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# Bogus Refunds & Bad Penalties: The Feckless and Fixable Refund Penalty System

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# BOGUS REFUNDS & BAD PENALTIES: THE FECKLESS AND FIXABLE REFUND PENALTY SYSTEM

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## I. INTRODUCTION

Bogus refund schemes, i.e., schemes created to generate undeserved tax refunds, have long plagued the Internal Revenue Service ("IRS").[1] In 2011-2013, the IRS identified and stopped over $53 billion fraudulent refunds, yet paid over $10 billion in fraudulent refunds during the same period.[2] Those bogus refunds, however, are not a new phenomenon: a 2005 report by the Treasury Inspector General for Tax Administration ("TIGTA") to Congress noted that in that year, there were approximately 70,000 bogus claims for refund, totaling over $100 million.[3] By 2007, the Joint Committee on Taxation (the "Joint Committee"), echoing TIGTA's concerns, told Congress that bogus refund claims had created "unnecessary burdens on both taxpayers and the IRS by straining IRS resources and impeding effective tax administration."[4]

1. *See, e.g.*, Leslie Book, *Closing the Tax Gap: Refund Anticipation Loans and the Tax Gap*, 20 STAN. L. & POL'Y REV. 85 (2009); George Guttman, *Improper Refunds Sapping Billions; IRS, Treasury, Hill Seek Answers*, 65 TAX NOTES 19, 20 (1994); Malcolm K. Sparrow, *1993 Report on IRS Vulnerability to Refund Fraud*, TAX NOTES TODAY, Feb. 20, 1996, at 35-51, § 2.3.1; William J. Turnier, *Electronic Filing: A Very Dubious Success*, 59 TAX NOTES 569 (1993).

2. *See* TREASURY INSPECTOR GEN. FOR TAX ADMIN., INTERIM RESULTS OF THE 2014 FILING SEASON (2014), *available at* http://www.treasury.gov/tigta/auditreports/2014reports/201440029fr.html. *See also* Gregory Wallace, *IRS Paid $3.6 Billion in Fraudulent Tax Refunds*, CNN MONEY (Nov. 7, 2013), http://money.cnn.com/2013/11/07/pf/taxes/irs-fraud/ ("The IRS paid out $3.6 billion in fraudulent tax refunds to identity thieves last year, according to an inspector general report.").

3. *See* TREASURY INSPECTOR GEN. FOR TAX ADMIN., SEMIANNUAL REPORT TO CONGRESS: APRIL 1, 2005-SEPTEMBER 30, 2005, *available at* http://www.treasury.gov/tigta/semiannual/semiannual_dec2005.pdf [hereinafter 2005 TIGTA REPORT].

4. STAFF OF J. COMM. ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2008 BUDGET PROPOSAL 186 (Comm. Print 2007) [hereinafter 2007

In response to both TIGTA's and the Joint Committee's concerns, in 2007, Congress enacted Internal Revenue Code (the "Code") section 6676,[5] which gave the IRS the power to penalize erroneous and fraudulent refund claims.[6] Congress later amended section 6676 in 2010, extending the section 6676 refund penalty to refund claims based on transactions lacking economic substance.[7]

While well-intentioned, section 6676 has been feckless.[8] For the five years between May 2007 and May 2012, the IRS assessed only 84 section 6676 erroneous refund penalties, collecting roughly $1.9 million.[9] However, TIGTA found that for the approximately one-year period between June 3, 2012 and May 25, 2013, "the IRS could have potentially assessed erroneous penalties totaling more than $1.5 billion."[10] This Article explains why those potential penalties have not

JCT REPORT].

5. Unless otherwise indicated, all references herein to "section" refer to the Internal Revenue Code of 1986, as amended. Tax Reform Act of 1986, Pub. L. 99-514, § 2, 100 Stat. 2095 (1986) (codified as amended in scattered sections of 26 U.S.C.).

6. Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28, § 8247, 121 Stat. 112, 204 [hereinafter Work Opportunity Tax Act].

7. Health Care and Education Reconciliation Act of 2010, Pub. L. 111-152, § 1409(d), 124 Stat. 1029, 1070. Prior to 2007, there was no penalty for filing an "excessive" claim for a tax refund under section 6676. The predecessor of the current penalty based on erroneous claims for refund was first mentioned in a September 15, 2006 Senate bill that was ultimately not passed. *See* S. 1321, 109th Cong. (2006). That bill proposed a 20% penalty for an erroneous claim for refund, and the authors of the bill stated as the reason for the bill, "the filing of erroneous refund claims is being used by some taxpayers to put a strain on IRS resources and to delay the resolution of tax matters." S. COMM. ON FINANCE, TELEPHONE EXCISE TAX REPEAL AND TAXPAYER PROTECTION AND ASSISTANCE ACT OF 2006, S. REP. NO. 109-336 (2006).

8. Instead of fixing the penalty, at least one member of Congress is seeking to expand it. In 2013, Rep. Jerry McNerney (D-CA) introduced H.R. 2740, the "Stop Outsourcing and Create American Jobs Act of 2013." The bill would amend the section 6676 penalties by adding a new penalty for corporations claiming refunds related to tax haven countries. The text of the bill, in pertinent part, would redesignate subsection (d) as subsection (e) by inserting after subsection (c) the following new subsection:

> (d) INCREASE IN PENALTY IN CASE OF TAX HAVEN COUNTRIES.—In the case of claim or credit by a corporation for any excessive amount due for credits or refunds involving funds held or invested in a tax haven country (as defined in section 6662(k)(2)), subsection (a) shall be applied by substituting "40 percent" for "20 percent."

Stop Outsourcing and Create American Jobs Act of 2013, H.R. 2740, 113th Cong., § 3(d).

9. TREASURY INSPECTOR GEN. FOR TAX ADMIN., THE LAW WHICH PENALIZES ERRONEOUS REFUND AND CREDIT CLAIMS WAS NOT PROPERLY IMPLEMENTED 2 (2013), *available at* http://www.treasury.gov/tigta/auditreports/2013reports/201340123fr.pdf [hereinafter 2013 TIGTA REPORT).

10. *Id*.

been assessed.

Part of the blame for section 6676's ineffectiveness is a lack of guidance regarding implementation, and that blame falls squarely at the feet of both the IRS and the U.S. Treasury Department ("Treasury").[11] Since enactment, Treasury has failed to issue implementing regulations for section 6676, relying instead on the IRS to, in effect, make it up as they go along. That has not worked out so well. The IRS, in making it up, got it wrong at least twice and left its employees largely in the dark about how the penalty should be implemented.[12]

Another part of the blame goes to Congress, which failed to think through material issues regarding section 6676's purpose before passing it.[13] As noted by the Joint Committee, the bogus refund claims highlighted in the 2005 TIGTA report were a major impetus for passing section 6676.[14] Among other findings, that report found that taxpayers fraudulently claiming the Earned Income Tax Credit ("EITC") were a significant part of the bogus refund problem.[15] So what did Congress do? It passed a refund claim penalty that excluded EITC-based refund claims.

The Joint Committee also foretold of the problems with administering the penalty, noting "the proposal (i.e., the new penalty) may lead to some additional complexity in the administration of the penalty provisions. For example, administration of the new penalty may be impacted by uncertainty regarding its application in cases in which present-law penalties also might apply."[16] Those prescient sentences presaged the morass that is the current state of section 6676.

In 2013, TIGTA identified steps the IRS could take to correct its internal procedures to properly impose the penalty. In addition, based on

11. The IRS is a bureau of Treasury, and section 7805(a) gives Treasury the power to create the necessary rules and regulations for enforcing the Code. *See* I.R.C. § 7805(a) (2012).

12. *See* 2013 TIGTA REPORT, *supra* note 9. Specifically, the report noted that section 6676 penalties have not been assessed because (i) IRS administration failed to provide guidance to employees about when the penalty should be assessed, and (ii) IRS Counsel provided incorrect legal guidance to IRS employees regarding the IRS's authority to assess the erroneous refund penalty. *Id.* at 10.

13. *See* Christine S. Hooks, *Spotlight on the Penalty for Excessive Refund Claims, I.R.C. § 6676*, INSIDE BASIS, Spring 2013, at 5, 5, *available at* http://www.fedbar.org/image-library/events/2013-Annual-Meeting/Newsletter-Winners/TAX.pdf ("Despite the breadth of the penalty provision, it appears that Congress had in mind only a few types of excessive erroneous refund claims when it enacted the penalty.").

14. The 2005 TIGTA Report is cited in the first line of the "Analysis" section of the 2007 JCT Report. *See* 2007 JCT REPORT, *supra* note 4, at 186.

15. *See* 2005 TIGTA REPORT, *supra* note 3, at 16.

16. *See* 2007 JCT REPORT, *supra* note 4, at 186.

discussions with IRS administrators, TIGTA noted that the IRS would seek to implement section 6676 penalties more aggressively in the future.[17] Notwithstanding TIGTA's suggested corrections, aggressive implementation only portends more problematic issues for section 6676, including: (1) the law is beset with unaddressed structural problems; (2) as drafted, implementation may violate the U.S. Constitution; and (3) well-represented taxpayers may be able to avoid the penalty. As one headline regarding the current state of affairs regarding the section 6676 penalty noted, it is "A Tax Morass Only a Lawyer Could Love."[18]

This Article analyzes the problems with section 6676 as it currently applies and offers suggestions to change it. The Article begins by identifying the reasons section 6676 has been unable to accomplish its policy goals and then highlights problems on the horizon. It ends by suggesting legislative and regulatory changes that will ameliorate the problems with section 6676 and allow the law to accomplish the goals Congress sought to achieve through its enactment.

Part II of this Article lays out the problems associated with erroneous claims for refund and past legislative attempts to deal with the problem, ultimately leading to the enactment of section 6676. Part II also explains generally how section 6676 differs from most other tax penalty provisions, and how those differences have hampered its implementation.

Part III examines the problematic legal and policy issues the section 6676 penalty raises. Part III.A explores administrative problems with the section 6676 penalty, and begins with an examination of the issues that have arisen regarding the penalty's procedure and implementation. Many of those problems were on the horizon when the law was passed, but, to date, have not been addressed.[19] One issue, regarding how to properly calculate the section 6676 penalty, was recently addressed by the U.S. Tax Court ("Tax Court"), and not in the government's favor. Using the Three Stooges as an example, the section demonstrates how

17. *See* 2013 TIGTA REPORT, *supra* note 9. The report noted that the IRS stated, in response to TIGTA's recommendation, that "a cross-functional team of affected stakeholders will determine the operational and procedural changes needed to integrate assessment of the erroneous refund penalty into the Campus Operations." *Id*. at 2. My understanding of that corporate-speak suggests this is how the IRS states it will try to do better in the future.

18. Ilya Shapiro & Matt Gilliam, *A Tax Morass Only a Lawyer Could Love*, AMERICAN (Dec. 10, 2012), *available at* http://www.american.com/archive/2012/december/a-tax-morass-only-a-lawyer-could-love.

19. In what should be a textbook definition of understatement, the Joint Committee stated in 2007 that, "depending on certain details of the proposal [section 6676] that have not yet been specified, the proposal may lead to some additional complexity in the administration of the penalty provisions." 2007 JCT REPORT, *supra* note 4, at 186.

that Tax Court decision increased exponentially the procedural and administrative complexity of implementing section 6676.

Part IV analyzes a number of outstanding legal and policy issues raised by section 6676. The section begins by examining how imposing the section 6676 penalties may not pass constitutional muster. Briefly, requesting a tax refund is a well-established, constitutionally-recognized form of First Amendment petitioning activity, and any infringement upon that right must provide certain procedural safeguards. As currently implemented, section 6676 has no such safeguards. The section then explores other unresolved legal and policy issues on the horizon for section 6676.

Part IV.C explains a more practical problem with section 6676: the penalty may be avoidable by well-represented taxpayers. The section demonstrates how taxpayers and their counsel, by skillfully navigating the sometimes Byzantine procedural aspects of tax litigation may structure their refund requests in such a way that could leave the IRS powerless to impose the penalty. Such tactics would make section 6676 a *de facto* poor people's tax, applicable only to those who lacked the skill and sophistication to avoid it. That cannot be what Congress intended.

Part V suggests legislative and regulatory changes to section 6676 that would not only ameliorate the procedural and administrative problems, but also satisfy the goals identified by TIGTA and the Joint Committee. Those changes seek to balance the government's need to address the problem of bogus refund claims with both taxpayers' and the IRS's need for clear rules and procedures. Lastly, Part VI offers a conclusion, as well as a hope for a more effective law.

## II. TAX PENALTIES, REFUNDS AND TAX SHELTERS

For the most part, taxpayers are rational. They will not engage in behaviors, such as cheating on their taxes, if the expected costs of those actions outweigh the benefits.[20] One item on the cost side of that cost-benefit calculation is tax penalties, which increase the cost of cheating.[21]

20. *See* Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1783 (2000):

> A simple approach to the problem of tax compliance holds that when people decide whether to pay their taxes, they take account only of the cost of the tax and of the expected legal sanction from noncompliance. If the expected sanction exceeds the tax payment, the person will pay; otherwise, he will not.

21. Yoram Keinan, *Playing the Audit Lottery: The Role of Penalties in the U.S. Tax Law in the Aftermath of* Long Term Capital Holdings v. United States, 3 BERKELEY BUS. L.J. 381, 395

According to the IRS Internal Revenue Manual (the "IRM"), "[P]enalties exist to encourage voluntary compliance by supporting the standards of behavior required by the Internal Revenue Code."[22] Although often spun using the positive terminology of encouraging voluntary compliance, the reality is that penalties serve as a deterrent to intentional non-compliance. The deterrent effect is particularly necessary in the tax context, because the chance of the IRS detecting non-compliance is relatively small. In 2010, for example, the overall probability of audit for individual taxpayers was just over 1%.[23] Absent a penalty, there would be no rational (as opposed to a moral or ethical) reason for a taxpayer to comply with tax laws, because the taxpayer would have a 99% chance of his non-compliance going undetected.[24]

### A. *Refund Schemes*

Based on the 2007 Joint Committee report, the focus of section 6676 was bogus refund schemes, i.e., individuals filing fraudulent tax returns to claim an undeserved refund. For purposes of this Article, individuals seeking fraudulent refunds will be called "Fraudsters."

Section 6676 was amended in 2010 to include transactions lacking economic substance. That amendment was part of broader legislation ostensibly aimed at discouraging tax shelters and other tax avoidance transactions by high net worth individuals and corporations. As amended, section 6676 imposed a penalty on those seeking tax refunds by gaming the tax system with sophisticated tax shelters and other tax avoidance transactions. For purposes of this Article, those seeking to game the tax system through sophisticated tax avoidance transactions will be called "Gamers."

Between the Fraudsters and the Gamers are the vast majority of

(2006) ("in the absence of penalties or when the probability of penalties is much less than unity, taxpayers who are not risk-averse will be expected to enter into tax-motivated transactions").

22. IRM 20.1.1.2.1(5) (Aug. 5, 2014). *See also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-567, IRS SHOULD EVALUATE PENALTIES AND DEVELOP A PLAN TO FOCUS ITS EFFORTS 3 (2009) (noting that, "in order to advance the fairness and effectiveness of the tax system, penalties should be severe enough to deter noncompliance, encourage noncompliant taxpayers to comply, be objectively proportioned to the offense, and be used to educate taxpayers and encourage their future compliance").

