REPORT #698

TAX SECTION

New York State Bar Association

Report on Proposed Regulations Relating to
the Accuracy-Related Penalty

September 10, 1991

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TAX SECTION
New York State Bar Association

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September 13, 1991

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20024

Dear Commissioner Goldberg:

I am enclosing a report prepared by our Committee on Compliance and Penalties on proposed regulations relating to the accuracy-related penalty. The report notes that, on the whole, the proposed regulations are helpful and accurately reflect the statute. On the other hand, they should go further in carrying out the purposes of the 1989 revisions in the civil penalty rules to rationalize and coordinate civil penalties and make them more predictable and evenhanded.

We would be pleased to discuss the report with you or members of your staff.

Very truly yours,

James M. Pesaslee
Chair

Enclosure

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Tax Report #698

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON COMPLIANCE AND PENALTIES

Report on Proposed Regulations Relating to the Accuracy-Related Penalty

September 10, 1991

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON COMPLIANCE AND PENALTIES

Report on Proposed Regulations Relating to the Accuracy-Related Penalty

I. INTRODUCTION AND BACKGROUND.

On March 4, 1991, the Internal Revenue Service ("Service") issued proposed regulations ("Proposed Regulations") under sections 6662 and 6664[1] (pertaining to the accuracy-related penalty) and section 6694 (penalties on income tax return preparers). This report[2] comments on the Proposed Regulations relating to the accuracy-related penalty and, to a much lesser extent, the penalties for income tax return preparers.

The Omnibus Reconciliation Act of 1989 ("1989 Act") substantially revised and improved the civil penalty provisions of the Code.[3] The 1989 Act consolidated the penalties for negligence or disregard of rules or regulations, valuation overstatements and substantial understatement of tax under chapter 1, formerly found in sections 6653, 6659 and 6661,

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[1] Except as otherwise indicated, all section references herein are to sections of the Internal Revenue Code of 1986 (the "Code") or, where the reference begins with "1." to sections of the Proposed Regulations.

[2] The authors of this report are Robert S. Fink and Arnold Y. Kapiloff, co-chairs of the Committee on Compliance and Penalties. Helpful comments were received from Donald C. Alexander, John A. Corry, Sherry S. Kraus, James M. Peaslee and Michael B. Quigley.

[3] Some of problems addressed by the legislation were discussed in a 1988 report of the Tax Section which is reprinted in Tax Notes, February 1, 1988 at 511.

respectively, into a single 20% accuracy-related penalty found in section 6662. The legislation also added section 6663 (fraud) and section 6664 (definitions and special rules). The 1989 Act changes were effective for returns due (without regard to extensions) after December 31, 1989.

The extensive revisions to the civil penalties regime enacted in 1989 were the subject of extensive comments and hearings. See. Executive Tax Force, Report on Civil Tax Penalties, Internal Revenue Service (February 21, 1989). The primary criticism of the civil penalties regime prior to the 1989 Act was the lack of coordination between the various penalties which led to the "stacking" of numerous penalties for the same misconduct. The intent behind the 1989 Act, was to consolidate all civil penalties into one part of the Code, to coordinate civil penalties with the fraud penalty and to eliminate any stacking of penalties. See. H.R. Conf. Rep. No. 101-386, 101st Cong., 1st Sess. 651 (1989). The reason for the change was described as:

> The committee believes that the number of different penalties that relate to accuracy of a tax return, as well as the potential for overlapping among many of these penalties, causes confusion among taxpayers and leads to difficulties in administering these penalties by the IRS. Consequently, the committee has revised these penalties and consolidated them. The committee believes that its changes will significantly improve the fairness, comprehensibility, and administrability of these penalties.

H. R. Rep. No. 101-247, 101st Cong., 1st Sess. 1388 (1989).

In 1990, the Service issued Notice 90-20 giving guidance with respect to the accuracy-related penalty and the income tax return preparer penalties. The notice served as a preview of the Proposed Regulations.

The accuracy-related penalty applies not only to the items mentioned above, but also to substantial overstatements of pension liabilities, estate or gift tax valuation understatements and, as a result of 1990 legislation, certain adjustments under section 482. These other penalty provisions are not addressed in the Proposed Regulations.

