher standard. This article will arbitrarily define aggressive tax planning and analyze its attractiveness to clients. The pre-TEFRA penalty provisions will be detailed, followed by a close look at the new provisions. Finally, an attempt will be made to predict the future of aggressive tax planning in light of the old and new penalty provisions.

In a perfect world there would be a definite answer to every question. A particular tax strategy would either work or not work; it would be that simple. Needless to say, our world is not perfect and practitioners are often uncertain as to the proper outcome of any given tax strategy.

© 1982, Randall W. Roth

The White, Black and Gray Areas

When a taxpayer has at least a reasonable argument for a particular result and the IRS does not have at least a reasonable argument for a different result, we might describe that taxpayer's position as being in the *white* area of the law. (See Exhibit I at page 58.) Any tax strategy in the *white* area is conservative. If the IRS attacks a conservative strategy, it will (by definition) lose in court and, as a penalty, pay the taxpayer's attorney's fees.¹

When the IRS has at least a reasonable argument for a particular result and the taxpayer does not have at least a reasonable argument for a different result, we might describe any position other than the IRS position as being in the *black* area. Numerous penalty provisions, criminal as well as civil, are at least potentially applicable when the taxpayer is in the *black*.² Any tax strategy in the *black* area is inappropriate. Under no circumstances should a practitioner knowingly allow a client to take a position in the *black* area.

In between the *white* and the *black* is a fairly broad area that we call the *gray* area. A position is in the *gray* area when both the taxpayer and the IRS have, at a minimum, a reasonable argument for their respective positions. Structuring and/or reporting a situation based upon a *gray* area position constitutes aggressive planning. Perhaps it will work; perhaps it will not work.

It is common knowledge that greater amounts of taxes can (potentially) be saved, or the same amount of taxes can be saved at less sacrifice, as the taxpayer moves from the *white* area toward the *black* area. The *black* has always been off limits but the *gray* area has not. Perhaps that is changing. Before addressing a possible change in this regard, however, it is necessary to acknowledge the main reason so much aggressive planning has been recommended over the years by experienced practitioners. After all, why be greedy when at least some taxes can usually be saved through utilization of conservative strategies?

The answer is easy. As a practical matter, taxpayers who have taken position in the *gray* area have generally won by default. This fact is so important to the thrust of this article that it deserves being repeated. Only a minority of the time does an aggressive position even come to the attention of the IRS. Most of the time, aggressive tax planning works by default.

This "virtue" of aggressive planning is not a heavily guarded secret. Any seasoned tax prac-

titioner is aware of it. Former IRS Commissioner Jerome Kurtz said as much when addressing the ABA Section of Taxation in May of 1978 about the "unfair" nature of aggressive tax planning. He complained that the system worked against the IRS when taxpayers plan aggressively: "There is a good chance that they will prevail because the return will not be examined, or if the return is examined the item won't be found. . . ." He later described the aggressive taxpayer's chance for victory by default as a "substantial likelihood."³

To simply say that aggressive tax planning will probably work does not in and of itself make it as attractive as conservative planning. After all, conservative planning will definitely work. The real advantage of *gray* area planning over conservative planning is that it offers either greater tax savings or the same tax savings at less sacrifice.

Specific Situations.—To illustrate, let's consider a specific situation. Joe Client stops by our office to inform us that he just read a magazine article extolling the advantages of shifting income from the highest tax bracket of a parent to the low brackets of his minor children. He asks us how he can do this. We begin by explaining that a gift of an income-producing asset will serve to shift all subsequently generated income to the donee. But he quickly vetoes that approach by emphasizing that he wants to give up only income, not income-producing assets. Undaunted, we suggest a short-term trust which will enable him to shift income while retaining the right to recover his income-producing asset in 10 years or so. He responds that he does not want to tie up his assets for 10 years, he wants more flexibility. Of course there are a few other strategies we might suggest,⁴ but let's assume we conclude that all the conservative shifting strategies involve more sacrifice than this guy is willing to

¹ A taxpayer who prevails in civil tax litigation in any federal court (including the Tax Court) may be awarded reasonable attorney's fees and other litigation costs if he establishes that the government's position was unreasonable. Note, however, the maximum award is only \$25,000 and this provision applies only to civil tax litigation begun between March 1, 1983, and December 31, 1985. Section 7430.

² Strategies that fall within the *black* area are *beyond* aggressive; given the definition of aggressive provided herein. Practitioners who allow clients to venture into the *black* (e.g., establish family trusts) are either ignorant of the law or unethical or both.