23. *See* IRS, DATA BOOK, 2010, at 22 (2010), *available at* http://www.irs.gov/pub/irs-soi/10databk.pdf (providing that as of 2010, the chance of audit for all individual taxpayers was about 1.1%).

24. For a more detailed analysis of taxpayers' cost-benefit analysis, see Del Wright Jr., *Financial Alchemy: How Tax Shelter Promoters Use Financial Products to Bedevil the IRS (And How the IRS Helps Them)*, 45 ARIZ. ST. L.J. 611, 654-59 (2013).

taxpayers who improperly seek tax refunds based on a mistake of law or fact. This group of taxpayers generally cannot afford tax lawyers to help them navigate the sometimes difficult provisions of the Code. For purposes of this Article, this group will use the sobriquet "99 Percenters."

One subgroup of the 99 Percenters is particularly relevant for purposes of this article: those seeking tax refunds based on refundable tax credits. A refundable tax credit (a "refundable credit") is a tax credit that the IRS treats as a cash-equivalent payment. Thus, if the amount of a refundable credit exceeds a taxpayer's tax liability, the government will pay the excess to the taxpayer as a refund. Refundable credits are unlike the majority of tax credits, which are nonrefundable. Those nonrefundable credits may reduce a taxpayer's federal income tax liability to zero, but any excess credits are not refunded to the taxpayer.

"Most refundable tax credits were created to meet social policy goals, such as providing income support for low-income households, expanding health insurance coverage, or increasing college enrollment."[25] For the most part, they were enacted to assist working people in the low-to-middle income ranges, and phase out at upper incomes. For the purposes of this Article, taxpayers eligible to claim refundable credits are referred to as "Strivers." Though designed for Fraudsters and Gamers, section 6676 applies effectively only to Strivers.

### 1. Fraudster Refund Schemes

*"Although the government can be slow to build roads and fix budgets, it can issue tax [refunds] within days"*[26]

In 2013, CNN reported that tax refund fraud has "ballooned" in recent years, increasing over 400% from $166 million in 2007 to $758 million in 2010 (the latest year available at the time).[27] TIGTA estimates

25. *See* CONGRESSIONAL BUDGET OFFICE, REFUNDABLE TAX CREDITS 2 (2013), *available at* https://www.cbo.gov/sites/default/files/43767_RefundableTaxCredits_2012_0.pdf. Recent refundable credits include the Earned Income Credit, the Excess Social Security Credit, the Additional Child Tax Credit, the Health Coverage Tax Credit, and the American Opportunity Credit (which is only partly refundable).

26. *See* David Wolman, *Beware of Gangsters Filing Tax Returns*, BLOOMBERG BUSINESSWEEK (Jan. 9, 2014), http://www.businessweek.com/articles/2014-01-09/tax-refund-fraud-fake-returns-net-gangsters-millions. The article noted incorrectly that the government can issue tax "returns," not "refunds."

27. *See* Blake Ellis, *Prisoners Rake in Millions from Tax Fraud*, CNN MONEY (Jan. 30, 2013), http://money.cnn.com/2013/01/17/pf/taxes/prisoner-tax-fraud/. This problem is not just a recent one. In its 2005 report to Congress, TIGTA noted that "refund fraud committed by prisoners is growing at an alarming rate. The number of false returns from prisoners identified by the IRS

refund fraud has since grown to $2.3 billion in 2011, and forecasts, as of December 2013, "approximately $11.4 billion in fraudulent refunds over the next five years."[28]

One reason refund fraud has proliferated is the ease with which savvy criminals (Fraudsters) can file a false tax return and request a bogus refund. For the most part, all Fraudsters need to make bogus refund requests are "real Social Security numbers, dates of birth, bank account information, addresses, and an Internet connection."[29] The ease of using the tax system to steal from the government has not been lost on criminal syndicates. According to *Businessweek*, "[O]rganized crime has learned that stealing from the federal government [through tax fraud] can be easier and more lucrative than dealing drugs."[30]

> *"But he that filches from me my good name, Robs me of that which not enriches him, And makes me poor indeed."*
>
> *— Shakespeare, Othello, act iii. Sc. 3.*

Unsurprisingly, many Fraudster refund schemes are linked to identity theft.[31] According to the Federal Bureau of Investigation

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grew" from 4,300 returns to over 18,000 returns in a two-year period, and the IRS only screened about "36,000 of the 455,000 prisoner refund returns." 2005 TIGTA REPORT, *supra* note 3, at 15. Since that report, the number of fraudulent prisoner tax returns has again more than doubled from the over 18,000 identified in the 2005 TIGTA Report to approximately 50,000 identified by the IRS in 2009. *See* Press Release, Treasury Inspector Gen. for Tax Admin., *IRS Efforts to Identify Prisoner Tax Refund Fraud: Significant Problems Persist, TIGTA Finds*, U.S. DEP'T TREASURY (Jan. 4, 2011), http://www.treasury.gov/tigta/press/press_tigta-2011-1.htm. Fraudulent refunds claimed rose from $68.1 million to $295.1 million during the same period. The IRS's number likely understates the problem. The 2009 TIGTA Report noted that the IRS data was limited to only those tax returns the IRS identified and chose to evaluate for fraud. TIGTA identified 540,984 tax returns that were filed by prisoners in 2009, of which 54,410 were not identified by the IRS as having been filed by a prisoner. *See* TREASURY INSPECTOR GEN. FOR TAX ADMIN., SIGNIFICANT PROBLEMS STILL EXIST WITH INTERNAL REVENUE SERVICE EFFORTS TO IDENTIFY PRISONER TAX REFUND FRAUD (2010), *available at* http://www.treasury.gov/tigta/auditreports/2011reports/201140009fr.pdf.

28. TREASURY INSPECTOR GEN. FOR TAX ADMIN., STOLEN AND FALSELY OBTAINED EMPLOYER IDENTIFICATION NUMBERS ARE USED TO REPORT FALSE INCOME AND WITHHOLDING (2013), *available at* http://www.treasury.gov/tigta/auditreports/2013reports/201340120fr.pdf.

29. Wolman, *supra* note 26.

30. *Id*.

31. "Identity theft," as defined by the IRS, is:

> the use of another person's identifying information stolen from a wide variety of places and through a wide variety of means. With respect to the IRS, identity theft manifests itself in several ways. First, it is used to defraud the government of funds through the filing of fraudulent refund claims. Second, in many instances it victimizes an innocent taxpayer by impeding his or her ability to get a refund from us. Fraudulent filings may also cause us to initiate an adverse enforcement action against the innocent taxpayer.

*See Hearing on Identity Theft and Return Preparer Fraud Before the Subcomm. on Crime,* ("FBI"), "this type of crime is perceived by criminals and organized criminal enterprises as relatively easy, seemingly low-risk, and, ultimately, pure profit which can be used to fund other criminal activities . . . like drug trafficking, money laundering, public corruption, or even terrorism."[32]

From 2008 through May 2012, more than 550,000 taxpayers have had their identities stolen for the purpose of claiming bogus refunds.[33] From 2011 through November 2013, the IRS believes its efforts have prevented the issuance of over $50 billion in bogus refunds based on identity theft.[34]

While clearly illegal, Fraudster refund schemes are exceedingly difficult to detect and prosecute. The IRS has hundreds of millions of returns to process and must maintain a delicate balance: to minimize fraud and abuse but, at the same time, not unduly delay tax refunds.[35]

A significant factor in the proliferation of Fraudster refund schemes was that, before the enactment of section 6676, there was almost no sanction to filing a bogus request.[36] As noted in the 2007 Joint

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*Terrorism and Homeland Security of the H. Comm. on the Judiciary* 1 (June 28, 2012) (written testimony of Rebecca Sparkman, Dir., Operations, Policy & Support Criminal Investigation Div., IRS), *available at* http://judiciary.house.gov/_files/hearings/Hearings%202012/Sparkman%2006282012.pdf [hereinafter Sparkman Testimony].

32. *See Investigating Tax Refund Fraud, FBI Works Cooperatively with Federal Partners*, FBI STORIES (Mar. 18, 2014), http://www.fbi.gov/news/stories/2014/march/investigating-tax-refund-fraud/investigating-tax-refund-fraud.

33. *See* Sparkman Testimony, *supra* note 31, at 3. *See also* Press Release, Office of Public Affairs, *Justice Department Highlights Efforts to Combat Stolen Identity Tax Refund Fraud*, U.S. DEP'T JUST. (Feb. 24, 2014), http://www.justice.gov/opa/pr/2014/February/14-tax-193.html.

34. *See* IRS Newsroom, *IRS Combats Identity Theft and Refund Fraud on Many Fronts*, IRS (Jan. 2014), http://www.irs.gov/uac/Newsroom/IRS-Combats-Identity-Theft-and-Refund-Fraud-on-Many-Fronts-2014.

35. *See* Sparkman Testimony, *supra* note 31, at 2:

> We cannot manually inspect 100 million refunds to ensure all are correct – nor is there any justification for doing so. That is neither practical nor in keeping with Congressional intent. The IRS has a dual mission when it comes to refunds, particularly when they are generated in whole or in part by tax credits. Refundable and other tax credits are provided to achieve important policy goals, such as relieving poverty, encouraging work, or boosting the economy. The IRS must deliver refunds in the intended time frame, while ensuring that appropriate controls are in place to minimize errors and fraud. We must balance the need to make payments in a timely manner with the need to ensure that claims are proper and taxpayer rights are protected.

36. Although fraudulent refund claims clearly warranted sanction, the available remedies were somewhat limited. Criminal charges were, as they are now, certainly an option, but the scope of the problem, as well as the relatively small amounts at issue, could overwhelm the U.S. Department of Justice. For the 2013 fiscal year, the IRS initiated 1,492 identity theft-related criminal investigations leading to criminal charges in 1,050 cases. *See* IRS Newsroom, *IRS Criminal Investigation Combats Identity Theft Refund Fraud*, IRS (Jan. 2014), http://www.irs.gov/

Committee Report, existing (pre-section 6676) penalties generally were based on tax underpayments, not on whether taxpayers made a claim for refund.[37] Thus, even when the IRS detected that a claim was bogus, the taxpayer's costs were generally "limited to repayment of the refund plus interest for the period of time such funds were held."[38]

One Fraudsters scheme that was mentioned in the lead-up to section 6676's enactment was the aptly titled 1099-OID tax fraud scheme. The scheme is relatively simple: so-called taxpayers[39] would create fictitious Forms 1099-OID (forms used legitimately to report accruing interest for certain types of debt instruments) claiming that taxes had been withheld based on the original issue discount ("OID") that had been included in their gross income. Those "taxpayers" would then submit fraudulent returns claiming refunds based on the tax purportedly withheld.[40] To provide a sense of the breadth of the problem with just the 1099-OID tax fraud scheme, in one 2012 prosecution, three defendants pleaded guilty to a nationwide scheme claiming "nearly $100 million in fraudulent refunds from the IRS."[41]

Another "popular" Fraudster refund scheme is committed by those in prison. According to TIGTA, "fraudulent tax returns filed by prisoners and identified by the IRS [have] increased from more than 18,000 tax returns in 2004 to more than 168,000 tax returns in 2010, with the refunds claimed on these returns increasing from $68 million to $757 million."[42] In testimony to Congress, TIGTA estimated that bogus

uac/Newsroom/IRS-Criminal-Investigation-Combats-Identity-Theft-Refund-Fraud. While significant, according to TIGTA, "billions of dollars in potentially fraudulent tax refunds continue to be issued without detection." *See* TREASURY INSPECTOR GEN. FOR TAX ADMIN., DETECTION HAS IMPROVED; HOWEVER, IDENTITY THEFT CONTINUES TO RESULT IN BILLIONS OF DOLLARS IN POTENTIALLY FRAUDULENT TAX REFUNDS (2013), *available at* http://www.treasury.gov/tigta/auditreports/2013reports/201340122fr.pdf.

37. *See* 2007 JCT REPORT, *supra* note 4, at 186 ("Generally, existing penalties are calculated on the existence of a tax underpayment and not on whether claim results in a refund.").

38. *Id*.

39. The word "taxpayers" is a bit of a stretch in this context.

40. *See* United States v. Sundberg, No. C-09-4085 EMC, 2011 U.S. Dist. LEXIS 93653, at *3-4 (N.D. Cal. Aug. 22, 2011). Under a typical Form 1099-OID refund scheme, . . . a taxpayer claims to have either issued or purchased a debt instrument that generated OID interest income. The taxpayer further claims that federal income taxes were withheld by the borrower for the full amount of the OID interest income purportedly earned by the taxpayer. The taxpayer then reports the total amount of the false withholding (and sometimes the false OID interest income) on their income tax return, resulting in a large (and completely unsubstantiated) refund. *Id*.

41. *See* Press Release, U.S. Att'ys Office, W. Dist. Mo., *Georgia Woman Pleads Guilty to Tax Fraud: Nearly $100 Million Scheme Is Largest False Claims Case Ever Prosecuted in MO*, U.S. DEP'T JUST. (Apr. 10, 2012), http://www.justice.gov/archive/usao/mow/news2012/wilson_jennifer.ple.html.

42. Press Release, Treasury Inspector Gen. for Tax Admin., *More Improvements Needed to*

refund claims rose the following year (2011) to $3.7 billion.[43]

In an effort to slow the growth of prisoner refund fraud, Congress passed The Inmate Tax Fraud Prevention Act of 2008 (the "Inmate Tax Fraud Prevention Act"), which gave the IRS the authority to disclose information concerning prisoners who filed a false tax return to the head of the Federal Bureau of Prisons, as well as state departments of corrections.[44] The law also requires TIGTA to provide Congress with a report on the IRS's progress in sharing prisoner tax information. As of October 2010, TIGTA found that the IRS had not shared any such information.[45] As recently as January 2014, the situation has not changed.[46]

One impetus for passing section 6676 was to address prison refund fraud.[47] I leave for others to deduce the logic and efficacy of seeking to impose a tax penalty on prison refund schemes. Not to put too fine a point on it, but those already incarcerated are not likely to be dissuaded from engaging in fraudulent refund schemes based on a potential 20% penalty.[48]

As noted above, refund schemes based on identity theft constitute a significant portion of Fraudster refund schemes. In 2012, TIGTA estimated that "the IRS could issue approximately $21 billion in fraudulent tax refunds resulting from identity theft over the next five years."[49] In response, the IRS listed identity theft at the top of its "'Dirty

*Stop Prisoner Tax Fraud, TIGTA Finds*, U.S. DEP'T TREASURY (Jan. 17, 2012), http://www.treasury.gov/tigta/press/press_tigta-2013-02.htm.

43. *See Oversight Hearing – Internal Revenue Service: Hearing Before the Subcomm. on Fin. Serv. & Gen. Gov't of the H. Comm. on Appropriations*, 113th Cong. 23 (2014) (testimony of the Hon. J. Russell George, TIGTA), *available at* http://www.treasury.gov/tigta/congress/congress_02262014.pdf [hereinafter J. Russell George Testimony] ("The IRS informed us that the number of fraudulent tax returns identified by the IRS as filed using a prisoner SSN has increased from more than 18,000 tax returns in CY 2004 to more than 186,000 tax returns in CY 2011. The refunds claimed on these tax returns increased from $68 million to $3.7 billion.").