II. GENERAL COMMENTS.

On the whole, the Proposed Regulations accurately reflect the revised statutory provisions and are helpful, particularly in illustrating how the penalties are computed. On the other hand, we believe, as explained in our comments, that the Proposed Regulations should go further in carrying out the purposes of the 1989 Act, to rationalize and coordinate civil penalties and to make them more predictable and evenhanded.

We have two general comment on the Proposed Regulations, which are set forth immediately below. More technical comments, organized by sections of the Proposed Regulations, are found in part III.

1. Coordination of Standards.

More attention should be given to coordinating the different parts of the regulations, with a view either to

Sharpening the differences that exist between various standards of misconduct or to eliminating apparent differences that are not likely to be significant in practice. The Proposed Regulations are difficult to understand because they use so many different tests for reasons that are not always clearly explained.

To illustrate, in order to determine under section 1.6662- 3 whether the negligence penalty applies, it may be necessary to ascertain not only whether a taxpayer "made a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return", but also whether a position (1) was "frivolous", (2) lacked a "reasonable basis", (3) if contrary to a revenue ruling, "has a realistic possibility of being sustained on the merits", and (4) would seem to a reasonable and prudent person to be "too good to be true". As explained in our more detailed comments, we believe that the relationship between the first two tests is not adequately explained, and that the last two could (and should) be omitted. Given that these various formulations are inherently imprecise, and are directed at similar issues, it might be better, as an approach to drafting the regulations, to state the standard of misconduct more simply and then to explain what is meant by giving concrete examples of cases where the standard is or is not met.

Another area where the Proposed Regulations might be better coordinated involves the income tax preparer penalty found in section 6694(a). Subject to various exceptions, the penalty is imposed if a position is taken for which there was not a "realistic possibility of being sustained on its merits". Section 1.6694-2(b) states that a position is considered to meet this test if a reasonable and well informed analysis by a knowledgeable person would lead that person to conclude that the

position has approximately a one in three (or greater) chance of being sustained on the merits. Further, the analysis used in determining whether there is “substantial authority” for purposes of applying the substantial understatement penalty also applies to determine if the realistic possibility standard is met, and the authorities that may be taken into account under both provisions are the same. The Proposed Regulations then go on to give a number of examples of how the realistic possibility test is applied that are not repeated or cross-referenced under the substantial understatement penalty section.

It would be helpful to know how the “realistic possibility” test relates to the “substantial authority” and “reasonable basis” tests that apply for purposes of the accuracy-related penalty. Section 1.6662-4(d)(2) indicates that “substantial authority” is less stringent than the “more likely than not” test, which requires a greater than 50% probability of success, but more stringent than the “reasonable basis” standard. A position that is “arguable, but fairly unlikely to prevail in court” satisfies the reasonable basis test but not the substantial authority test. It would seem that the “reasonable basis” test is close to the “realistic possibility” test, since a “fairly unlikely” prospect of success does not seem much different from “one in three,” but both tests would seem less stringent than the “substantial authority” test. Thus, it would appear that the realistic possibility test should in all cases be met with respect to a position if there is substantial authority for the position.

Curiously, the Proposed Regulations imply that the “realistic possibility” test is more stringent than the substantial authority test. Section 1.6694-2(c)(3)(ii)(A)(2) refers to a “rare” case where a position has substantial

authority but does not meet the realistic possibility standard. How can this be? We recommend that the Proposed Regulations clarify that the realistic possibility test is always met if there is substantial authority for a position.

In a similar vein, the Proposed Regulations, in applying the substantial understatement penalty, strongly imply that the negligence or disregard of rules or regulations penalty will never apply because a position is taken for which there is substantial authority (see section 1.6662-4(d)(2), second sentence); but curiously this point is nowhere stated in section 1.6662- 3 which defines the misconduct that is subject to the negligence or disregard penalty. Indeed, as discussed in part III.A.2. below, some of the language in section 1.6662-3 could be read to support a different result.