³ "Discussion of Questionable Positions," 32 *Tax Lawyer* 13, 15 (1979).

⁴ See Roth, "Ten Ways to Shift Income to Minor Children", *CCH Estate Planning Review*, Special Report, (1982) 35-39.

make. Now that we know there is no conservative strategy that appeals to this client, we step into the *gray* and introduce the client to a variety of aggressive tax planning strategies. For example, we describe how a trust can be established for the benefit of the client's children, minimally funded, and then lent a significant amount of money, interest free. The trustee can use the borrowed money to generate income that will arguably be taxed to the trust or its beneficiaries, not the settlor/lender who made it all possible. We explain that this strategy eliminates the need to make a substantial gift of anything but income. Furthermore, the client now has the ability to get his cash back at any time, for any reason; simply by calling the note due.⁵

Of course, there are other aggressive possibilities,⁶ but let's assume that this particular client likes this income-shifting strategy and immediately says "let's do it." It is at this point that the practitioner must very carefully explain that while he has a reasonable argument that the interest-free loan will have the effect of shifting income from the lender to the borrower, the IRS has (or may think it has) a reasonable argument for a different result. In other words, this strategy is in the *gray* area and therefore the ultimate result cannot be predicated with any certainty.

Once the client understands that this is not a conservative planning tool, the next step is to help the client analyze the potential ramifications of being in the *gray* area in this particular situation. First of all; we need to at least attempt to determine whether we are in the *light gray*, the *mid gray* or the *dark gray*. In other words, do we think that our argument is better than that of the IRS (the *light gray* area), do we think the IRS's position is the better of the two arguments (the *dark gray* area) or do we think it is a toss-up as to which position is correct (the *mid gray* area). We would rather be in the *light gray* than the *dark gray*, but either way we stand a good chance of winning by default.

It should be noted that being in the *light gray* does not assure victory if the issues comes up on audit. If the agent thinks the IRS's position is reasonable, he may refuse to accept the taxpayer's position.⁷ While the controversy can (and probably should) be pursued further, at least within the IRS if not in court, that can be expensive. It is not uncommon that *gray* area issues raised on audit are at least partially conceded by the client because he cannot afford to fight, if for no other reason. This can be hard for the client to swallow when he and his advisor are convinced

the issue is in the *light gray* (i.e., they have the better argument).

If the practitioner feels sure his client's position is somewhere within the *gray* area, he should not have to worry about the imposition of a Section 6653(a) (or any other pre-TEFRA penalty provision) penalty against the client or a Section 6694 preparer's penalty. The reason is simple. The standard used to determine whether a Section 6653 or a Section 6694 penalty should be asserted is whether the position in question is a "good faith reasonable position."⁸ The same standard is used in establishing the ethical limits for lawyers and CPAs.⁹ By definition, a position is only in the *gray* area if the taxpayer has at least a reasonable argument. Therefore, these, pre-TEFRA penalty provisions theoretically should not affect ethical practitioners and their clients.

Presumably, "good faith" only means the party really believes his position is reasonable. Disclosure of a *gray* area issue is not essential to avoid Section 6653 and Section 6694 penalties, but it may be an indication that the reasonable position was held in "good faith."

The problem with this theory is that reasonable people sometimes differ as to what is a reasonable position. An agent may argue that the taxpayer's position is not only incorrect, it

⁵ See Roth, "Can lender be charged with receiving taxable income as a result of an interest-free loan?," 52 *Journal of Taxation* 136 (March 1980).

⁶ See note 4, *supra*.

⁷ While its source could hardly be described as highly authoritative, I feel compelled to share the following quote:

First of all, [the agent] is taught tax law, but only as the IRS sees it. There is little theory here, no *gray* areas, no Harvard Law School pacing back and forth, with "on the one hand . . . on the other hand". . . . [The agent's] training makes the tax law simple. If it's income, tax it. When in doubt, tax it. If there are questionable deductions and credits, turn them down.

Strassels and Wool, "All You Need To Know About the IRS," Random House, New York, 1980, at 156-57.

⁸ Reg. §§ 1.6653-1 and 1.6694-1(a)(4).