44. Inmate Tax Fraud Prevention Act of 2008, Pub. L. No. 110-428, 122 Stat. 4839.

45. *See* J. Russell George Testimony, *supra* note 43, at 23-24.

46. *Id*.

47. Prison refund schemes were one of the two "certain refund schemes [that] have overwhelmed IRS resources" identified in the 2005 TIGTA Report, which was cited as basis for passing section 6676. *See* 2007 JCT REPORT, *supra* note 4, at 186 (citing 2005 TIGTA REPORT, *supra* note 3).

48. *See To Examine Tax Fraud Committed by Prison Inmates: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 109th Cong. 15 (2005) (statement of Rep. Tom Feeney) (noting that "prisoners often engage in this form of criminal activity without concern for the consequences because they are already incarcerated").

49. Treasury Inspector Gen. for Tax Admin., There Are Billions of Dollars in Undetected Tax Refund Fraud Resulting From Identity Theft 3 (2012), *available at* http://www.treasury.gov/tigta/auditreports/2012reports/201242080fr.pdf.

Dozen' Tax Scams for 2014"[50] and declared, "[S]topping identity theft and refund fraud is a top priority."[51]

For reasons that are patent, however, section 6676 will have no deterrent effect on identity theft schemes. First, the person making the claim is not the taxpayer, making enforcement problematic. Moreover, if identity theft is conducted by a criminal enterprise, it would be difficult to determine who, exactly, should be liable for the penalty. Second, identity theft is already subject to numerous criminal sanctions.[52] A potential 20% penalty likely adds little deterrence. Lastly, because much identity theft originates from abroad,[53] the IRS would have little opportunity to collect the penalty even if it identified the foreign perpetrators.

2. Gamers Refund Schemes

In addition to Fraudster refund schemes, the government must also combat tax avoidance transactions seeking to exploit the tax code, i.e., tax shelters.[54] The reason is simple: tax shelters for businesses and high

50. IRS Newsroom, *IRS Releases the "Dirty Dozen" Tax Scams for 2014; Identity Theft, Phone Scams Lead List*, IRS (Feb. 19, 2014), http://www.irs.gov/uac/Newsroom/IRS-Releases-the-%E2%80%9CDirty-Dozen%E2%80%9D-Tax-Scams-for-2014;-Identity-Theft,-Phone-Scams-Lead-List.

51. *See* IRS Newsroom, *IRS Combats Identity Theft and Refund Fraud on Many Fronts*, IRS (Mar. 2013), http://www.irs.gov/uac/Newsroom/IRS-Combats-Identity-Theft-and-Refund-Fraud-on-Many-Fronts.

52. Identity theft is often prosecuted under 18 U.S.C.§ 1028(a)(7) (2012), which makes it a crime to "knowingly transfer[], possess[] or use[], without lawful authority, a means of identification of another person with the intent to commit, or to aid or abet, or in connection with, any unlawful activity that constitutes a violation of Federal law, or that constitutes a felony under any applicable State or local law." This offense, in most circumstances, carries a maximum term of fifteen years' imprisonment, a fine, and criminal forfeiture of any personal property used or intended to be used to commit the offense. Identity theft also may involve violations of other statutes, such as identification fraud (§ 1028), credit card fraud (§ 1029), computer fraud (§ 1030), mail fraud (§ 1341), wire fraud (§ 1343), or financial institution fraud (§ 1344). All these statutes are felonies carrying substantial penalties, in some circumstances as high as thirty years' imprisonment, fines, and criminal forfeiture.

53. *See* Gregory Korte, *Worldwide Identity Thieves Steal Millions in Tax Refunds*, USA TODAY (Nov. 8, 2013, 9:12 PM), http://www.usatoday.com/story/news/politics/2013/11/07/identity-theft-tax-fraud-lithuania/3466663/.

54. The tax shelters described in this Article are "technical" tax shelters, described by former Treasury Assistant Secretary Eric Solomon as "tax-engineered transaction[s] normally with little business purpose except to save taxes with minimal risk or profit potential often designed to create [a] tax loss without an economic loss or in some cases to make income nontaxable." *See* Eric Solomon, U.S. Dep't of Treasury, Address at the Tax Policy Center-Tax Analysts Forum on Tax Shelters 11 (Feb. 11, 2005) (transcript on file with author); *see also* Wright, *supra* note 24, at 614-15.

net worth individuals have cost the U.S. Treasury billions annually.[55]

In what some argue was an effort to stem the tide of tax shelters, Congress in 2010 enacted section 7701(o), codifying the long-standing economic substance doctrine ("ES Codification").[56] ES Codification gave the IRS statutory authority to deny the tax benefits of a transaction unless "the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and . . . the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction."[57]

Economic substance is one of five common law doctrines that can be applied to deny the tax benefits of a tax shelter (or any other tax-motivated transaction), notwithstanding the fact that the transaction may have satisfied the literal requirements of specific tax provisions.[58] Before ES Codification, none of those common law doctrines appeared in the Code. Instead, empowered with the discretion to determine whether a transaction's tax benefits should be denied despite its arguable adherence to the Code, courts developed the doctrines over the years.[59] Though beyond the scope of this Article, it is universally acknowledged

55. *See* TAX DIVISION: U.S. DEP'T JUSTICE, FY 2013 CONGRESSIONAL BUDGET 8, *available at* http://www.justice.gov/jmd/2013justification/pdf/fy13-tax-justification.pdf. *See also* Wright, *supra* note 24, at 613.

56. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), 124 Stat. 1029, 1067. Others have argued that it was a way to manipulate the budget. ES Codification was scored to raise $4.5 billion, and supporters of bills that included ES Codification were "looking for revenue wherever it might be found." *See* Erik M. Jensen, *Legislative and Regulatory Responses to Tax Avoidance: Explicating and Evaluating the Alternatives*, 57 ST. LOUIS U. L.J. 1, 22 (2012). *See also* Jeremy Coder, *The Journey to Codify Economic Substance Is Over, but Will It Be Worth It?*, 127 TAX NOTES 16 (2010) (noting that "many in the tax community have suspected that codification was pushed in part because of its revenue-raising ability").

57. I.R.C. § 7701(o)(5)(A) (2012). That definition of economic substance evolved from a long line of federal tax cases, including Coltec Indus., Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 2006), *vacating and remanding* 62 Fed. Cl. 716 (2004); ACM P'ship v. Comm'r, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 189 (1997); *and* Klamath Strategic Inv. Fund, LLC v. United States, 472 F. Supp. 2d 885 (E.D. Texas 2007), *aff'd* 568 F.3d 537 (5th Cir. 2009). On at least three occasions, the U.S. Tax Court has noted that section 7701(o) represents Congress' adoption of the economic substance as articulated by the U.S. Court of Appeals for the Third Circuit in the case of ACM Partnership. *See, e.g.*, Crispin v. Comm'r, 103 T.C.M. (CCH) 1349, at *16 n.14 (2012); Blum v. Comm'r, 103 T.C.M. (CCH) 1099, at *17 n.21 (2012); Rovakat, LLC v. Comm'r, 102 T.C.M. (CCH) 264, at *27 n.11 (2011).

58. The others are substance over form, step transaction, sham transaction, and business purpose. *See* Yoram Keinan, *The Economic Substance Doctrine*, 508 Tax Mgmt. Port. (BNA) A-58 (2007) for a thorough discussion of the doctrines. *See also* Patricia Lampreave, *An Assessment of Anti-Tax Avoidance Doctrines in the United States and the European Union*, BULL. INT'L TAX'N, Mar. 2012, at 153.

59. *See* Lawrence Zelenak, *Controlling Corporate Tax Shelters*, 44 S.M.U. L. REV. 177, 183 (2001).

that substantial overlap existed, and still exists, among the doctrines, and the lines between one doctrine and others are often blurred.[60]

ES Codification gave the IRS additional weapons to combat shelters: new strict liability penalties for transactions lacking economic substance.[61] One such penalty was a new 20% (increased to 40% under certain circumstances)[62] strict liability penalty for any "transaction lacking economic substance . . . or failing to meet the requirements of any similar rule of law."[63] In addition to the new penalty, Congress also made taxpayers strictly liable for penalties related to transactions lacking economic substance by eliminating the reasonable cause defense.[64] The new strict liability penalty was intended to change the calculus for Gamers by making the potential cost of engaging in tax avoidance transactions greater.[65]

One issue left unresolved in ES Codification was in what circumstances the codified economic substance, as opposed to one or more of the other four common law doctrines, would apply.[66] Even if it

60. The overlap among the doctrines is beyond the scope of this Article. However, examples can be found in certain substance-over-form cases in which courts have examined (i) whether the substance of the transaction comported with its form, (ii) whether the transaction had economic substance, and (iii) whether the transaction had a legitimate business purpose. *See* STAFF OF J. COMM. ON TAXATION, 111TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL: PART THREE 98 n.300 (Comm. Print 2009) [hereinafter 2009 TECHNICAL EXPLANATION]; BB&T Corp. v. United States, 1 U.S. Tax Cas. (CCH) P50,130 (M.D.N.C. 2007), *aff'd* 523 F.3d 461 (4th Cir. 2008). Although the Second Circuit found for the government in *TIFD III–E, Inc. v. United States*, on remand to consider issues under section 704(e), the district court found for the taxpayer. *See* TIFD III–E Inc. v. United States, 660 F. Supp. 2d 367 (D. Conn. 2009). *See also* Yoram Keinan, *Rethinking The Role of the Judicial Step Transaction Principle and a Proposal For Codification*, 22 AKRON TAX J. 45 (2007).

61. *See* I.R.C. § 6662(b)(6), which applies the accuracy-related penalty of section 6662 to the portion of any underpayments attributable to a transaction lacking economic substance. Congress also (1) amended section 6664(c), eliminating the reasonable cause exception for underpayments to any portion of any underpayment attributable to a section 6662(b)(6) transaction; and (2) amended section 6664(d) so that the reasonable cause exception found in section 6664(d)(1) shall not apply to any reportable transaction understatement (within the meaning of section 6662A(b)) attributable to a section 6662(b)(6) transaction. *Id.* § 6664(c)-(d).

62. *See id.* § 6662(h)-(i).

63. *Id.* § 6662(b)(6).

64. *See supra* note 61.

65. While that may have been the intent, I have argued that codification had little actual effect on changing Gamers' behavior, because even with the added costs, the benefits will outweigh the costs for most taxpayers. *See* Wright, *supra* note 24, at 654.

66. No official legislative history exists for section 7701(o). However, the *2009 Technical Explanation* was introduced contemporaneously with the introduction of the law. Although not considered formal "legislative history," it does provide insight into section 7701(o). A detailed review of the economic substance doctrine and the proposals to codify it are found in 2009 TECHNICAL EXPLANATION: PART TWO, *supra* note 60, at 34-71 *and* STAFF OF J. COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE

is clear that a tax avoidance transaction's tax benefits should be denied, substantial uncertainty exists regarding whether the reason for denial is a lack of economic substance (which generates harsher penalties) or one of the other four common law doctrines.[67] Some commentators have noted that by failing to provide rules for when the economic substance doctrine would apply, Congress left a gap that prevented the IRS from using ES Codification to aggressively combat all but the most egregious tax shelters.[68]

As part of ES Codification, Congress also added section 6676(c), extending the 20% strict liability penalty to refund claims based on transactions lacking economic substance.[69] Congress also eliminated the reasonable basis defense to the section 6676 penalty for transactions determined to be devoid of economic substance.[70]

It is unclear why Congress added an economic substance penalty to section 6676. In the 2010 Joint Committee Technical Explanation, fifteen pages are devoted to explaining ES Codification, but the only detail about the section 6676(c) penalty is the following sentence:

> Similarly, a claim for refund or credit that is excessive under section 6676 due to a claim that is lacking in economic substance or failing to meet the requirements of any similar rule of law is subject to the 20 percent penalty under that section, and the reasonable basis exception is not available.[71]

A Lexis search of the terms "economic substance" and "6676" returned no cases in which the IRS has asserted the penalty.[72] No other

"RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT" 142-56 (Comm. Print 2010) [hereinafter 2010 TECHNICAL EXPLANATION].

67. That uncertainty gives the IRS wide discretion to apply one or more of those judicial doctrines to a certain transaction. The IRS has chosen to exercise that discretion cautiously and has provided that, "until further guidance is issued, the related penalty provisions are limited to the application of the economic substance doctrine and may not be imposed due to the application of any other 'similar rule of law' or judicial doctrine, e.g., step transaction doctrine, substance over form, or sham transaction." *See* I.R.S. Chief Couns. Notice CC-2012-008 (Apr. 3, 2012).

68. Bryan C. Skarlatos, *Penalties: Unintended Consequences of the Economic Substance Penalty*, J. TAX PRAC. & PROC., Oct.-Nov. 2012, at 21, 21, *available at* http://kflaw.com/siteFiles/News/39E7E7D53F3FEF97D5B42E3EB3A9B034.pdf; Carol P. Tello, *Dealing with Codified Economic Substance in the Context of International Issues: Self Help, the Only Game in Town*, TAX EXECUTIVES INST., Spring 2011, at 43, 44, *available at* http://www.tei.org/news/articles/Pages/TTE_SPRING11_dealing_with_codified_economic_substance_in_the_context_of_international_issues.aspx.

69. *See* I.R.C. § 6676(c) (2012).

70. *See id.*

71. *See* 2010 TECHNICAL EXPLANATION, *supra* note 66, at 156.

72. The only case where the terms are mentioned together, *TIFD III-E Inc. v. United States*,

information suggests the IRS has levied the penalty in other circumstances.[73]

The likely reason there is no evidence of the IRS's use of the economic substance penalty under section 6676(c) is that Gamers enter into tax shelters and other tax avoidance transactions not to generate false refunds, but to avoid paying taxes.[74] As was the case with prisoner refund schemes, the deterrent effect of section 6676(c) on Gamers is dubious at best.

### *B. Erroneous Refunds – The Strivers*

> *"My power is discombobulatingly devastating . . . It's ludicrous these mortals even attempt to enter my realm."*
>
> *–Mike Tyson*[75]

If we eliminate the refund schemes of Fraudsters and Gamers, the only thing left covered by section 6676 is the erroneous refunds based on mistakes of law or fact, or aggressive, but not fraudulent, return positions. That means the Strivers (other than those improperly claiming the EITC, which is exempt from section 6676),[76] are the only group that will bear the brunt of the section 6676 penalty, because, as explained above, the penalty cannot reach most Fraudsters and Gamers. However, unlike almost every other tax penalty, section 6676 contains no reasonable cause defense; therefore, the Strivers have only a limited ability to escape the penalty. In other words, the penalty that Congress enacted to cover Fraudsters and Gamers covers neither group well, but did have the effect of creating a new, hard-to-escape penalty for Strivers – the very group it would like to help. As Iron Mike Tyson would say

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refers to section 6676 only to evaluate the IRS's position on the reasonable basis standard, as articulated by an IRS Chief Counsel Memorandum that looked to section 6662 for guidance in determining reasonable basis. *See* TIFD III-E Inc. v. United States, 8 F. Supp. 3d 142 (D. Conn. 2014).