A final illustration of the need for better coordination concerns the reasonable cause and good faith exception. This exception applies to the income tax return preparer penalty under section 6694(a) and in that context is addressed in section 1.6694-2(d). An identically worded exception applies to avoid imposition of the accuracy-related penalty and is discussed in section 1.6664-4. Clearly the exception should not apply in exactly the same way in the two contexts, because a professional return preparer should be held to a higher standard of knowledge and competence than the average taxpayer, but there are common elements. For example, the first three factors discussed in section 1.6694-2(d) (nature of the error, frequency of errors and materiality of errors) should be relevant in both contexts. Although some of the same thoughts appear in section 1.6664-4, the language is quite different. We recommend that a close comparison be made between the two provisions with a view to

coordinating the exceptions except where differences are intended.

2. Guidance as to When Penalties do not Apply.

The Proposed Regulations should provide more affirmative guidance as to circumstances in which the various penalties will not apply. Too often, the Proposed Regulations are written only to define the circumstances where a penalty will be imposed. To give only one example, section 1.6662-3, in defining negligence, states that a position is attributable to negligence if it lacks a reasonable basis. There is no statement (except as an aside in another part of the Proposed Regulations[4]) that the existence of a reasonable basis for a position will prevent application of the penalty. Other similar examples are given in part III below.

III. SPECIFIC COMMENTS.

A. Section 1.6662-3 (Negligence or Disregard of Rules or Regulations).

1. Overview.

This portion of the Proposed Regulations applies the penalty for negligence or disregard of rules or regulations set

[4] Section 1.6662-4(d)(2) includes the following: "The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard (the standard which, if satisfied, generally will prevent imposition of the penalty under section 6662(b)(1) for negligence or disregard of rules or regulations). A return position that is arguable, but fairly unlikely to prevail in court, satisfies the reasonable basis standard, but not the substantial authority standard."

forth in section 6662(b)(1). Section 6662(c) states that "'negligence' includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term 'disregard' includes any careless, reckless, or intentional disregard."

Paragraph (a) of section 1.6662-3 describes the penalty generally (including the point that it does not apply if a position is contrary to a revenue ruling if the position has a realistic possibility of being sustained on its merits, applying the definition that applies for purposes of the income tax return preparer penalty). Negligence, and the disregard of rules or regulations, are defined in paragraphs (b) and (c), respectively.

2. Scope of Penalty.

The Proposed Regulation should do a better job of defining the misconduct that is subject to the negligence or disregard penalty. In order to understand its scope, this penalty may usefully be contrasted with the substantial understatement penalty. The substantial understatement penalty is generally triggered by an understatement of tax that exceeds certain dollar thresholds if, viewed objectively, there was no substantial authority for the position taken. Thus, the substantial understatement penalty is triggered by erroneous legal positions that are fairly clearly wrong and involve material amounts of taxes, regardless of the efforts made by the taxpayer to determine the correct amount of tax due.[5]

By contrast, the negligence or disregard penalty can apply even to immaterial tax underpayments, and, correspondingly,

[5] The taxpayer's efforts may be taken into account in applying the reasonable cause and good faith exception.

requires a higher standard of misconduct. In particular, the penalty should not apply to a position if the position, viewed objectively, has a reasonable basis (which is an easier standard for a taxpayer to meet than the substantial authority test). Further, the penalty should not apply if the taxpayer acted reasonably in attempting to ascertain his correct tax liability, even though the position in question was wrong.

Although not clear, section 1.6662-3 appears to read the negligence and the disregard of rules or regulations tests quite differently. As explained below, it does not clearly allow a reasonable basis defense, or a defense based on the reasonableness of the taxpayer's actions to ascertain his correct tax liability.

Reasonable basis. There is no general exception in section 1.6662-3 for cases where a position has a reasonable basis. Such an exception is referred to in a different part of the Proposed Regulations[6] but not here, where it belongs. Section 1.6662-3(b) states that a position with respect to an item is attributable to negligence if it is frivolous or if not frivolous lacks a reasonable basis, but does not say that the existence of a reasonable basis is a defense.

Certain parts of section 1.6662-3 could be read to deny a reasonable basis defense. Specifically, paragraph (a) states that a taxpayer who takes a position contrary to a revenue ruling is not subject to the penalty if the position has a realistic possibility of being sustained on its merits. A realistic possibility of success standard would seem to require more than a reasonable basis. More important, singling out revenue rulings

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[6] See footnote 4 above.

implies that a taxpayer who takes a position contrary to the Code or regulations would be liable for the penalty even if his interpretation has a reasonable basis (or a realistic possibility of success).