⁹ Rule 102 of the AICPA Code of Professional Ethics states, "In tax practice, a member may resolve doubt in favor of his client as long as there is reasonable support for his position."; Opinion 314 of the ABA Committee on Professional Ethics states, ". . . a lawyer who is asked to advise his client in the course of the preparation of the client's tax returns may freely urge the statement of positions most favorable to the client just as long as there is reasonable basis for those positions. Thus where the lawyer believes there is a reasonable basis for a position that a particular transaction does not result in taxable income, or that certain expenditures are properly deductible as expenses, the lawyer has no duty to advise that riders be attached to the client's tax return explaining the circumstances surrounding the transaction or the expenditures."

is unreasonable. Does this ever happen? Consider another quote from former Commissioner Kurtz, this one regarding assertion of preparer negligence penalties by agents:

Our statistics indicate that a significant number of cases that go to appeals are reversed, which indicates that either there is a lack of understanding of the rules by appeals officers or penalties are being asserted where they should not be.¹⁰

A practitioner who feels a position is in the *light gray* area will probably not worry too much about the possibility of a negligence or other penalty being slapped on him or his client. Similarly, a position in the *mid gray* is generally not too worrisome. But a position the practitioner thinks is in the *dark gray* will require at least some concern about the possibility of a negligence penalty being asserted.

To illustrate, a properly documented interest-free loan to the independent trustee of a children's trust is an income-shifting strategy that falls in the *light gray* area. Consequently, the worst that can happen is that it will not work. Income that would have been taxed to the parent if he had done nothing will end up being taxed to him. He will pay interest on the deficiency, but that will be computed at approximately the prime lending rate. This can hardly be considered a significant downside risk since the taxpayer had the use of the tax dollars for an extended period of time. Most clients would love to borrow regularly from the government, or anyone else, at the prime rate.

While the possibility of incurring interest costs is not a significant deterrent to aggressive planning, the possibility of a nondeductible penalty can lurk as a meaningful deterrent. But with this last strategy which is characterized as being in the *light gray* area, negligence penalties would not be seen as a significant threat.

Let's change the facts a bit. Joe Client wants to cut a few corners in shifting income. He wants less costs and does not want to give up use of his money for any significant period of time. Specifically, he wants to make the interest-free loan directly to his minor children and then have his wife borrow that money from the minor children at a 20% rate of interest. Assuming (1) the children make no express or implied agreement to lend the money to their mother prior to borrowing it from their father, (2) the minors are reasonably mature, and (3) the wife is not acting as a mere agent of her husband

when she borrows the money from the children, this variation would be in the *gray* area and therefore something the client can try.¹¹ But it is (at best) in the *dark gray* and many agents would view it as being in the *black*. Consequently, negligence and other pre-TEFRA penalties are a real possibility. The downside risk is that it may not work and penalties may be imposed. Disclosure on the return can lessen the possibility of a penalty, but even that is no guarantee. And, of course, few clients like to make special disclosure of questionable positions because it arguably increases the chance of an audit.¹²

Summary of Downside Risk

If a strategy is such that its failure to work results in the same tax liability that would have resulted if it had not been attempted, one could argue that the only downside risk is the possibility of a penalty. Interest at prime is a reasonable cost of delaying the payment of taxes.

Of course, one cannot forget that the cost of implementation and administration of a tax strategy is not recouped just because the strategy fails. Also, there is the possibility of an opportunity cost. That is, the alternative to the aggressive approach might have been a less desirable conservative approach that would have saved some taxes.

TEFRA Penalty Provisions

Based upon the discussion thus far, aggressive tax planning can be quite attractive. Save more and/or sacrifice less and probably win by default, if not on the merits of the argument. Keep an eye on possible penalties, but recognize that all one needs to avoid these is a good faith reasonable argument, which is arguably a low standard. Aggressive tax planning certainly can be very attractive.

That's the problem. It has worked too well, at least in the eyes of Congress. In an attempt to reduce the current attractiveness of aggressive tax planning, Congress has established two new penalty provisions, Section 6661, entitled "Substantial Underpayment of Liability" and Section

¹⁰ 11 *Tax Advisor* 425 (July, 1980).

¹¹ Two significant differences between this fact pattern and the one in Revenue Ruling 82-94, 1982-20 IRB 5, is that here the second borrower is someone other than the first lender and there is no prearranged understanding that the second loan will be made.

¹² In polling many CPAs about their experience with special disclosure, the author has discovered that the vast majority have indicated that special disclosure on a return has not seemed to increase the chance of audit.

6701, entitled "Penalties for Aiding and Abetting Understatement of Tax Liability." There are other penalty provisions in TEFRA, but they are aimed solely at *black* area strategies, not *gray* area strategies. For example, Section 6700 imposes a penalty on persons promoting abusive tax shelters. The specifics of this provision make it clear that it only applies where unreasonable and/or deceitful positions are involved.