73. In an admittedly *ad hoc* effort to determine whether the IRS sought to enforce any such penalties, I reached out to attorneys at my old firms, Skadden Arps and Steptoe. None mentioned being aware of any attempt by the IRS to impose the section 6676(c) penalty.

74. *See* Kyle D. Logue & Gustavo G. Vettori, *Narrowing the Tax Gap Through Presumptive Taxation*, 2 COLUM. J. TAX L. 100, 103 (2010) ("Tax shelters are extraordinarily complex and highly aggressive (though usually not patently illegal) transactions designed entirely for the purpose of reducing, and in some cases eliminating, the tax liabilities of large corporate or wealthy individual taxpayers.").

75. *See* Brian Opal, *Mike Tyson: Top 25 Quotes*, FIGHT SAGA (Nov. 27, 2014, 1:13 PM), http://www.fightsaga.com/news/item/4980-Mike-Tyson-Top-25-quotes.

76. Section 6676 specifically exempts taxpayers erroneously claiming the EITC from the penalty. *See* I.R.C. § 6676(a) (2012).

(and has said, see above quote), this is "ludicrous."

Before delving into the myriad legal and administrative problems associated with section 6676, an overview of the existing penalty structure, as well as how section 6676 fits into that structure, is necessary to put the issues in context. For readers already familiar with the current tax penalty structure, as well as the available defenses and procedures for challenging those penalties, please skim this section and move to Part III.

### *C. Current Law*

#### 1. Penalties

Section 6676, as noted above, has no specific legislative history. The first legislative attempt to address the problem of erroneous refund claims can be found in a 2006 Senate Finance Committee draft, which proposed a 20% penalty for erroneous refund claims.[77] Although that 2006 draft was not enacted, Congress eventually passed the erroneous refund penalty as part of the 2007 Act. The Joint Committee acknowledged that a major impetus for Congress in passing section 6676 was the 2005 TIGTA Report, noted above, which highlighted the problems experienced by the IRS in dealing with erroneous or bogus refund claims.[78]

The law is relatively short. Section 6676 in its entirety reads:

> (a) Civil penalty. If a claim for refund or credit with respect to income tax (other than a claim for a refund or credit relating to the earned income credit under section 32) is made for an excessive amount, unless it is shown that the claim for such excessive amount has a reasonable basis, the person making such claim shall be liable for a

77. S. COMM. ON FINANCE, TELEPHONE EXCISE TAX REPEAL AND TAXPAYER PROTECTION AND ASSISTANCE ACT OF 2006, S. REP. NO. 109-336 (2006). Explaining the provision, the Committee noted:

> The filing of erroneous refund claims is being used by some taxpayers to put a strain on IRS resources and to delay the resolution of tax matters. The Committee believes a meaningful penalty on a refund claim with no reasonable basis for the claimed treatment will deter the use of such claims for the purpose of impeding effective tax administration.

*Id*. at 66.

78. *See* 2007 JCT REPORT, *supra* note 4 (citing 2005 TIGTA REPORT, *supra* note 3, at 186); *see also* TREASURY INSPECTOR GEN. FOR TAX ADMIN., STATISTICAL PORTRAYAL OF THE CRIMINAL INVESTIGATION FUNCTION'S ENFORCEMENT ACTIVITIES FROM FISCAL YEAR 2000 THROUGH FISCAL YEAR 2006 10 (2007) (showing that tax refund fraud increased 36.2% between 2003 and 2005).

> penalty in an amount equal to 20 percent of the excessive amount.
>
> (b) Excessive amount. For purposes of this section, the term "excessive amount" means in the case of any person the amount by which the amount of the claim for refund or credit for any taxable year exceeds the amount of such claim allowable under this title for such taxable year.
>
> (c) Noneconomic substance transactions treated as lacking reasonable basis. For purposes of this section, any excessive amount which is attributable to any transaction described in section 6662(b)(6) shall not be treated as having a reasonable basis.
>
> (d) Coordination with other penalties. This section shall not apply to any portion of the excessive amount of a claim for refund or credit which is subject to a penalty imposed under part II of subchapter A of chapter 68.[79]

Unlike penalty provisions based on a taxpayer's underpayment of a tax liability, section 6676 penalizes *mere claims* for erroneous refunds or credits. The ability to penalize claims specifically was noted by the Joint Committee, which found that because existing penalties were based on tax underpayments and not the amount of a refund claim, there was "very little expected cost to the taxpayer who files an erroneous refund claim under present law."[80]

The "existing penalties" referenced by the Joint Committee included the section 6662 accuracy-related penalty , enacted in 1989 to replace a number of separate penalties.[81] That section 6662 penalty imposes a 20% penalty on underpayments of tax attributable to, *inter alia*, "negligence or disregard of rules or regulation."[82] In general, the accuracy-related penalty can be avoided upon a showing of reasonable cause.[83] The term "underpayment," defined in section 6664 and its implementing regulations, seeks to capture the difference between the

79. I.R.C. § 6676(d).

80. 2007 JCT REPORT, *supra* note 4, at 186.

81. *See* Improved Penalty Administrative Compliance Tax Act ("IMPACT"), P.L.101-239, tit. VII, subtit. G of Omnibus Budget Reconciliation Act of 1989.

82. I.R.C. § 6662(b)(1). The section 6662 penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. The penalty for underpayments attributable to these failures is generally 20% of the underpayment, but in the case of a gross valuation misstatement, it is 40%. The section 6662 and 6676 penalties do not overlap, as section 6676(d) prohibits the IRS from imposing the section 6676 penalty to any portion of a refund claim subject to, *inter alia*, a section 6662 underpayment.

83. *See id.* § 6664(c)(1).

tax paid and the tax that should have been paid.[84]

Section 6676(c), added in 2010 as part of ES Codification, applies to claims for refunds based on transactions lacking economic substance or, pursuant to section 7701(o), "failing to meet the requirements of any similar rule of law."[85] With respect to the "any similar rule of law" clause, the Joint Committee noted that it was intended to apply to "a transaction the tax benefits of which are disallowed as a result of the application of the similar factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine."[86] The IRS has stated that it will not seek to utilize the "any similar rule of law" provision in applying the section 6676 penalties.[87]

2. Penalty Defense

As a way to protect taxpayers, Congress gave taxpayers the right to challenge section 6662 penalties prior to assessment.[88] In addition, notice and demand for payment ("notice and demand"), often the start of the IRS's collection procedures, in most cases cannot be initiated prior to assessment.[89]

Generally, before assessing a section 6662 penalty, the IRS must first send to the taxpayer a legally valid notice of deficiency, and that notice of deficiency is a prerequisite for collection under the IRS's

84. *See id.* § 6664(a), which defines "underpayment" as "the amount by which any tax imposed by this title exceeds the excess of—

(1) the sum of—

(A) the amount shown as the tax by the taxpayer on his return, plus

(B) amounts not so shown previously assessed (or collected without assessment), over

(2) the amount of rebates made.

85. STAFF OF J. COMM. ON TAXATION, 111TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 111TH CONGRESS 381 (Comm. Print 2011). Under section 7701(o), a transaction is treated as having economic substance only if it passes a conjunctive, two-prong test. The test requires that (i) the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position, and (ii) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction. I.R.C. § 7701(o).

86. 2010 TECHNICAL EXPLANATION, *supra* note 66, at 155 n.359.

87. I.R.S. Guidance LB&I-4-0711-015 (July 15, 2011), *available at* http://www.irs.gov/Businesses/Guidance-for-Examiners-and-Managers-on-the-Codified-Economic-Substance-Doctrine-and-Related-Penalties. In the Guidance, the IRS stated that the penalties provided in section 6676 "are limited to the application of the economic substance doctrine and may not be imposed due to the application of any other 'similar rule of law' or judicial doctrine (e.g., step transaction doctrine, substance over form or sham transaction)." *Id.*

88. "Assessment" is the formal recording of a tax liability by the IRS. *See* I.R.C. § 6203.

89. If collection of the tax is in jeopardy, the IRS is not required to wait ten days after giving the taxpayer notice and demand or thirty days after giving notice of intent to levy and notice of a right to a CDP hearing. *See* IRM 5.17.15.4.2 (Oct. 23, 2014).

collection procedures.[90] Once a taxpayer receives a notice of deficiency, the taxpayer can appeal the penalty with the IRS, or, after the IRS issues a notice of deficiency, challenge the penalty assessment in the U.S. Tax Court ("Tax Court"), the only pre-payment forum for taxpayers seeking to challenge an IRS tax or penalty assessment.[91]

The procedures for challenging notices of deficiency are outlined in sections 6211–6213, and are commonly referred to as deficiency procedures ("Deficiency Procedures").[92] Most tax cases are litigated in Tax Court, primarily because it permits taxpayers to challenge deficiencies prior to payment.[93]

Unlike section 6662 penalties, taxpayers have no right to challenge section 6676 penalties prior to assessment because section 6676 does not permit Deficiency Procedures.[94] Pursuant to Section 6671(a), the IRS can impose section 6676 penalties by notice and demand, without the issuance of a notice of deficiency.[95] As such, section 6676 penalties are immediately assessable and may be imposed at whatever point the IRS deems them applicable.

As an immediately assessable penalty, a taxpayer has no explicit right to challenge the section 6676 penalty assessment before its imposition. Whether the IRS will countenance a pre-assessment right to challenge the section 6676 penalty, however, is far from clear. Internal IRS guidance suggests section "[section] 6676 cases are generally subject to pre-assessment and appeal rights procedures."[96] Unfortunately for taxpayers, internal IRS guidance is not binding on the IRS and may not be relied on by taxpayers.[97]

The only legally prescribed methods for taxpayers seeking to challenge section 6676 penalties are to either (i) pre-pay the penalty and sue for refund in either a U.S. District Court or the Court of Federal Claims ("Refund Procedures"),[98] or (ii) request a Collection Due Process

90. *See id.* 5.17.15.4.1.

91. *See* I.R.C. §§ 6212-6213.

92. *See id.* §§ 6211-6216, found in I.R.C. Chapter 63, Subchapter B–Deficiency Procedures in the Case of Income, Estate, Gift, and Certain Excise Taxes.

93. *See* Danshera Cords, *Tax Court Appointments and Reappointments: Improving the Process*, 46 U. RICH. L. REV. 501, 533 (Jan. 2012) ("Due to a number of factors, including that the taxpayer need not prepay the tax prior to filing a petition in the Tax Court, the majority of tax cases are filed in the Tax Court.").

94. I.R.C. § 6676 is located in I.R.C. Chapter 68, Subchapter B–Assessable Penalties.

95. *See id.* § 6671(a).

96. *See* IRM 8.11.1.2.7(4) (Oct. 16, 2014).

97. *See, e.g.*, Kristin E. Hickman, *Unpacking the Force of Law*, 66 VAND. L. REV. 465, 502-09 (2013).

98. Pursuant to 28 U.S.C. § 1346(a)(1) (2012), district courts and the Court of Federal Claims

("CDP") hearing after the IRS initiates collection procedures.[99] If the taxpayer and the IRS cannot resolve the issue in a CDP hearing, the taxpayer may seek resolution with the Tax Court, which gives taxpayers the ability to challenge not only the IRS's collection procedures, but also the underlying liability ("CDP Procedures").[100]

### 3. Exceptions to Penalties

Taxpayers can challenge the imposition of section 6662 penalties if they can show they acted with "reasonable cause . . . and . . . in good faith" ("reasonable cause").[101] The reasonable cause defense excuses from penalties taxpayers who can show an "honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer."[102]

For reasons that are not entirely clear, taxpayers seeking to challenge section 6676 penalties may not raise the reasonable cause defense.[103] As part of the 2007 JCT Report, the Joint Committee contemplated a reasonable cause exception to the then-proposed section 6676 penalty, noting that the penalty would apply absent a reasonable basis or if "the taxpayer did not have reasonable cause."[104] However, the reasonable cause defense was excluded from the final bill, leaving only the "reasonable basis" exception discussed below, which has an entirely different meaning than reasonable cause.[105]

Absent a reasonable cause defense, section 6676 applies to erroneous refund claims lacking a "reasonable basis in law."[106] Section

have original jurisdiction over:

> Any civil action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected under the internal-revenue laws.

99. *See* I.R.C. § 6330(a)(3)(B).

100. *Id.* § 6330(d)(1). *See also* Callahan v. Comm'r, 130 T.C. 44 (2008) (holding the Tax Court had jurisdiction under section 6330(d) to hear return penalty cases).

101. I.R.C. § 6664(c)(1). Section 6664 does not define reasonable cause. However, Treasury Regulations provide that "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." Treas. Reg. § 1.6664-4(b)(1) (as amended in 2003). *See also* William A. Drennan, *Strict Liability and Tax Penalties*, 62 OKLA. L. REV. 1, 15 (2009).

102. Treas. Reg. § 1.6664-4(b)(1).

103. Section 6676 permits only the reasonable basis defense. *See* I.R.C. § 6676(a).

104. 2007 JCT REPORT, *supra* note 4, at 186.

105. Work Opportunity Tax Act, *supra* note 6.

106. 2007 JCT REPORT, *supra* note 4, at 186.

6676 does not define the term "reasonable basis," and, to date, no regulations have been issued articulating a definition in the context of the section 6676 penalty.[107] Nevertheless, the IRS appears to have adopted the definition found in Treasury Regulation § 1.6662-3(b)(3), which defines the term as follows:

> Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or [more] of the authorities set forth in [Treas. Reg.] § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in [Treas. Reg.] § 1.6662-4(d)(2).[108]

That reasonable basis definition eliminates penalties only for transactions with one or more valid legal, as opposed to factual, justifications. Thus, unlike the reasonable cause defense available under section 6662, taxpayers cannot rely on good faith legal or factual errors to escape section 6676 penalties.

A question left unanswered is how the IRS will determine whether a refund claim has a reasonable basis. Neither Treasury nor the IRS has articulated procedures for determining whether a reasonable basis exists in the context of the section 6676 penalty.[109] In fact, the IRS has issued conflicting guidance surrounding the determination of "reasonable basis," leaving taxpayers and practitioners in the dark, and potentially exacerbating the First Amendment issues discussed *infra*.

In 2013, the IRS appeared to indicate, following a TIGTA inquiry, that it will make the reasonable basis determination without taxpayer input. Specifically, the IRS asserted that, "the determination of reasonable basis is a judgmental decision based on a review of the position taken on the return and all applicable supporting authorities for the position."[110] That language does not appear to suggest taxpayers will

107. *See* I.R.S.Chief Couns. Mem. POSTN-152570-09 (Feb. 26, 2010) ("While section 6676 does not define 'reasonable basis' and there are no regulations in effect under that statute, we look to the definition of 'reasonable basis' in regulations promulgated under the section 6662 accuracy-related penalty for guidance.").

108. *Id*. (citing Treas. Reg. § 1.6662-3(b)(3) (as amended in 2003)).

109. *See, e.g.*, Jeremy Coder, *Waiting for Direction on Refund Penalties*, TAX NOTES TODAY, July 2, 2012, at 127-3.

110. 2013 TIGTA REPORT, *supra* note 9, at 15.

be given an opportunity to present arguments for reasonable basis.

However, conflicting advice to IRS employees is provided in two 2010 Chief Counsel Memoranda.[111] In both, IRS Counsel states that taxpayers will be given the opportunity to show reasonable basis. Specifically, both memoranda state that the section 6676 penalty will apply unless taxpayers "*can* show" that their claim has a reasonable basis.[112] Use of the word "can" suggests taxpayers will have an opportunity to demonstrate their reasonable basis to the IRS and avoid the penalty.