The regulations should provide expressly for a reasonable basis defense that applies to both parts of the penalty (negligence and disregard of rules or regulations).[7] If that is done, there would be no need to provide a specific rule for revenue rulings. A position that is contrary to a revenue ruling would not be subject to the penalty if there was a reasonable basis for the position, based on the language of the Code or regulations, case law or other factors.[8] A statement or example to this effect should be added.

Reasonable conduct defense. If a taxpayer acts reasonably in determining his tax liability, he should not be liable for the negligence or disregard penalty, even if he unknowingly takes a position that is clearly incorrect. However, the Proposed Regulations seem to require a different result. Section 1.6662-3(b)(1) states flat out that a position is attributable to negligence if it lacks a reasonable basis (which would ordinarily be true of a position that is unquestionably wrong).

Similarly, section 1.6662-3(b)(1) states that negligence includes "any failure by the taxpayer to keep proper books and records or to substantiate items properly". This language is

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[7] See the statement in footnote 4 (which refers to both negligence and the disregard of rules or regulations).

[8] See also the second proposed example in part III.A.3. below, illustrating how the reasonable conduct defense would apply to a case where a position contrary to a revenue ruling is taken.

ambiguous. It would be consistent with the spirit of the negligence standard to define "proper" books and records and substantiation based on a reasonable person standard. On the other hand, if the word "proper" were read to mean "required in order to sustain a position taken on a return," then again a requirement of negligence (a failure to act as a reasonable person would) would effectively be read out of the Code where a tax deficiency is based on inadequate record keeping.

Moreover, in the definition of negligence set forth in section 1.6662-3(b) the Proposed Regulations should set forth standards for the adequacy of books and records. Issues such as how long records must be maintained, what detail is generally sufficient to avoid application of a negligence penalty, and possibly incorporation by reference of the section 1.6001 recordkeeping regulations would be appropriate.

Examples. The examples under the definition of negligence in section 1.6662-3(b) should be expanded. Only four examples are provided. One example relates to the failure of a taxpayer to report an amount reported on an information return and two examples relate to the obligation of a partner or shareholder in a partnership or S corporation to report consistently with the entity. The last example seems to derive from a tax shelter situation in which a taxpayer claims a deduction, credit or exclusion which is "too good to be true". More specific examples of negligence, with more wide ranging applicability, should appear in the final regulations. Examples should be derived from the multitude of cases which deal with the negligence penalty in the context of a failure to report income, the overstatement of a deduction, large discrepancies between actual and reported income, a failure to keep adequate records,

and the burden of proof necessary for a taxpayer to overcome the assertion of negligence.

We suggest that examples be added illustrating how the reasonable basis defense might apply. One example could involve a taxpayer who studies a section of the Code and related regulations and other relevant authorities and interprets the section in his favor. It is later determined that his interpretation was incorrect. The example would conclude that if, in light of the statutory text and other authorities, there was any reasonable argument in favor of the taxpayer's interpretation, then he would not be considered to have acted negligently or to have disregarded a rule or regulation.

Possible examples illustrating the reasonable conduct defense are discussed in the next section.

3. Testing for Reasonable Conduct.

Under the Proposed Regulations, a taxpayer is negligent if he fails to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return. A rule or regulation is disregarded if the taxpayer carelessly disregards the rule or regulation by not exercising reasonable diligence to determine the correctness of a return position that is contrary to the rule or regulation.[9] The Proposed Regulations give no specific guidance illustrating the standard of conduct that must be met in order to act reasonably. Presumably the required standard of conduct must take into consideration a number of factors, including, among others, the nature of the taxpayer (an

[9] Section 1.6662-3(b)(2) also defines a "reckless" disregard of a rule or regulation, but presumable reckless conduct would also be careless.

individual or business), the overall sophistication of the taxpayer's activities, the routine or unusual nature of the item in question and the materiality of the item.

