Department of the Treasury | Internal Revenue Service | Office of Chief Counsel

Notice

CC-2004-036

September 22, 2004

Subject: Penalty Administration **Cancel Date**: Upon incorporation into CCDM

Purpose

This Notice is intended to ensure that Chief Counsel attorneys understand the role of penalties in tax administration and support the imposition of penalties when the Service has developed and applied penalties properly.

Discussion

A. Penalty Administration

When properly developed and applied, penalties assist the Service in promoting sound tax administration by increasing the economic costs of noncompliance. In the context of corporate taxpayers, the required disclosure of penalties creates an additional deterrent effect. Although Service policy specifically provides that penalties are not a "bargaining point," taxpayers and their representatives frequently offer to agree to all, or a larger portion, of a deficiency in exchange for a government concession of the penalties. When the Service develops and imposes penalties properly, a concession of the penalties does not reflect the hazards of litigation, even if the net dollar settlement for a larger deficiency would produce the same revenue as a settlement for a portion of the deficiency and a portion of the penalty. Conceding penalties in such cases also risks undercutting efficient tax administration by reducing the deterrent effect of penalties.

Taxpayers and tax practitioners will have less incentive to voluntarily comply if they believe that they can routinely bargain away penalties. In the context of tax shelters (especially listed transactions and potentially abusive transactions), the proper imposition and sustention of penalties in Appeals and in litigation can serve as an effective tool to combat the proliferation of abusive tax shelters. Similar considerations arise in the context of the net section 482 transfer price adjustment penalty under section 6662(e)(3) and the information-reporting and non-compliance penalties under section 6038A. The appropriate imposition and sustention of such penalties

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substantially increases the prospects of the timely submission to the Service of information and documentation that is critical to the examination process.

As a compliance tool, it is important that all Service functions coordinate the application of penalties so that: (1) Examination employees consider, develop, and impose penalties where appropriate, with heightened scrutiny given to cases involving a listed transaction or a transaction that the Service has otherwise identified as potentially abusive; (2) Appeals and Counsel resolve penalties based on their merits, including a hazards assessment; and, finally, (3) Counsel defends the penalty determination in litigation based on an analysis of the hazards of litigation for the penalty independent of the hazards of litigation for the underlying tax adjustments.

Attached to this Notice is a copy of the June 21, 2004 memorandum from the Chief, Appeals directing that Appeals should no longer trade penalty issues.

B. Role of Chief Counsel

Chief Counsel attorneys should consider the proper application and development of penalties when advising Service employees during examinations and in Appeals, and in the attorneys' conduct of litigation. In deciding whether to settle docketed cases, Chief Counsel attorneys must consider the hazards of litigation with respect to the penalties independent of the hazards of litigation with respect to the underlying tax adjustments. The Counsel Settlement Memorandum should include an analysis of the hazards of litigation as to the penalties.

If the Chief Counsel attorney and manager conclude that the hazards of litigation with respect to the penalties do not support a settlement of the penalties, the Chief Counsel attorney must lay the evidentiary foundation for the penalties. In that regard, Chief Counsel attorneys will have the burden of production to establish an individual taxpayer's liability for any penalty. I.R.C. § 7491(c). Taxpayers, however, have the burden to establish defenses, such as reasonable cause, substantial authority, or similar defenses to the imposition of penalties. See also Long-Term Capital Holdings v. United States, __ F.Supp. 2d __ , 2004 U.S. Dist LEXIS 17765 (D. Conn. 2004), for a discussion of the burden of proof issue under section 7491.

One of the most common taxpayer defenses is the claim that the taxpayer reasonably relied in good faith on the advice of a professional tax advisor in taking a return position. I.R.C. § 6664(c). While professional tax advice can afford taxpayers a defense to the imposition of penalties, the mere fact that the taxpayer obtained such advice does not necessarily, in and of itself, meet the requisite burden of proof. Circumstances may show that the taxpayer did not rely on the advice in good faith, or that the taxpayer's reliance was not reasonable. The regulations under section 6664 provide a nonexclusive description of circumstances where taxpayers may not rely on the advice of others as a defense to accuracy-related penalties. See Treas. Reg. § 1.6664-4(c); Long-Term Capital Holdings.

Further guidance on the development and litigation of the penalties is available in an Audit Technique Guide.

Should you have any questions regarding this Notice, please contact Bridget Tombul at (202) 622-4940.

/s/
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Chief Counsel

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

CHIEF, APPEALS

June 21, 2004

MEMORANDUM FOR ALL APPEALS EMPLOYEES

FROM: David B. Robison */s/ David B. Robison*
Chief, Appeals

SUBJECT: Interim Guidance on Appeals Policy Regarding Trading Penalties

The purpose of this memorandum is to establish a new policy for Appeals concerning the settlement of penalty issues. Effective immediately we will no longer trade penalty issues in Appeals. Penalties can and should still be settled, but the settlement should be based on the merits and the hazards surrounding each penalty issue standing alone.

This guidance will be incorporated into IRM 8.6.1.3 by March 2005.