## III. UNMET POTENTIAL

Before section 6676's enactment, a taxpayer filing an erroneous claim for refund faced three circumstances (ignoring potential criminal or fraud allegations):[113]

(1) the IRS denies the claim—no penalty;

(2) the IRS wrongly accepts the claim, issues a refund check, but timely realizes the error—potential penalty; or

(3) the IRS wrongly accepts the claim, issues a refund check, and fails to timely realize the error—no penalty.

Only in the second circumstance were penalties potentially applicable. In that case, the applicable section 6662 penalty would be based on the "underpayment" of tax, defined in section 6664 and its implementing regulations to capture the difference between what was paid and what should have been paid.[114] With respect to the erroneously-

111. *See* I.R.S. Chief Couns. Mem. POSTN-152570-09 (Feb. 26, 2010) and I.R.S. Chief Couns. Mem. POSTN-125498-10 (Aug. 27, 2010).

112. *See* sources cited *supra* note 111 (emphasis added).

113. Criminal tax crimes and tax fraud are exceedingly difficult for the government to prove. For tax crimes, the government must demonstrate, beyond a reasonable doubt, that the taxpayer acted willfully. *See, e.g.*, Cheek v. United States, 498 U.S. 192, 193 (1991); United States v. Pomponio, 429 U.S. 10, 12 (1976); United States v. Bishop, 412 U.S. 346, 358-59 (1973); Sansone v. United States, 380 U.S. 343, 351 (1965); Holland v. United States, 348 U.S. 121, 124, 139 (1954). For civil tax fraud, the IRS must demonstrate "clear and convincing evidence to prove that some part of the underpayment of tax was due to fraud." *See* IRM 25.1.6.1 (Nov. 5, 2014). For an interesting look at what does (and does not) constitute fraud, see Brown v. Comm'r, 106 T.C.M. (CCH) 630 (2013).

114. *See* I.R.C. § 6664(a) (2012). "Underpayment is defined in I.R.C. § 6664 and the implementing regulation expresses the definition of this term by the following formula: Underpayment = W - (X + Y - Z), where W= the amount of income tax imposed, X = the amount shown as the tax by the taxpayer on his return; Y = the amounts not so shown previously assessed (or collected without assessment), and Z = the amount of rebates made. Treas. Reg. § 1.6664-2(a)." I.R.S. Chief Couns. Mem. POSTS-119273-12 (May 30, 2012), *available at* http://www.irs.gov/

issued refund, the IRS often ignored it in its underpayment calculation, and simply required taxpayers to repay the erroneous refund claim with interest.[115]

Section 6676 gives the IRS the ability to penalize taxpayers in the first circumstance, and a greater opportunity to penalize them in the second. In both cases, the penalty calculation appears straightforward: 20% of the erroneous refund claim. However, as discussed *infra*, calculation of that penalty has raised significant definitional issues that have thrust the IRS into a procedural nightmare.

### *A. Problems Since Enactment*

#### 1. Internal IRS Issues

In 2008, the IRS completed a study on "how best to implement the erroneous refund penalty" and estimated that "establishing and maintaining an erroneous refund penalty unit would cost at least $3.4 million per year and could result in the assessment of $101 million in penalties each year."[116] As of 2013, the IRS had taken no steps toward implementing its own recommendations.[117]

To make matters worse, in 2009 and 2010, the IRS made incorrect legal determinations regarding when it could assess the section 6676 penalty. A memorandum issued by IRS Counsel on November 20, 2009 ("2009 IRS Counsel Memorandum") concluded incorrectly that if the IRS disallowed refundable tax credits and did not issued a refund based on those disallowed credits (a "frozen refund"), the frozen refund amount nevertheless should be included in the section 6662 penalty calculation.[118] In other words, if the IRS denied a taxpayer's refund claim based on refundable credits and froze (i.e., did not issue) a refund, the IRS came to the absurd conclusion that it should penalize the

pub/lanoa/pmta_2012-16.pdf.

115. *See* 2007 JCT REPORT, *supra* note 4, at 186:

> Generally, existing penalties are calculated on the existence of a tax underpayment and not on whether claim results in a refund. Even in the case where an erroneous refund claim is detected, the taxpayer's costs may be limited to repayment of the refund plus interest for the period of time such funds were held. Thus, there is very little expected cost to the taxpayer who files an erroneous refund claim under present law.

116. 2013 TIGTA REPORT, *supra* note 9, at 3.

117. *See id*.

118. I.R.S. Chief Couns. Mem. POSTS-128277-09 (Nov. 20, 2009), exs. 1, 2, and 6, *available at* http://www.irs.gov/pub/lanoa/pmta_2010-01.pdf (showing a pre-refund example in which a taxpayer's section 6662 penalty calculation was determined based on an improperly claimed, but unpaid, refundable tax credit).

taxpayer under section 6662 as if it had actually issued the refund, and the frozen refund amount should be included in the section 6662 underpayment calculation. In a 2010 IRS counsel memorandum (the "2010 IRS Counsel Memorandum"), the IRS again made the same incorrect determination.[119]

Those 2009 and 2010 IRS Counsel Memoranda (the "2009 & 2010 IRS Memos") authorized IRS examiners to seek section 6662 penalties in the precise situation section 6676 was enacted to address, i.e., erroneous claims for refund. Moreover, because section 6676(d) prohibits the imposition of section 6676 penalties if "any portion of the excessive amount of a claim for refund or credit which is subject to a penalty imposed under" inter alia, section 6662, the 2009 & 2010 Memos prohibited proper application of section 6676.[120]

The 2009 & 2010 Memos were flat wrong. The IRS acknowledged as much in a May 12, 2012, IRS Counsel Memorandum (the "2012 IRS Counsel Memorandum"), which determined correctly that a frozen refund could not constitute part the section 6662 underpayment calculation.[121]

Relying on the 2009 & 2010 Memos prevented the IRS from assessing the erroneous refund penalty in numerous cases.[122] As a way to explain its errors, the IRS placed the blame on unclear Treasury Regulations, a startling result for the agency charged with enforcing the tax laws and working with Treasury to draft tax regulations.[123]

What the IRS did after the 2012 IRS Counsel is more troubling, however. After determining the 2009 & 2010 Memos were wrong in 2012, the IRS blithely continued to impose section 6662 penalties on frozen refund claims for roughly ten months.[124] Moreover, despite

119. *See* I.R.S. Chief Couns. Mem. POSTN-125498-10 (Aug. 27, 2010), ex. 2, *available at* http://www.irs.gov/pub/lanoa/pmta-2011-003.pdf (including the unpaid refund amount in the underpayment calculation).

120. *See* I.R.C. § 6676(d) (2012).

121. I.R.S. Chief Couns. Mem. POSTS-119273-12 (May 30, 2012), *available at* http://www.irs.gov/pub/lanoa/pmta_2012-16.pdf. *See also* 2013 TIGTA REPORT, *supra* note 9, at 5.

122. 2013 TIGTA REPORT, *supra* note 9, at 5.

123. *See id.* ("The IRS indicated that the incorrect interpretation contained in the November 2009 memorandum occurred because a Treasury Regulation that provided guidance on this subject was not clear.").

124. *See* 1 TAXPAYER ADVOCATE SERV., 2013 ANNUAL REPORT TO CONGRESS 184 (2013), *available at* http://www.taxpayeradvocate.irs.gov/userfiles/file/2013FullReport/ACCURACY-RELATED-PENALTIES-The-IRS-Assessed-Penalties-Improperly,-Refused-to-Abate-Them,-and-Still-Assesses-Penalties-Automatically.pdf ("The IRS continued imposing substantial understatement penalties on frozen refund claims for about ten months after receiving the May 30, 2012 guidance.").

acknowledging it was wrong, the IRS did not give taxpayers hit with the improper penalties a break, and "failed to remove over 46,000 penalties totaling more than $40 million that it imposed in the two and a half years between the issuance of the first [IRS] Counsel opinion (November 20, 2009) (which [IRS] Counsel has implicitly acknowledged was incorrect) and the most recent [IRS] Counsel opinion (May 30, 2012)."[125] In a stunning rebuke to the IRS on this issue, TIGTA wrote that the "IRS's failure to expend the resources needed to remove these improper and inapplicable penalties signals disrespect for the law and a disregard for taxpayer rights."[126]

As was the case with the erroneous application of the section 6662 penalty, the IRS may not be exercising the diligence required with respect to section 6676. In 2009, the American Institute of Certified Public Accountants (AICPA) reported that it had become "aware of section 6676 penalties being imposed automatically and regularly when a claim for refund is denied, without any consideration of whether the position has a reasonable basis."[127] The AICPA suggested that the IRS's actions were possibly "attributable to the fact that to date the IRS has not published regulations or other guidance with respect to section 6676."[128]

### 2. Fresh Gas on the Fire

As if refund penalties were not complicated enough to administer, the Tax Court made the IRS's job even more difficult in November 2013. In *Rand v. Commissioner* ("*Rand*"), a divided Tax Court concluded that the IRS was wrong in how it calculated underpayments based on certain refundable tax credits.[129]

Before discussing the *Rand* case, a bit of background is necessary. In order to calculate the amount of a section 6662 penalty, the first step is to determine the "underpayment." The penalty is generally 20% of the underpayment.[130] For penalty purposes, underpayment means:

> the amount by which any tax imposed by this title exceeds the excess of—
>
> (1) the sum of—

125. 2013 TIGTA REPORT, *supra* note 9, at 10.

126. TAXPAYER ADVOCATE SERV., *supra* note 124, at 182.

127. PENALTY REFORM TASK FORCE, AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, REPORT ON CIVIL TAX PENALTIES: THE NEED FOR REFORM 18 (2009).

128. *Id*.

129. Rand v. Comm'r, 141 T.C. 376 (2013).

130. *See* I.R.C. § 6662 (2012). The penalty can be increased to 40% in certain circumstances. *See id.* § 6662(h).

(A) the amount shown as the tax by the taxpayer on his return, plus

(B) amounts not so shown previously assessed (or collected without assessment), over

(2) the amount of rebates made.[131]

Treasury regulations set forth the underpayment calculation in the following formula:

Underpayment = W– (X+Y– Z) where:

W = the correct amount of tax required to be shown on the return;

X = the tax reported (actually shown) on the return;

Y = the amount not shown, but previously assessed (or collected without assessment); and

Z = certain rebates.[132]

Since the Section 6662 penalty was created in 1989, one issue that sometimes arose was how refundable tax credits fit into the underpayment calculation. In 1991, Treasury adopted regulations that stated explicitly that withholding credits under sections 31 and 33 ("refundable withholding credits") be included in the underpayment calculation.[133] However, the 1991 regulations failed to address how refundable non-withholding tax credits, such as the Additional Child Tax Credit ("ACTC") codified in section 24, the First-Time Homebuyer Tax Credit ("FTHBC") codified in section 36 or the EITC codified in section 32 (collectively, "refundable non-withholding credits"), should be treated.[134]

Before *Rand*, erroneously-claimed refundable tax credits were included as a negative number in the "tax reported (actually shown) on the return," i.e., the "X" above. As a negative amount included in "X" above, including the erroneously-claimed refund increased the underpayment. Although the regulations do not address the treatment, for underpayment purposes, of those refundable non-withholding credits, the IRS's position was that refunds based on refundable non-withholding

131. For purposes of paragraph (2), the term "rebate" means so much of an abatement, credit, refund, or other repayment as was made on the ground that the tax imposed was less than the excess of the amount specified in paragraph (1) over the rebates previously made. *Id.* § 6664(a).

132. *Id.* § 6664(a)(1)-(2); Treas. Reg. § 1.6664-2(a)(1)-(2) (as amended in 2007). *See also* Snow v. Comm'r, 141 T.C. 238, 241 (2013).

133. *See* Treas. Reg. § 1.6664-2(b)(1), (2), and (3); *see also id.* § 1.6664-2(g), ex. (3); Feller v. Comm'r, 135 T.C. 497, 509 (2010).

134. *See* T.D. 8381, 1992-1 C.B. 374.

credits should be included in the underpayment calculation in the same manner as refundable withholding credits.[135] In *Rand*, the Tax Court told the IRS the section 6662 penalty calculation was not that simple.[136]

### *B. The Rand Case*

The facts of *Rand* are straightforward: the taxpayers had a tax liability of $144 and claimed a total of $7,471 of refundable non-withholding tax credits, including the ACTC and the EITC.[137] After applying the refundable credits, the taxpayers claimed, and the IRS issued them, a refund of $7,327 ($7,471 in tax credits - $144 in tax liability). The IRS and the taxpayer later agreed that the taxpayers were not entitled to claim the refundable credits, but disagreed on the amount of the underpayment.

The IRS sought to include the $7,327 erroneously-claimed refund, based on the ACTC and EITC refundable credits, in its underpayment calculation. The taxpayers, on the other hand, argued that refundable credits should be excluded, or alternatively, that any underpayment be limited to their original $144 tax liability. The Tax Court disagreed with the taxpayers' primary argument,[138] but agreed with the alternative argument, finding that the underpayment in the case was $144, and the section 6662 penalty was $29 (20% of $144).[139]

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135. *See* Rand v. Comm'r, 141 T.C. 376, 382 (2013).

136. In one of the first cases to cite *Rand*, the Tax Court held that the IRS could not impose section 6662 penalties based on erroneously-claimed first-time homebuyer credits. Li v. Comm'r, No. 117-12S, T.C. Summ. Op. 2013-97, at *4 (2013) (citing *Rand*, 141 T.C. at 384) ("We have recently held that refundable credits such as the first-time homebuyer credit are taken into account in calculating 'the amount shown as the tax by the taxpayer on his return' under section 6664(a)(1)(A), but may not reduce the amount shown on the return below zero."). *See also* Richardson v. Comm'r, No. 4280-12S, T.C. Summ. Op. 2014-9, at *8 (2014). Both the *Li* and *Richardson* cases are Tax Court Small tax cases (each an "S-case") and, pursuant to section 7463(b), are nonreviewable.

137. *See Rand*, 141 T.C. at 382.

138. The Tax Court reasoned:

> Because the Code specifies that certain credits should be disregarded when determining the tax shown on the return, we can infer that other credits should not be disregarded. Under the canon *expressio unius est exclusio alterius*, if a statute provides specific exceptions to a general rule, we may infer that Congress intended to exclude any further exceptions. . . . This is not a rigid rule and will not apply if the result "is contrary to all other textual and contextual evidence of congressional intent." Burns v. United States, 501 U.S. 129, 136 (1991) . . . . In this instance we see no evidence of a contrary congressional intent.

*Id.* at 387 (citations omitted).

139. The Tax Court relied on the fact that another penalty provision, section 6694, explicitly discusses understatements to include refundable credits. The court noted that "Congress could have similarly taken such credits into account under the definition of an underpayment under section

In *Rand*, both the IRS and the taxpayers agreed on three elements of the underpayment calculation: the "W" was $144, and both the "Y" and "Z" were zero. They disagreed about the "X." The IRS argued that the "X" was -$7,327, making the underpayment $7,471 (equal to $144 - (-$7,327)). The taxpayers argued that there was no "statutory or regulatory basis for reducing" the "X" below zero, thereby capping the underpayment at $144.