Given the factual nature of the inquiry, we think the Proposed Regulations should include a number of examples illustrating circumstances where the reasonable care test is met. A few suggested examples are set forth below. In each case the taxpayer takes a position that is clearly wrong, but he is unaware of that fact.

> Example: An individual taxpayer has his return prepared by a professional tax advisor who appears to be competent. He answers truthfully the questions posed to him, provides all required information, and does not claim any deductions that eliminate a substantial portion of his taxable income. The taxpayer erroneously claims a deduction that the preparer tells him is allowable.
>
> Example: An individual prepares his own return. He claims a deduction in an amount that does not eliminate a substantial portion of his taxable income. The claimed deduction could reasonably be read to fit the description of the deduction found in the instructions to Form 1040. However, there is a revenue ruling holding that the deduction is not allowed and the ruling has been sustained by several courts.
>
> Example: A taxpayer participated in a significant transaction during a taxable year. In connection with that transaction he obtained a legal opinion describing the tax consequences. After the transaction occurred and before he filed his return, a court decision directly contrary to the position recommended in the legal opinion was decided. The lawyers rendering the opinion did not inform the taxpayer of the decision and he was not otherwise aware of it.
>
> Example: A taxpayer takes an erroneous position based on an erroneous instruction in an IRS form. The taxpayer is not aware of the error.[10]

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[10] Compare section 1.6694-2(b)(3), Example 4 (reliance on an erroneous form may be a basis for applying the reasonable cause and good faith exception to the income tax preparer penalty where the Service has announced a correction of the form but the preparer is unaware of the announcement.

Section 1.6662-3(b)(1)(iii) states that negligence is strongly indicated if a "taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be 'too good to be true' under the circumstances." We do not think this new test adds anything to the analysis because it requires a determination of what a "reasonable" taxpayer would do to ascertain the correctness of an item and applies only if the item would seem to be too good to be true "to a reasonable and prudent person"; thus, it begs the question.[11] We think the "too good to be true test" should be deleted and replaced with a concrete example illustrating specific factors that should put someone on notice that he should be cautious is claiming a deduction.[12]

4. Frivolous Positions.

Section 1.6662-3(b)(1) includes the following sentence: "A position with respect to an item is attributable to negligence if it is frivolous, or is not frivolous, but lacks a reasonable basis." This sentence is confusing because it mixes together the standard necessary to avoid a negligence penalty with the much less stringent standard that will negate an adequate disclosure.

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[11] Further, given some of the tax benefits that have been provided by Congress over the years, a "too good to be true" test may not be the right standard. Safe harbor leasing and ACRS, to give two examples, might well fit the bill. Reference could also be made to the listing of exceptions to the tax shelter provisions at section 1.6665-3(g)(2)(ii).

[12] The Proposed Regulation gives some guidance on this point indirectly through examples applying the reasonable cause and good faith exception, but the examples are quite limited. In any event, we believe it is appropriate to try to define as clearly as possible the misconduct that invokes the penalties (before application of the reasonable cause and good faith exception).

We recommend that the use of the term frivolous not be used in defining negligence. The definition of a frivolous position should be applicable only to the adequate disclosure exception of section 1.6662-3(c).

If our recommendation is followed, a definition of frivolous would still be needed. A “frivolous” position is defined in section 1.6662-3(b)(3) as one that is “patently improper”. The phrase “patently improper” is not self-defining. The dictionary definition of “patent” is obvious, but obvious to whom? Must the error in a position be obvious on its face, without the need for tax research? The standard for being “not frivolous” should clearly be a lower one than the standard for “having a reasonable basis.” However, if a position is “patently improper” only if it is obviously wrong from the perspective of one with reasonable knowledge of the law, then the line between “frivolous” and “no reasonable basis” would become very thin.[13]

To sharpen the question, suppose a thrift institution claimed that an early withdrawal penalty constituted discharge of indebtedness income. Before the recent Supreme Court decision in Centennial Savings Bank,[14] such a position would have had a reasonable basis, but following the decision it would not (assuming there was no potentially relevant distinction from the facts of the Supreme Court case). Suppose that in 1992, the thrift treats an early withdrawal penalty as discharge of indebtedness income on its return and attaches a Form 8275. In one case the Form cites the Supreme Court case and says that it

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[13] As discussed above in part III.A.2., we are not suggesting that a taxpayer need have any significant knowledge of the tax law in order to avoid the negligence or disregard penalty, since the penalty can be avoided, even for positions having no reasonable basis, through the taxpayer's reasonable conduct in ascertaining his tax liability.