Section 6661: "Substantial Underpayment of Liability"

The Statement of the Managers accompanying TEFRA makes it clear that while the members of the Congressional conference committee wanted to reduce the attractiveness of aggressive tax planning, they did not want to penalize a taxpayer just because his tax position might not reflect the "correct treatment." They decided to discourage positions supported by a "mere reasonable basis." Interestingly, the Statement of the Managers confirms the generally held belief that a reasonable basis is not a terribly high standard, "a 'reasonable basis' being one that is arguable, but fairly unlikely to prevail in court upon a complete review of the facts and authorities."¹³

The new standard which must generally be met to avoid a penalty under Section 6661 is "substantial authority." That is, a position (other than one involving a tax shelter) will not result in a penalty if there was substantial authority for the taxpayer's treatment.¹⁴ Congress used this new terminology in an attempt to give the courts flexibility in applying the provision. The only specific guidance given by the Statement of Managers is the following range: "The conferees believe such a standard should be less stringent than a 'more likely than not' standard and more stringent than a 'reasonable basis' standard."¹⁵ Arguably, this means that Section 6661 applies only to positions in what this article has labelled as *dark gray*. The IRS has the flexibility to use the old "good faith reasonable argument" standard in applying Section 6661, but one has to wonder when it will do so except in exchange for some taxpayer concession.¹⁶ (See Exhibit II at page 58 for a representation of the likelihood of a taxpayer using any of these three standards successfully.)

Another way to escape the reach of Section 6661 (on matters other than tax shelters) is to disclose all the relevant facts affecting the item's tax treatment in the return or in a statement attached to the return.¹⁷ As commented earlier,

disclosure may be a paper tiger.¹⁸ If so, it provides a relatively painless way to completely sidestep the TEFRA shadow.

Special Rule for Tax Shelters

"Substantial authority" and/or disclosure will *not* serve to avoid Section 6661 when a "tax shelter" is involved. A "tax shelter" is defined broadly as "a partnership or other entity, any investment plan or arrangement, or any plan or arrangement, if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax."¹⁹ This could arguably encompass just about everything that falls under the heading of aggressive tax planning.

If a "tax shelter" is involved, disclosure does not prevent application of Section 6661. To avoid Section 6661, the taxpayer must show that he reasonably believed that his tax treatment was more likely than not the proper treatment. In other words, if the taxpayer's position regarding a tax shelter is beyond the *light gray*, he is running the risk of a Section 6661 penalty notwithstanding the fact that he makes full disclosure and has a reasonable position or even substantial authority for his position.

The Penalty

The Section 6661 penalty is 10% of any "substantial understatement of tax." For this purpose, an understatement is the excess of the amount of income tax imposed on the taxpayer for the taxable year over the amount of tax shown on the return. The understatement is "substantial" only if it exceeds the greater of 10% of the tax required to be shown on the return for the taxable year or \$5,000 (\$10,000 in the case of corporations other than Subchapter S corporations and personal holding companies). This definition of "substantial" makes Section 6661 totally inapplicable in many situations.

Example: Joe Client in the previous example files a tax return for 1983 reporting an amount of taxable income which does not include \$10,000 of income he shifted to his

¹³ Statement of the managers, Tax Equity and Fiscal Responsibility Bill of 1982, as published by Commerce Clearing House, August 19, 1982, at 575.

¹⁴ Section 6661 (b)(2)(B)(i).

¹⁵ See note 13, *supra*.

¹⁶ Section 6661(c).

¹⁷ Section 6661(b)(2)(B)(ii).

¹⁸ See note 12, *supra*.

¹⁹ Section 6661(b)(2)(C)(ii).

minor children through use of an interest-free loan. Assuming the worst: (1) he is audited, (2) the issue of the effectiveness of an interest-free loan as an income shifting device comes up, and (3) the issue is resolved against Joe Client, his "understatement of tax liability" will amount to \$5,000 or less. Consequently, Section 6661 is inapplicable.

As was the case with pre-TEFRA penalty provisions, taxpayers will probably escape penalties upon a showing they relied upon the advice of a competent tax advisor that their position was justifiable under the law.

Section 6701: "Penalties for Aiding and Abetting Understatement of Tax Liabilities"

In theory, this new provision is no problem for the honest practitioner who stays out of the *black*. It only applies to persons who (1) aid or assist in, procure, or advise with respect to, the preparation or presentation of any portion of a return, affidavit, claim, or other document in connection with any matter arising under the tax laws, (2) who know that such portion will be used in connection with any material matter arising under the tax laws, and (3) *who know that such portion (if so used) will result in an understatement of the liability for tax of another person*. It is the italicized ingredient that will be missing when the practitioner is doing his job properly. To take a position that practitioner *knows* will result in an understatement of taxes is beyond aggressive planning. He is in the *black* area.