In its decision, the court sided with the taxpayer. The court explained that prior to 1989, "'underpayment' was defined with an explicit cross-reference to the definition of a deficiency" in section 6211.[140] The court then stated that even though that cross-reference was removed in 1989, section 6211 would nevertheless "assist us in interpreting" the issues in the case.[141] Looking to section 6211 for guidance, the court noted section 6211(b)(4) authorizes the IRS to treat "any excess of the refundable credits claimed as compared to the amount to which the taxpayer was entitled is treated as a negative tax" for deficiency purposes. However, applying the canon *expressio unius est exclusio alterius*,[142] the court found that because section 6664 does not contain similar language (and Treasury has not addressed the issue in regulations), refundable non-withholding credits "would not be considered a negative tax."

As a result, the "X" in the underpayment calculation could not be negative based on refundable non-withholding credits. Thus, Rand's penalty would not be influenced by the erroneously-claimed ACTC and EITC refundable credits (i.e., the "X" would be zero).

The IRS argued to the *Rand* court that if its position (i.e., that refundable non-withholding credits be included in the underpayment calculation) were not accepted, it would lead to "a gap in the penalty regime," leaving the IRS no means to penalize excess refundable credits.[143] The court dismissed that argument, noting: "to the extent an erroneously claimed credit reduces a tax liability, it may be subject to an

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6664(a), but it did not." *Id.* at 392.

140. *Id.* at 386.

141. In its decision, the court noted "the historical link between the definitions of a deficiency and an underpayment" but found that Congress had broken that link when in "1988 Congress amended section 6211(b)(4) to specifically provide that certain refundable credits could be taken into account as negative amounts of tax." *Id.* at 391 (citing Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1015(r)(2), 102 Stat. 3342, 3572).

142. *See* BLACK'S LAW DICTIONARY 581 (9th ed. 2009) (defining "expressio unius est exclusio alterius" as "[w]hen certain . . . things are specified in a law, . . . an intention to exclude all others from its operation may be inferred"). *See also* Clifton Williams, *Expressio Unius Est Exclusio Alterius*, 15 MARQ. L. REV. 191, 195 (1931).

143. *Rand*, 141 T.C. at 394.

accuracy-related penalty under section 6662; to the extent that credit generates a refund, it may be subject to a penalty under section 6676."[144]

The IRS and Treasury response to *Rand* is not yet clear. On July 31, 2014, the IRS Office of Chief Counsel issued a notice ordering IRS attorneys to concede the *Rand* issue in Tax Court cases, i.e., to "not treat claims for refund or credit based on erroneous refundable credits as a negative amount of tax shown on the return when determining the amount of an underpayment subject to penalty under section 6662 or 6663."[145] It is unclear whether the IRS will seek to pursue the section 6676 penalty in those cases, because section 6676 is not subject to Deficiency Procedures, thus not directly subject to Tax Court litigation.

As *Rand* is now, absent IRS or Treasury changes, the law of the land, the court's holding mandates that if the IRS wanted to penalize both the underpayment of tax ($144) and the erroneously-claimed refund ($7,327), it would have to do the following:

- impose a section 6662 penalty on the $144 underpayment;
- impose a section 6676 penalty for the portion of the refund not related to the EITC, because section 6676(a) bars application of the penalty to EITC-related refund claims; and
- impose a non-monetary section 32(k) penalty on the erroneously-claimed EITC.[146] Section 32(k) permits the government to ban a taxpayer from claiming the EITC for either two years if she recklessly or intentionally disregards the EITC rules, or 10 years if she fraudulently claimed the EITC.[147]

If the IRS sought to assess all three penalties at the same time, the procedural aspects would be cumbersome. The section 6662 penalty would be assessed through Deficiency Procedures. Thus, the taxpayer could challenge the section 6662 penalty in the Tax Court.

It is unclear how, in practice, the section 32(k) penalty could be challenged. While section 32 penalties are clearly subject to Deficiency Procedures, the penalties would not be imposed until tax years subsequent to the year of the improper EITC claim.[148] However,

144. *Id*. at 395.

145. I.R.S. Chief Couns. Notice CC-2014-007 (Jul 31, 2014).

146. The two-year ban under section 32(k) applies when a taxpayer recklessly or intentionally disregards the EITC rules. *See* I.R.C. § 32(k)(1)(B)(ii) (2012). The ten-year ban applies when it is determined that a taxpayer fraudulently claimed the EITC. *See id.* § 32(k)(1)(B)(i).

147. *See id.* § 32(k)(1).

148. The minimum penalty under section 32(k) is two years. *See id.* § 32(k)(1)(B)(ii).

taxpayers generally cannot utilize Deficiency Procedures until the IRS issues a Notice of Deficiency, which may or may not happen in those subsequent years. Thus, until those later years, there is no penalty ripe to challenge.[149]

Lastly, because the section 6676 penalty is not subject to Deficiency Procedures, the taxpayer could not challenge that penalty along with the other two. Instead, the taxpayer would have to either pre-pay the section 6676 penalty and pursue Refund Procedures, or wait until the IRS initiated collection activities and pursue CDP Procedures, which could lead the taxpayer back to the same Tax Court that was precluded from hearing the section 6676 challenge in the first place. But it gets worse – it is unclear how the penalty should be calculated.

### *C. A Three Stooges Problem*

The problems associated with the interplay between the *Rand* decision and the calculation of section 6662 and 6676 penalties can be shown using the four most famous members of the Three Stooges: Moe, Larry, Shemp and Curly (each, a "Stooge") (apologies to Joe and Curly Joe).[150] Let us assume all the Stooges have a $1,000 tax liability and request a $500 erroneous refund based on improperly claiming $1,500 of different types of refundable credits. For example:

(1) Moe improperly claims $1,500 of refundable withholding credits (section 31 or 33) and receives a $500 erroneous refund;

(2) Larry improperly claims $1,500 of FTHBC and receives a $500 erroneous refund;

(3) Curly improperly claims $1,500 of FTHBC, but the IRS denies Curly's erroneous $500 refund claim; and

(4) Shemp improperly claims $750 of EITC (section 32) and $750 of FTHBC (section 36) and receives a $500 erroneous refund.

Under current law, each taxpayer would be penalized in a different

149. A detailed discussion of the procedural problems associated with section 32(k) penalties is beyond the scope of this Article. However, see Leslie Book, *The Ban on Claiming the EITC: A Problematic Penalty*, PROCEDURALLY TAXING (Jan. 23, 2014), http://www.procedurallytaxing.com/the-ban-on-claiming-the-eitc-a-problematic-penalty/.

150. Unbeknownst to many, Shemp was a member of the Stooges before Curly. Shemp left the Stooges in 1934 and was replaced by Curly. It was also in 1934 that the Stooges adopted the moniker the "Three Stooges." Also, it should be noted that there were two additional members of the Three Stooges, Joe Besser and Curly Joe DeRita. However, Moe, Larry, Shemp, and Curly starred in the vast majority of films. *See The Three Stooges*, FILMOGRAPHY, http://www.threestooges.com/filmography/ (last visited Jan. 28, 2015).

way:

**Moe**

Moe would be liable for a $300 Section 6662 penalty.

*Penalty Calculation—Section 6662*

> The underpayment calculation is W[$1,000]-X[- $500] = $1,500.[151] The "X" is -$500, the erroneously-paid $500 refund claim.
>
> The section 6662 penalty is 20% of the underpayment, $300.

*Penalty Defense*

> Moe would be able to challenge the penalty prior to payment through Deficiency Procedures in Tax Court, and may use the reasonable cause defense. Moe could also pay the penalty and sue for refund using Refund Procedures.

**Larry**

Larry would be liable for a $200 section 6662 penalty and a $100 section 6676 penalty.

*Penalty Calculation—Section 6662*

> The underpayment calculation is W[$1,000]—X[=0] = $1,000. The underpayment is not affected by the refund because, pursuant to *Rand*, refunds based on the FTHBC do not permit the "X" to go below zero.
>
> The section 6662 penalty is 20% of the underpayment, $200.

*Penalty Calculation—Section 6676*

> The section 6676 penalty is 20% of the $500 erroneous refund claim, $100.

*Penalty Defense*

> Larry would be able to challenge the section 6662 penalty prior to

151. The "Y" and the "Z" in this example, as well as the others that follow, are zero.

payment through Deficiency Procedures in Tax Court and may use the reasonable cause defense. Larry could also pay the section 6662 penalty and sue for refund using Refund Procedures.

To challenge the section 6676 penalty, Larry could either (i) pay the penalty and pursue Refund Procedures, or (ii) wait for the IRS to initiate collection activities and pursue CDP Procedures. Larry has no reasonable cause defense to the section 6676 penalty, and must rely instead on the IRS determining his claim had a reasonable basis.

**Curly**

Curly would be liable for a $100 section 6676 penalty.

*Penalty Calculation—Section 6676*

The section 6676 penalty is 20% of the $500 erroneous refund claim, $100.

*Penalty Defense*

Curly can challenge the section 6676 penalty by either (i) paying the penalty and pursuing Refund Procedures, or (ii) waiting for the IRS to initiate collection activities and pursuing CDP Procedures. Curly has no reasonable cause defense to the section 6676 penalty, and must rely instead on the IRS determining his claim had a reasonable basis.

**Shemp**

Shemp would be liable for three different penalties:

(1) a $200 Section 6662 penalty;

(2) a non-monetary EITC penalty; and

(3) a section 6676 penalty of between $0 and $100, but it is unclear how that penalty would be calculated

*(1) Penalty Calculation—Section 6662*

The underpayment calculation is W[$1,000] - X[$0] = $1,000.

The section 6662 penalty is 20% of the underpayment, $200.

*(1) Penalty Defense—Section 6662*

Shemp would be able to challenge the penalty prior to payment through Deficiency Procedures in Tax Court, and may use the reasonable cause defense. Shemp could also pay the section 6662 penalty and sue for refund using Refund Procedures.

*(2) Non-monetary EITC penalty—Section 32 (EITC)*

Shemp would be subject to the non-monetary penalties under section 32(k), either a two-year or ten-year ban from claiming the EITC.[152]

*(2) Penalty Defense—Section 32 (EITC)*

It is unclear what Shemp would be able to challenge regarding the imposition of the section 32(k) penalty, as section 32(k) imposes no penalty on the year of the improper conduct (the "conduct year"), but only subsequent years (the "ban years"). In one case touching on the issue, the Tax Court permitted the IRS to deny the EITC for the conduct year, but ruled that the penalty was inappropriate for the ban years because the taxpayer's conduct was not due to a "reckless or intentional disregard of the rules."[153] A question left unanswered is whether the court would have jurisdiction over those subsequent years if it found the taxpayer's conduct reckless, as no EITC claims for those subsequent years were before the court.

*(3) Penalty Calculation—Section 6676*

Whether Shemp would be liable for a section 6676 penalty is far from clear. Pursuant to section 6676(a), no portion of the section 6676 penalty can apply to the portion of a refund claim based on the EITC.[154] But what would that mean in Shemp's case? Shemp could legitimately argue that only the $750 of FTHBC should be included in his penalty calculations, and the $750 EITC should be ignored. By ignoring the EITC, the $750 FTHBC would act only to reduce Shemp's tax liability from $1,000 to $250, and, more importantly, would not generate a refund. Thus, by Shemp's logic, no section 6676 penalty could apply because there was no refund claim based solely on the FTHBC.

152. Section 32(k)(1)(A) provides for a "disallowance period" preventing taxpayers from claiming the EITC for a period of years after a taxpayer improperly claims the EITC. The disallowance period is either two or ten years, depending on the taxpayer's culpability. *See* I.R.C. § 32(k)(B).

153. Garcia v. Comm'r, T.C. Summary Op. 2013-28 (Apr. 3, 2013).

154. Claims for "refund or credit relating to the earned income credit under section 32" are excluded in I.R.C. § 6676(a).

Alternatively, the IRS could put forth two credible arguments:

IRS Argument 1: The IRS could argue that half of Shemp's $500 refund is based on the FTHBC, and the other half is based on the EITC. Thus, because 50% of the refund was based on the FTHBC, the portion of the refund claim not attributable to the EITC (which cannot be penalized pursuant to section 6676(a)) would be $250, and the penalty would be $50 [= 20% x $250].

IRS Argument 2: The IRS could also take a more aggressive position: that the EITC reduced Shemp's putative tax liability to $250. Thus, the $750 FTHBC generated the refund, and the entire $500 refund should be penalized, generating a $100 penalty [= 20% x $500].

*(3) Penalty Defense—Section 6676*

Shemp would be able to challenge penalties under section 6662 and 32 through Deficiency Procedures. However, as in Larry's case, Shemp would not be able to challenge the section 6676 penalty unless he either (i) pays the penalty and pursues Refund Procedures, or (ii) waits for the IRS to initiate collection activities and pursues CDP Procedures.

Shemp's case, more than the others, highlights and raises major problems in post-*Rand* penalty enforcement. It is no wonder the IRS has been hesitant in imposing these Kafkaesque penalties on taxpayers. Even if these mostly self-inflicted problems are corrected, others lurk just over the horizon.

## IV. LEGAL AND PRACTICAL PROBLEMS WITH SECTION 6676

Enforcing section 6676 after *Rand* is, as demonstrated above, challenging. However, *Rand* may be just the tip of the iceberg. Other problems are just around the corner.

### *A. Petition Clause Issues*[155]

Without careful implantation, section 6676 could violate the First Amendment by putting a potential sanction on citizens' ability to petition the government. Among other protections, the First Amendment provides that "Congress shall make no law . . . abridging . . . the right of

155. The potential First Amendment issues appear to have been first articulated in a letter by attorney Derek Ho to the IRS Commissioner arguing, *inter alia,* that section 6676 may violate the petition clause of the First Amendment. *See* Derek Ho, *Firm Cautions Against Unconstitutional Enforcement of Penalty Provision*, TAX NOTES TODAY, June 13, 2012, at 114-15.

the people . . . to petition the government for a redress of grievances."[156] That language, known as the Petition Clause, serves two invaluable purposes: it gives citizens a right to present their grievances against the government, and it allows the government to obtain information necessary to determine the validity of the grievances.[157] The Supreme Court has consistently characterized the right to petition as inseparable from the other cognate First Amendment rights of assembly, association, and speech.[158]

If the IRS chooses to impose section 6676 penalties without providing taxpayers some basic protections, it could easily violate taxpayers' First Amendment protections. The basis of those protections, and how implementation of section 6676 could violate those protections, is explained below.

The right to petition the government predates the U.S. Constitution by about fifty years.[159] One of the earliest cases to discuss the right to petition in the First Amendment context is *Crandall v. Nevada*, decided in 1867.[160] In *Crandall*, the State of Nevada sought to impose a tax on travelers passing through the State. The *Crandall* Court found that such a tax infringed on a traveler's right to "assert any claim he may have upon that government," thereby implicating the right to petition.[161] Section 6676 raises the same issue.

156. U.S. CONST. amend. 1. In English law, the right to petition reaches back at least to the Magna Carta, which stated:

> If we, our chief justice, our officials, or any of our servants offend in any respect against any man, or transgress any of the articles of the peace or of this security, and the offence is made known to four of the said twenty-five barons, they shall come to us – or in our absence from the kingdom to the chief justice – to declare it and claim immediate redress.