[14] 91-1 U.S.T.C. J 50,188 (April 17, 1991).

was wrongly decided. In the other case, the Form refers to a 1990 article from a tax journal, which says that the issue is a controversial one. The argument for treating the position as frivolous is compelling in the first case because the argument against following Supreme Court opinions is wrong on its face. In contrast, the argument in the second case is obviously wrong only if there is knowledge of the Supreme Court decision. What did the drafters intend on these facts?

Whether or not the term "frivolous" generally requires any knowledge of tax law, a position should be considered frivolous with respect to any taxpayer if the taxpayer has been put on notice that the argument is clearly wrong. Thus, if a taxpayer has litigated a position over the years and lost on each occasion, he should not be permitted to avoid negligence or disregard penalties by disclosing the position.

Another factor indicating that a position is frivolous is that the argument in favor of the position does not attempt to address the language of the Code or other authorities that are commonly looked to in interpreting the Code. One example might be that it is unjust to pay taxes under a system that does not index basis for inflation.

We recommend that the definition of "frivolous" be revised to apply to positions that have no reasonable basis and either are advanced in bad faith or are based on arguments that do not reflect an attempt to apply the internal revenue laws. The bad faith portion of the definition could be illustrated with an example involving the repeated assertion of a position by a taxpayer that has lost on the point in the past (with no intervening change in law). The no attempt to apply branch of the definition could be illustrated with an example that involves an

argument based on a disagreement with the law rather than an interpretation.

B. Section 1.6662-4: Substantial Understatement Penalty.

The substantial understatement penalty can be avoided (except in tax shelter cases) by demonstrating that there is substantial authority for a position. We have a number of comments on section 1.6662-4(d), which discusses the substantial authority rule.

First, section 1.6662-4(d)(3)(ii) states that an older private letter ruling, technical advice memorandum, general counsel memorandum or action on decision generally must be accorded less weight than a more recent one, and that any such document that is more than 10 years old generally is accorded very little weight. While the age of an authority may be a factor in deciding how much weight it should be given, we do not see why internal Service documents should be singled out as having a shorter shelf life than other authorities, or why there should be a special rule for documents more than a decade old.

Clearly, an older authority is more vulnerable than a recent one to being superseded by subsequent developments in the law. However, this concern is already dealt with by providing that an authority must be analyzed in light of other authorities and that an authority ceases to continue to be an authority once it is overruled or modified, implicitly or explicitly, by an authority of the same or a higher source.

There are several reasons why an old authority may be the most significant one. First, the authority may be the only

one dealing with a provision that is obscure and rarely applied. Second, the authority may deal with a provision that was repealed and then reinstated. For example, if the investment tax credit were reinstated with no change in language, old authorities might be quite relevant in construing the new law. Third, the old authority may have been accepted by taxpayers and the Service as resolving the question at issue and for that reason new authorities have not arisen. Fourth, only old rulings may be available because the Service may adopt a policy of refusing to rule in a general area because of a desire to stop issuing "comfort rulings". This has happened recently in the case of many types of reorganizations. Finally, a general counsel memorandum, action on decision or other internal document may be highly relevant in interpreting a revenue ruling, judicial decision or other authority that is not an internal Service document (and hence is not subject to the 10 year rule).

While we would not be troubled by a statement that when an old authority (including an internal Service document) is used, care should be taken to ensure that it has not been rendered obsolete by subsequent developments in the law, we recommend that the arbitrary cut off date be abandoned.[15]

The list of authorities in section 1.6662-4(d)(3)(iii) includes all types of regulations and "notices, announcements and

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[15] The arbitrary cut-off date appears to conflict with the legislative history of the 1989 Act. The House report states that the Treasury is allowed to issue regulations providing that specific internal Service documents, among other items, that were not issued prior to the date of enactment of the bill may not be considered to be substantial authority. For example, regulations could provide that private letter rulings issued prior to the date they began to be publicly disseminated are not substantial authority. However, the report cautions that "Any such limitation should, however, be as narrow as practicable, in order to further the committee's general intent that the list of authorities on which taxpayers may rely should be broadened." See H. R. Rep. No. 101-247, 101st Cong. 1st Sess., p. 1390, footnote 79.

other administrative pronouncements published by the Service in the Internal Revenue Bulletin". While we believe that the preamble to a regulation would in most if not all cases be an "announcement" or "other administrative pronouncement" given the importance of preambles in interpreting regulations, perhaps they should be mentioned explicitly.