The Section 6701 penalty is \$1,000 for each return or other document (\$10,000 when it relates to the tax liability of any corporation). The IRS must choose between this penalty and the Section 6694 preparer penalties. It cannot assert both in the same situation.

Again, in theory this provision should not affect the ethical practitioner. But in reality it might be problematic. Some agents may use

Section 6701 whenever they come across a very aggressive position, one in the *dark gray*. Their logic would be that the practitioner knew his argument was not a winning argument and therefore knew an adjustment would be made if the issue came up on audit. Thus, he knew there was an understatement; he just hoped it would not be picked up on audit.

The amount of Section 6701 penalty is the same whether the underpayment is "substantial" or minimal. And the fact disclosure might have been made does not directly affect imposition of this penalty. The penalty can be asserted even when the client escapes a Section 6661 penalty for some reason.

Where to Go from Here

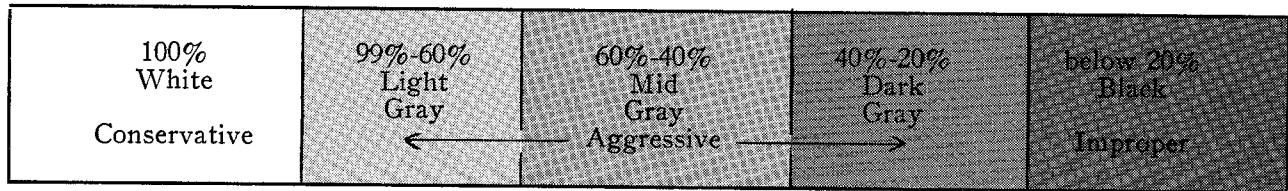
Ignoring for the moment the TEFRA penalty provisions, aggressive tax planning in general is just as attractive as ever. It is often fairly easy to design a strategy that seems almost too good to be true, that is safe from pre-TEFRA penalties because of the relatively low standard of a mere "good faith reasonable position."

But TEFRA has changed the ground rules. Beginning in 1983, the taxpayer and the tax advisor have new and potentially burdensome penalty provisions hanging overhead. *Their effect must be determined on a situation-by-situation basis*. For example, when the possible underpayment is \$5,000 or less, the TEFRA position potentially affecting taxpayers (Section 6661) will be inapplicable.

Generally speaking, the TEFRA provisions will probably serve to reduce significantly the amount of very aggressive tax planning (*dark gray* positions), reduce somewhat the amount of middle aggressive tax planning (*mid gray* positions), but leave untouched most mildly aggressive strategies (*light gray* positions). Furthermore, unlike the Section 6653 preparer penalties, the TEFRA provisions will probably increase significantly the number of times disclosure of a questionable position is made. ●

Exhibit I

Estimated % Chance of a Taxpayer's Position Being Upheld in Court

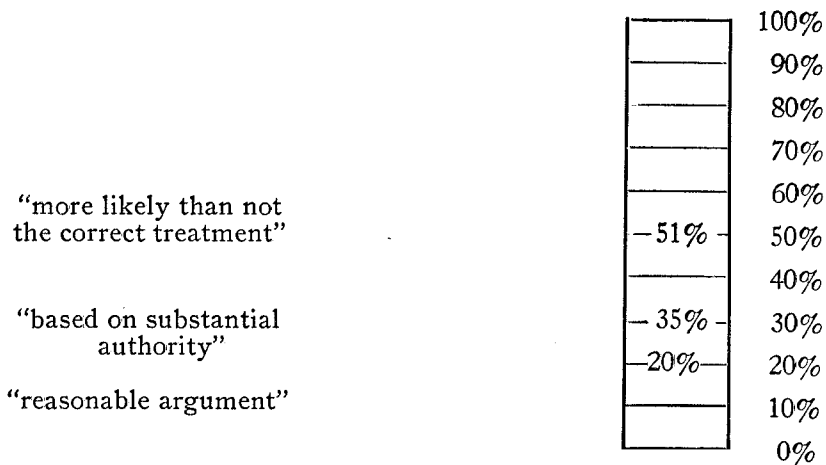


Greater Savings and/or Less Sacrifice →

Exhibit II

Estimated % Chance That a Taxpayer's Position Will Be Upheld by a Court of Law; Location of Various Standards Used in Applying Penalties

Standard



Suggested Ranges for Following Designations:

"more likely than not the correct treatment": 51%-100%.

"based on substantial authority": 35%-100%.

"reasonable argument": 20%-100%.