Magna Carta, ch. 61 (1215).

157. Daniel R. Fischel, *Antitrust Liability for Attempts to Influence Government Action: The Basis and Limits of the* Noerr-Pennington *Doctrine*, 45 U. CHI. L. REV. 81, 96-100 (1977).

158. *See, e.g.*, James B. Perrine, *Defining the "Sham Litigation" Exception to the* Noerr-Pennington *Antitrust Immunity Doctrine: An Analysis of the* Professional Real Estate Investors v. Columbia Pictures Industries *Decision*, 46 ALA. L. REV. 815, 835 (1995). *See also* Thomas v. Collins, 323 U.S. 516, 530 (1945) (finding the right to petition as "inseparable" from the other rights granted by the First Amendment and noting, "It was not by accident or coincidence that the rights to freedom in speech and press were coupled in a single guaranty with the rights of the people peaceably to assemble and to petition for redress of grievances. All these, though not identical, are inseparable.").

159. Fifty years before the Bill of Rights was adopted, the colonial assemblies treated the right to petition as a right deserving protection. *See* Norman B. Smith, *"Shall Make No Law Abridging . . .": An Analysis of the Neglected, but Nearly Absolute, Right of Petition*, 54 U. CIN. L. REV. 1153, 1155 (1986); Julie M. Spanbauer, *The First Amendment Right to Petition Government for a Redress of Grievances: Cut from a Different Cloth*, 21 HASTINGS CONST. L.Q. 15, 22 (1993).

160. Crandall v. Nevada, 73 U.S. 35, 44 (1867).

161. *Id*.

One long-recognized form of petitioning activity is seeking a tax refund.[162] In *Van Deelen v. Johnson*, the Tenth Circuit acknowledged that "the right at issue—to petition the government for the redress of tax grievances—has been with us and clearly established since the Sons of Liberty visited Griffin's Wharf in Boston."[163] The *Van Deelen* court discussed the breadth of the right to petition, noting that "the constitutionally enumerated right of a private citizen to petition the government for the redress of grievances does not pick and choose its causes but extends to matters great and small, public and private."[164] The court also acknowledged that even if the seeking of relief is animated by malevolence or self-interest, the First Amendment protects the right to petition of the person whose activities are genuinely aimed at procuring favorable government action.[165]

The right to petition, like all constitutional rights, is not unfettered. One of the first substantive restrictions on the right to petition arose in 1961 in *Eastern Railroad Presidents Conference v. Noerr Motor Freight, Inc.* ("*Noerr*"), in which the Supreme Court recognized, in dicta, that the right to petition the government could be abridged if the petitioning activity was "a mere sham to cover what is actually nothing more than an attempt to interfere directly with the business relationships of a competitor."[166] Four years later, the Supreme Court examined the scope of permissible restrictions to petitioning activity in *United Mine Workers of America v. Pennington* ("*Pennington*") and held that a person or firm is shielded from antitrust liability if the conduct at issue

162. *See, e.g.*, Blacklock v. United States, 208 U.S. 75 (1907); United States v. Perkins, 163 U.S. 625 (1896).

163. Van Deelen v. Johnson, 497 F.3d 1151, 1158 (10th Cir. 2007). The right to petition was imported from English law and has been recognized as early as 1031, and a right to petition was included in the Magna Carta. *See* Smith, *supra* note 159, at 1154-55:

The earliest petition recorded in our Anglo-American constitutional history is the English leaders' petition in 1013 to Aethelred the Unready. . . . [The] Magna Carta of 1215, the fundamental source of Anglo-American liberties, was the king's response to the barons' petition. This was one of several royal charters granted by Medieval English kings to guarantee baronial privileges and, to a lesser extent, popular rights. Petitioning as a right was specifically recognized in Magna Carta.

164. *Van Deelen*, 497 F.3d at 1153. The court went on to add that "a private citizen exercises a constitutionally protected First Amendment right anytime he or she petitions the government for redress; the petitioning clause of the First Amendment does not pick and choose its causes. The minor and questionable, along with the mighty and consequential, are all embraced." *Id*. at 1156.

165. City of Columbia v. Omni Outdoor Adver., Inc., 499 U.S. 365, 380 (1991) (quoting Allied Tube & Conduit Corp. v. Indian Head, Inc., 486 U.S. 492, 500 n.4, (1988)). Moreover, "Resort to administrative, legislative, political or judicial processes is protected by the first amendment so long as the petitioner is concerned with obtaining relief afforded by the system." LeBlanc-Sternberg v. Fletcher, 781 F. Supp. 261, 266 (S.D.N.Y. 1991) (citing *Omni Outdoor Adver., Inc.*, 499 U.S. 365 and California Motor Transport. Co. v. Trucking Unlimited, 404 U.S. 508, 510 (1972)).

166. E. R.R. Presidents Conference v. Noerr Motor Freight, Inc., 365 U.S. 127, 135 (1961).

constitutes legitimate First Amendment petitioning activity.[167]

After *Noerr* and *Pennington*, courts have shaped the contours of attempted restrictions to the right to petition the government through what has been called the *Noerr-Pennington* doctrine.[168] The doctrine holds generally that the act of petitioning the government deserves especially broad protection from liability (often antitrust liability) in the absence of proof that the petitioning activity is a "sham."[169] The *Noerr-Pennington* doctrine seeks to maintain the equilibrium in the tradeoff between deterring predatory activity and deterring petitioning activity.[170]

167. United Mine Workers of Am. v. Pennington, 381 U.S. 657, 668 (1965).

168. The doctrine takes its name from the first two cases that the Supreme Court considered in this jurisprudential line. *See Noerr*, 365 U.S. 127 and *Pennington*, 381 U.S. 657. In *Noerr*, a group of trucking companies and their trade association filed an antitrust lawsuit against major railroads, the presidents of those railroads, and their public relations firm. The plaintiffs' complaint alleged that the defendants had conspired to restrict trade and monopolize the long-distance freight business in violation of the Sherman Act. The plaintiffs claimed that the defendants' public relations firm lobbied Congress with the sole purpose of injuring the truckers, harming their reputation, and impeding their ability to compete against railroad companies. *Id.* at 129-30. The Court held that when the railroads lobbied the government to pass laws restraining the trucking companies, they were merely exercising their constitutional right to petition the government. *Id.* at 136. Although the Court found no antitrust violation, it noted that antitrust laws may apply in cases where such lobbying was "a mere sham to cover what is actually nothing more than an attempt to interfere directly with the business relationships of a competitor." *Id.* at 144.

169. *See* Matthew Avery et al., *The Antitrust Implications of Filing "Sham" Citizen Petitions with the FDA*, 65 HASTINGS L.J. 113, 117 (2013) (internal citations omitted). Sham litigation presents a problem because individuals or businesses "may use litigation solely as an attempt to raise its rivals' costs disproportionately, erect barriers to market entry, or facilitate collusive behavior." James D. Hurwitz, *Abuse of Governmental Processes, the First Amendment, and the Boundaries of* Noerr, 74 GEO. L.J. 65, 70 (1985). Some courts have pushed the definition of "petitioning"—the most fundamental limitation on the scope of *Noerr* immunity—to its limits, stretching it to encompass even communications that entail no government involvement at all. This view is best exemplified by the Fifth Circuit's decision in *Coastal States Marketing, Inc. v. Hunt*. Coastal States was alleged to be dealing in pirated oil illegally seized by the Libyan government and, as a result, was the target of threats of litigation. Coastal States Marketing, Inc. v. Hunt, 694 F.2d 1358 (5th Cir. 1983). These threats were directed at specific entities—including Coastal States, its customers, and third party contractors—and published generally. Coastal States argued that the threats—as opposed to the litigation itself—were not directed at the government and therefore could not constitute immunized petitioning, but the Fifth Circuit held otherwise. *Id*. at 1367. According to the court: "Given that petitioning immunity protects joint litigation, it would be absurd to hold that it does not protect those acts reasonably and normally attendant upon effective litigation. The litigator should not be protected only when he strikes without warning." *Id*.

170. *See* Christopher C. Klein, *Strategic Sham Litigation: Economic Incentives in the Context of the Case Law*, 6 INT'L REV. L. & ECON. 241, 245-51 (1986); Paul L. Joskow & Alvin K. Klevorick, *A Framework for Analyzing Predatory Pricing Policy*, 89 YALE L.J. 213 (1979) (arguing that antitrust bans on predatory pricing must balance the benefit of deterring predatory pricing against the cost of deterring desirable price-cutting). The same tradeoff is present for non-antitrust doctrines that deal with the problem of frivolous suits and strategic litigation. *See* Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869, 877-82 (1990) (arguing with respect to malicious prosecution and professional rules of conduct that any

Courts have extended the *Noerr-Pennington* doctrine from petitioning to various other claims made under both federal and state law.[171] Although the sham petitioning exception was initially recognized in *Noerr*, an exact definition of a sham petition was largely undefined until in 1972,[172] when the U.S. Supreme Court decided *California Motor Transport v. Trucking Unlimited* ("*California Motor Transport*").[173]

*California Motor Transport* involved a dispute between two trucking companies in which the plaintiff alleged that the defendant had conspired to injure plaintiff's business by filing numerous lawsuits in state and federal court.[174] The court focused on the defendant's litigation strategy, which it characterized as involving the institution of suits "with or without probable cause, and regardless of the merits of the cases."[175] In finding for the plaintiff, the court determined that the *Noerr-Pennington* doctrine was applicable not only to petitioning activities but also to litigation activities.[176] Ultimately, the court decided that the defendant's litigation activities were a sham and thus outside of the *Noerr-Pennington* immunity.[177]

*California Motor Transport* was the Supreme Court's first extended

definition of strategic litigation must trade off over- and under-inclusion); Avery Katz, *The Effect of Frivolous Lawsuits on the Settlement of Litigation*, 10 INT'L REV. L. & ECON. 3, 26 (1990) (concluding that the English rule of assessing legal expenses against the loser may help deter frivolous suits, but only at the cost of deterring meritorious suits).

171. "Although the *Noerr-Pennington* doctrine was initially recognized in the antitrust field, the federal courts have by analogy applied it to claims brought under both state and federal laws." Campbell v. PMI Food Equip. Group, Inc., 509 F.3d 776, 790 (6th Cir. 2007). The Ninth Circuit has applied the *PRE* test to retaliation claims under the Fair Housing Act, Pub. L. No. 90-284, 82 Stat. 81 (1968). *See* White v. Lee, 227 F.3d 1214, 1231 (9th Cir. 2000). Specifically, the Ninth Circuit noted that "*Noerr-Pennington* is a label for a form of First Amendment protection; to say that one does not have *Noerr-Pennington* immunity is to conclude that one's petitioning activity is unprotected by the First Amendment." *Id.*

172. *See* Paul More, *Protections against Retaliatory Employer Lawsuits after* BE&K Construction v. NLRB, 25 BERKELEY J. EMP. & LAB. L. 205, 223 (2004).

173. California Motor Transport v. Trucking Unlimited, 404 U.S. 508, 510 (1972).

174. *Id* at 509.

175. *Id.* at 512.

176. *Id.* at 513:

> Opponents before agencies or courts often think poorly of the other's tactics, motions, or defenses and may readily call them baseless. One claim, which a court or agency may think baseless, may go unnoticed; but a pattern of baseless, repetitive claims may emerge which leads the factfinder to conclude that the administrative and judicial processes have been abused. That may be a difficult line to discern and draw. But once it is drawn, the case is established that abuse of those processes produced an illegal result, *viz*., effectively barring respondents from access to the agencies and courts. Insofar as the administrative or judicial processes are involved, actions of that kind cannot acquire immunity by seeking refuge under the umbrella of "political expression."

177. *Id*. at 515-16.

treatment of the "sham" exception to the *Noerr-Pennington* immunity.[178] In the following years, however, courts "wrestled with the boundaries of the sham litigation exception."[179] In 1993, the Supreme Court addressed the scope of the sham litigation exception in *Professional Real Estate Investors, Inc. v. Columbia Pictures Industries, Inc.* ("*PRE*").[180] In *PRE*, the court outlined a two-part definition of sham litigation, requiring the litigation to be (1) "objectively baseless in the sense that no reasonable litigant could realistically expect success on the merits," and (2) "an attempt to interfere directly with the business relationships of a competitor."[181] The court concluded that if the first test was satisfied, the suit was "immunized under *Noerr*."[182]

The right to pursue all but objectively baseless petitions is a necessary ingredient in the U.S. system of justice.[183] The *Noerr-Pennington* doctrine provides protection to petitioning activity unless that activity is "objectively baseless" as set forth in *PRE*. However, section 6676 sanctions refund requests "lacking a reasonable basis," a standard significantly higher than the "objectively baseless standard" set forth in *PRE*. As such, absent some procedural safeguards, imposing the section 6676 penalty could easily violate the First Amendment by chilling a taxpayer's rights to seek refund that is objectively non-baseless.

As noted in Part II, the IRS appears to have adopted the "reasonable basis" standard used in Treasury Regulation § 1.6662-3(b)(3). Thus, the IRS can impose a section 6676 penalty so long as it determines a refund claim is not reasonably based on the specific types of authority outlined

178. The "sham" exception was first articulated in the *Noerr* case itself, in which the Supreme Court held that there may be instances in which a petitioning effort "ostensibly directed toward influencing governmental action, is a mere sham to cover what is actually nothing more than an attempt to interfere directly with the business relationships of a competitor." E. R.R. Presidents Conference v. Noerr Motor Freight, Inc, 365 U.S. 127, 144 (1961).

179. More, *supra* note 172, at 224.

180. Prof'l Real Estate Investors, Inc. v. Columbia Pictures Indus., Inc., 508 U.S. 49 (1993) [hereinafter *PRE*].

181. *Id*. at 60-61.

182. *Id*. at 60. The objectively baseless standard can be found in other areas as well, particularly Rule 11 of the Federal Rules of Civil Procedure ("Rule 11"). Rule 11 requires an attorney in federal court to certify that, after reasonable inquiry, there is an adequate legal and factual basis for submissions to the court. FED. R. CIV. P. 11. Attorneys violating Rule 11 face sanctions, and courts, in determining whether to impose those sanctions, apply standards consistent with the "baseless" standard set forth by Justice Thomas in *PRE*. *See, e.g*., Jerold S. Solovy et al., *Happy (?) Birthday Rule 11: Sanctions Under Rule 11: A Cross-Circuit Comparison*, 37 LOY. L.A. L. REV. 727 (2004); Lisa Wood, *In Praise of the* Noerr-Pennington *Doctrine*, 18 ANTITRUST A.B.A. 72 (2003).

183. *See, e.g*., Wood, *supra* note 182.

in Treasury Regulation § 1.6662-4(d)(3)(iii), which generally includes the Code, existing, temporary, and proposed Treasury Regulations, published IRS materials, and case law.[184] The reasonable basis standard surely exceeds the "objectively baseless" standard articulated in *PRE*.