The same paragraph of the Proposed Regulations states that

> "an authority does not continue to be an authority once it is overruled or modified, implicitly or explicitly, by an authority of the same or higher source. For example, a district court opinion on an issue is not an authority if overruled or reversed...."

The reference to "authority of the same or higher source" is not entirely clear. Presumably, a decision of a district court in one circuit would not be considered to be overruled by a decision of the Court of Appeals for a different circuit even though the appellate court might be considered a "higher source" (although the appellate decision would, of course, have to be taken into account as a contrary authority). Similarly, a decision by one judge in a district court should not be considered to be overruled or modified because there is a contrary decision by a different judge in the same district, which arguably is the "same source". It should also be recognized that an authority may be overturned or modified only in part.

To address these points, we suggest that the language quoted above be replaced with the following:

> "an authority does not continue to be an authority to the extent it is overruled or modified, implicitly or explicitly, by an authority issued by a body having the power to overrule or modify the earlier authority.

> For example, a district court opinion on an issue is not an authority if reversed or overruled by the court of appeals for such district."

One final situation that requires special mention is the reversal of a decision of the Tax Court by the Court of Appeals for one or more (but less than all) circuits. We would not consider the Tax Court decision to no longer be authority because the Tax Court is not required to follow the appellate court except for taxpayers in the same circuit. Obviously, however, the appellate decision should be taken into account as contrary authority. We recommend that a statement or example to this effect be added.

Section 1.6662-4(d)(iv)(A)(2), concerning written determinations which are revoked or modified after the date of issuance, should provide that, if a taxpayer obtains a ruling and takes a return position in reliance upon the ruling and subsequently the ruling is revoked, but not because of a misstatement or omission of material fact by the taxpayer, no accuracy-related penalty should be asserted against the taxpayer for relying on the ruling. This is likely the proper interpretation of the Proposed Regulations, particularly in light of the timing provision of section 1.6662-4(d)(iv)(C), which provides that the presence of substantial authority is determined either at the time the return containing the item is filed or on the last day of the taxable year to which the return relates. However, if the provision of the Proposed Regulations concerning modification or revocation of written determinations is confined to such acts taken after the issuance of a ruling and before the close of the taxable year to which the return relates, the regulations should so state.

Section 1.6662-(d)(3)(iv)(B) states that (1) the applicability of court cases to the taxpayer by reason of the taxpayer's residence in a particular jurisdiction is not taken into account in determining whether there is substantial authority and (2) there is substantial authority for the tax treatment of an item if the taxpayer's position is supported by controlling precedent of a United States Court of Appeals to which the taxpayer has a right of appeal with respect to the item. We interpret the first of these rules to mean that if there are two conflicting circuit Courts of Appeals decisions on a issue, a taxpayer who resides in the circuit with the adverse decision is treated the same as one who resides in neither of the circuits.[16] We understand that the reference in the second rule to United States Court of Appeals includes the United States Court of Appeals for the Federal Circuit which takes appeals from the Claims Court. Because the Claims Court is a national court, a "controlling precedent" by the Federal Circuit could presumably be relied upon by all taxpayers.

We suggest that examples be added discussing whether there is substantial authority where there are splits between different courts (in particular, between Courts of Appeal, or between the Tax Court and one or more but less than all Courts of Appeal). Splits between courts arise very often, and some specific guidance would be welcomed.

C. Section 1.6662-5: Substantial and Gross Valuation Misstatements under Chapter 1.

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[16] In fact, such a taxpayer would be in a somewhat weaker litigation position, although perhaps this could be avoided by paying a deficiency and suing in the Claims Court. If the taxpayer resided in the circuit with the pro-taxpayer decision, then he could rely on the second rule referred to in the text.

1. Overview.

An accuracy-related penalty of 20% applies to the portion of an underpayment of tax attributable to any substantial valuation misstatement. A substantial valuation misstatement occurs if the value of any property (or the adjusted basis of any property) claimed on any return is 200% or more of the amount determined to be the correct amount. The penalty increases to 4 0% in the event of a gross valuation misstatement, i.e., where the value claimed on the return is 400% or more of the correct amount.[17] There is no disclosure exception to these penalties, but the exception for reasonable cause and good faith applies.

Section 1.6662-5(e) describes a valuation misstatement using the words of the statute. The section adds that the term "property" refers to both tangible and intangible property, the existence of a valuation misstatement is determined on a property-by-property basis (so that a smaller misstatement of the value of one item is not averaged with a larger misstatement with respect to another item), and that the value or basis of an item with a correct value or basis of zero is considered to be 400% or more of the correct amount (so that the 40% penalty rate applies).

2. Misstatements due to Legal Errors.

The term "valuation misstatement" suggests that this penalty is concerned only with valuation issues, which are

[17] The Omnibus Budget Reconciliation Act of 1990 made certain section 482 transfer price adjustments subject to the accuracy-related penalty by characterizing the price adjustment as a valuation misstatement. Section 6662(e)(1)(B). Section 1.6662-5(j) has been reserved for the future issuance of regulations under this provision.

typically factual in nature. Presumably this is why there is no disclosure exception.

However, the basis of property may be affected by the resolution of disputes over legal issues. Although many examples could be given, consider the following: A corporation acquires property in a purported purchase, and the Service asserts successfully that the property was acquired in a reorganization or section 351 transaction and has a carryover basis substantially below the purchase price. A taxpayer who “leases” property claims that he should be treated as the tax owner of the property, but it is determined that the transaction was a lease. A corporation purchases property from a target affiliate following a qualified stock purchase of the target, and the Service argues successfully that the corporation should take a carryover basis under the section 338 consistency rules.

Suppose that in each of these cases the taxpayer's argument had substantial authority or was disclosed on Form 8275 and that the overstatement of basis resulting from the legal error was more than 200%. Was it really intended that a taxpayer under these circumstances would potentially be subject to the substantial valuation penalty (including the 40% penalty rate if the overstatement exceeds 400%)? The statute (and the Proposed Regulations which mimic the statute) could be read to achieve these results, but we do not believe they were intended. The legislative history of the valuation penalty (which was added in 1981) clearly indicates that it was intended to avoid disputes over the fair market value of property—not legal issues, which were addressed by other penalties.[18]

[18] See General Explanation of the Economic Recovery Tax Act of 1981, at 332.

We strongly recommend that underpayments attributable to legal errors (as contrasted with errors in determining fair market values, which may of course be reflected in basis) be carved out of the valuation misstatement penalty.

2. Timing Issues.

Suppose that a taxpayer overstates the tax basis of an item of property in a taxable year but does so at the cost of losing a deduction in a different year. Could the valuation misstatement penalty apply?

To illustrate, suppose that an individual A owns all of the stock of corporation C. A's basis in the stock at the end of 1990 is $1 million, and A claims a $1 million worthless stock deduction with respect to such stock in 1992. It is determined that in fact the stock became worthless in 1991. Thus, A's 1992 capital loss is denied and (assuming 1991 is still open) a refund (with interest) is granted for 1991. Is A potentially liable for a 40% substantial misstatement penalty for 1992, on the ground that the basis of the stock was claimed to be $1 million, but in fact it was zero? The definition of underpayment in section 1.6664-2 would not seem to allow the 1991 refund to be offset against the 1992 deficiency, but it seems quite unfair to impose a penalty in a case where, looking at 1991 and 1992 together, A did not seek to overstate the basis of the stock.

One technical solution to the problem described above would be to maintain that a taxpayer does not "claim on a return" that the adjusted basis of property exceeds its correct amount unless he asserts that the number is greater than it has been in his hands in any year. On that theory, the penalty would not

apply in the example, because A never claimed a basis greater than $1 million.