In addition to the higher standard, the lack of a means to challenge the penalty prior to assessment exacerbates the First Amendment issue. As noted above, section 6676 is an immediately assessable penalty with no good faith defenses. As such, it is essentially an immediately assessable strict liability penalty for taxpayers. Such penalties have been deemed appropriate in limited circumstances.[185] Those circumstances include situations in which "the prohibited activity 'impairs the efficiency of controls deemed essential to the social order as presently constituted.'"[186]

However, in circumstances in which a strict liability statute touches on protected First Amendment activity (as is the case with section 6676), the Supreme Court has noted that strict liability penalties may have the effect of "inhibiting the freedom of expression, by making the individual the more reluctant to exercise it."[187] The Court also added that First Amendment protections are warranted to "assure to the freedoms of speech and press that 'breathing space' essential to their fruitful exercise."[188]

Because of the potential chill a strict liability penalty could have on protected First Amendment rights, courts generally require some safeguards prior to the imposition of a penalty.[189] In fact, the "Ninth Circuit has explained that [u]nder the *Noerr-Pennington* rule of statutory

184. Treas. Reg. § 1.6662-4(d)(3)(iii) (as amended in 2003).

185. *See* American-Arab Anti-Discrimination Comm. v. City of Dearborn, 418 F.3d 600, 610 (6th Cir. 2005). Most strict liability penalties are related to the regulation of motor vehicles, commercial goods, or food and drug legislation where the safety and health of the public is of ultimate concern. *Id*. (citing Smith v. California, 361 U.S. 147, 152-53 (1960)).

186. *American-Arab Anti-Discrimination Comm.*, 418 F.3d at 610 (citing Morissette v. United States, 342 U.S. 246, 256 (1952)).

187. *Smith*, 361 U.S. at 151. *See also* Roth v. United States, 354 U.S. 476, 484 (1957) (holding that the First Amendment protections at issue were "fashioned to assure unfettered interchange of ideas for the bringing about of political and social changes desired by the people").

188. Sosa v. DirecTV, Inc., 437 F.3d 923, 933 (9th Cir. 2006) (quoting Gertz v. Robert Welch, Inc., 418 U.S. 323, 342 (1974)).

189. An exception to this general rule is commercial speech. *See, e.g., American-Arab Anti-Discrimination Comm*., 418 F.3d at 611 n.7 ("the Supreme Court has held that the usual concern of chilling protected speech 'applies weakly, if at all, in the ordinary commercial context.' Bates v. State Bar of Ariz., 433 U.S. 350, 380 (1977). Strict liability regimes regulating commercial speech have thus been approved because 'the economic motivations that inspire advertising neutralize the fear that protected speech will be chilled.'" Accounting Outsourcing, L.L.C. v. Verizon Wireless Pers. Comm., L.P., 329 F. Supp. 2d 789, 812 (M.D. La. 2004)).

construction, we must construe federal statutes so as to avoid burdening conduct that implicates the protections afforded by the Petition Clause unless the statute clearly provides otherwise."[190] Section 6676 lacks such a safeguard.

The refund claims of Fraudsters deserve no First Amendment protection because they are, by their very nature, objectively baseless. However, refund claims of Strivers and Gamers often fall short of being "objectively baseless." Instead, those refund claims, based on errors of law or fact, will often have some objective, albeit erroneous, basis. As such, any infringement on their right to claim that non-baseless refund must be afforded some minimum First Amendment protections. As drafted, section 6676 offers no such protections.

### B. *Imperfect Claims for Refund*

Another problem with section 6676 is that the IRS, through informal guidance to its employees, sought to broaden the reach of section 6676 by extending its reach to inchoate refund claims. As set forth below, there is no legal or policy justification for the IRS's actions.

The IRS has asserted that the section 6676 penalty applies to informal claims for refunds,[191] i.e., refund claims that fail to meet the formal requirements of the law governing refund claims.[192] However, no court has had the opportunity to opine on the matter, and nothing in the Code or Treasury Regulations supports the IRS's position. Moreover, the IRS's position opens a Pandora's box of thorny legal issues for the IRS and could ultimately cause the IRS more harm than good.

The rules determining what constitutes a valid refund claim are delineated in the Code and regulations, to wit: a legally sufficient claim for refund must set forth, in a written declaration that is executed under penalties of perjury, each ground upon which a refund is claimed and facts sufficient to apprise the Commissioner of the exact basis of the claim.[193] Claims for refund must generally be filed "within [three] years from the time the return was filed or [two] years from the time the tax

190. *See* Hartman v. Great Seneca Fin. Corp., 569 F.3d 606, 615 (6th Cir. 2009) (citing *Sosa*, 437 F.3d at 931).

191. *See* IRM 20.1.5.16(3) (Jan. 24, 2012) ("The [section 6676] penalty applies to all claims, formal and informal, relating to federal income taxes.").

192. Treasury regulations set forth the requirements for a valid claim for refund. *See* Treas. Reg. § 301.6402-2(b)(1) (as amended in 1977); *id.* § 301.6402-3(a) (as amended in 2014).

193. *See* Treas. Reg. § 301.6402-2. The regulations do offer some flexibility for less-than-complete compliance with the rules and permit the IRS to consider claims, provided the taxpayer sets forth detailed grounds upon which the refund is claimed and a factual basis for the claim and includes a jurat. *See id.* § 301.6402-2(b)(1).

was paid, whichever of such periods expires the later."[194] To request a refund consistent with section 6511, taxpayers may either claim a refund on the tax return itself, or file an amended return claiming the refund.[195]

Although the law states that claims for refund failing to comply with the regulatory requirements will not be considered, courts, "with the IRS's reluctant acquiescence," have fashioned an equitable remedy for taxpayers failing to meet the strict legal and regulatory requirements—the informal claim doctrine.[196] The informal claim doctrine allows taxpayers to toll "the statute of limitations related to refund claims when a taxpayer puts the Service 'on notice' of a pending refund claim, but fails to satisfy the formalities outlined in the regulations for filing a valid claim."[197] For an informal claim to be considered adequate, courts and the IRS generally require the claim to (i) be in writing, (ii) apprise the IRS that a refund is being claimed, and (iii) specify the tax and the year or years for which the refund is being sought.[198]

The Supreme Court first recognized the informal claim doctrine in 1941, and the doctrine has been recognized by the courts and the IRS ever since.[199] In cases in which the informal claim doctrine has been applied, the courts have required taxpayers to supplement their informal

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194. *See* I.R.C. § 6511(a) (2012), which states:
Claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time which the tax was paid.

195. Treas. Reg. § 301.6402-3. "A return or amended return shall constitute a claim for refund or credit if it contains a statement setting forth the amount determined as an overpayment and advising [the Internal Revenue Service] whether such amount shall be refunded to the taxpayer or shall be applied as a credit." *Id.* § 301.6402-3(a)(5).

196. *See* BCS Fin. Corp. v. United States, 118 F.3d 522, 524 (7th Cir. 1997).

197. *See* United States v. Commercial Nat'l Bank of Peoria, 874 F.2d 1165, 1175-76 (7th Cir. 1989) (holding that the taxpayer met the claim requirement where the taxpayer first filed a timely letter with the IRS that requested a refund and, subsequently, filed a formal refund claim). *See also* William A. Neilson, *Informal Claims For Refund—A Winding Road*, 26 AKRON TAX J. 147, 148 (2011).

198. *See* MICHAEL I. SALTZMAN & LESLIE BOOK, IRS PRACTICE AND PROCEDURE ¶ 11.08[2]; *see also* Neilson, *supra* note 197, at 152.

199. *See* United States v. Kales, 314 U.S. 186, 194 (1941), holding:

> A notice fairly advising the Commissioner of the nature of the taxpayer's claim, which the Commissioner could reject because too general or because it does not comply with formal requirements of the statute and regulations, will nevertheless be treated as a claim where formal defects and lack of specificity have been remedied by amendment filed after the lapse of the statutory period.

*See also* AmBase Corp. v. United States, 731 F.3d 109, 118 (2d Cir. 2013); Furst v. United States, 678 F.2d 147, 151 (Ct. Cl. 1982); Am. Radiator & Standard Sanitary Corp. v. United States, 318 F.2d 915, 923 (Ct. Cl. 1963).

claims with proper formal claims before initiating litigation, to give the government a "full opportunity to address the problem administratively."[200] In effect, the courts have required the filing of a valid refund claim as a prerequisite to application of the informal claims doctrine.

The IRS's decision to apply section 6676 penalties to informal claims is contrary to that history. As a preliminary matter, the IRS's position runs contrary to the Code and Treasury regulations. Section 6676, on its face, applies only to a taxpayer's "claim for refund," and the rules governing claims for refund can be found in section 6511 and its implementing regulations. Implicit in those rules is the assumption that "claims for refund," as used in section 6511 and its regulations, means valid claims for refund. Otherwise, section 6511 would stand for the absurd proposition that its rules apply to invalid claims, which would obviate the need for a definition of valid claims.

If you accept that the validity of a claim is an implicit assumption in 6511, as a matter of statutory construction, the same rule should be applied to section 6676, absent evidence to the contrary.[201] No such evidence exists. Moreover, nothing in what little legislative history exists with respect to section 6676 indicates, or even suggests, that invalid refund claims should fall within the purview of the penalty.

More damning is Treasury Regulation § 301.6402-2(b)(1), which directly contradicts the IRS's position, stating that a refund claim that fails to comply with the formal requirements of a refund claim "will not be considered <u>for any purpose</u> as a claim for refund."[202] If the IRS sought to impose the section 6676 penalty for an informal refund claim, no court would likely rule in the IRS's favor. That, however, is not the end of the discussion.

### C. *An Avoidable Penalty*

> "Only the little people pay taxes"
>
> —Leona Helmsley

The above quote, attributable to the "Queen of Mean,"[203] is not

200. Greene-Thapedi v. United States, 549 F.3d 530, 533 (7th Cir. 2008) (citing *BCS Fin. Corp.*, 118 F.3d at 524-25).

201. For a detailed examination of the statutory construction of tax statutes, see Michael Livingston, *Congress, the Courts, and the Code: Legislative History and the Interpretation of Tax Statutes*, 69 TEX. L. REV. 819 (1991).

202. Treas. Reg. § 301.6402-2(b)(1) (as amended in 1977) (emphasis added).

203. Leona Helmsley was nicknamed the "Queen of Mean" in various periodicals, and that nickname was memorialized by a 1990 movie of her life, aptly titled, *Leona Helmsley: the Queen of*

true,[204] but it may be accurate with respect to those from whom the IRS will collect section 6676 penalties. As drafted, section 6676 penalties may be entirely avoidable through procedural planning. One such strategy, set forth below, requires a fairly sophisticated understanding of tax procedure. As such, for all practical purposes, only taxpayers who can afford tax counsel can likely avail themselves of it, resulting in penalty enforcement primarily against the Strivers, i.e., "the little people" referenced by Helmsley above.

One method for avoiding the penalty, outlined in a 2011 *Tax Notes* article,[205] is as follows:

1. Taxpayer files a federal tax return without the transaction that may give rise to the refund (the "Questionable Transaction").

2. Taxpayer files an amended tax return seeking only a nominal portion of the benefits of the Questionable Transaction. In the amended return, the taxpayer discloses all the relevant legal and factual issues regarding the Questionable Transaction, but seeks only some small portion of the Questionable Transaction's tax benefits.

3. Taxpayer waits to see what the IRS does:

    a) if the IRS accepts the taxpayer's request, the taxpayer then requests the full amount;

    b) if the IRS denies the taxpayer's request, the taxpayer files a refund suit, requesting full amount of Questionable

*Mean* (CBS television broadcast Sept. 23, 1990). *See* IMDB, http://www.imdb.com/title/tt0100004 (last visited Apr. 5, 2015).

204. According to the Congressional Budget Office, for 2010 (the latest year available as of this writing), "[h]ouseholds in the top quintile (including the top percentile) paid 68.8 percent of all federal taxes, households in the middle quintile paid 9.1 percent, and those in the bottom quintile paid 0.4 percent of federal taxes." CONG. BUDGET OFFICE, THE DISTRIBUTION OF HOUSEHOLD INCOME AND FEDERAL TAXES, 2010, at 1 (2013), *available at* http://www.cbo.gov/sites/default/files/cbofiles/attachments/44604-AverageTaxRates.pdf.

205. *See* Donald B. Susswein, *Is There a Disclosure Exception to the Economic Substance Penalty?*, TAX NOTES TODAY, Nov. 14, 2011, at 221-13. *See also* Gerald A. Kafka & Paul B. Hynes, Jr, *Recent Developments to Consider When Filing Formal and Informal Claims for Refund*, 2011 TAX EXECUTIVES INST. 137, *available at* http://www.tei.org/news/articles/Pages/TTE-MJ11-Recent-Developments-to-Consider-When-Filing-Formal-and-Informal-Claims-for-Refund.aspx.

Transaction's tax benefits.[206]

Under this scenario, the IRS would be able to assert the section 6676 penalty only if it denied the taxpayer's request, but the penalty would apply only to the nominal portion of the Questionable Transaction's tax benefits that would have generated a refund. This is because section 6676 applies only to IRS administrative refunds, not refunds requested in litigation.[207] Thus, because the full refund claim was not made to the IRS, but instead to a court in a refund action, the IRS could not seek to impose the section 6676 penalty to the full amount of the Questionable Transaction's tax benefits that generated the potential refund.

A reasonable question at this point is what would happen if the IRS accepted the claim. If it never challenged the transaction, the taxpayer would keep all the Questionable Transaction's tax benefits. If the IRS later determined that the transaction's tax benefits should have been denied, the IRS would be hard-pressed to argue that a taxpayer relying on the IRS's own determination (i.e., the initial decision accepting the Questionable Transaction's benefits) did not have a reasonable basis. For taxpayers, it would be a "heads I win, tails you lose" gambit.

One potential problem for a taxpayer seeking to use this strategy could be the variance doctrine, which bars taxpayers from raising new issues relating to their tax claims unless the new issue is "derived from or is integral to the ground timely raised in the [initial] refund claim."[208] The variance doctrine is derived from Treasury regulations that require taxpayers to set forth specific grounds for their refund claims.[209]

It is unclear how a court would view the taxpayer in this circumstance. On the one hand, the taxpayer has, as the regulation requires, "set forth in detail each ground upon which a credit or refund is

206. Pursuant to I.R.C. § 6532(a)(1) (2012), the taxpayer must generally wait six months before filing a refund suit.

207. *Id*.

208. Ottawa Silica Co. v. United States, 699 F.2d 1124, 1139 n.6 (Fed. Cir. 1983).

209. *See* Treas. Reg. § 301.6402-2(b)(1) (as amended in 1977), which states:

> No refund or credit will be allowed after the expiration of the statutory period of limitation applicable to the filing of a claim therefor except upon one or more of the grounds set forth in a claim filed before the expiration of such period. The claim must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof. . . . A claim which does not comply with this paragraph will not be considered for any purpose as a claim for refund or credit.

*See also* United States v. Felt & Tarrant Co., 283 U.S. 269, 270 (1931); J.P. Stevens Engraving Co. v. United States, 53 F.2d 1, 2 (5th Cir. 1931).

claimed and facts sufficient to apprise the Commissioner of the exact basis [of the refund claim]," by disclosing all the relevant legal and factual issues regarding the Questionable Transaction.[210] In such a case, the taxpayer would appear to have satisfied the variance doctrine requirements, as there would be no "new" factual or legal theories at issue.[211]

On the other hand, the IRS could argue that there is substantial factual variance from the filed refund claims and the refund claim before the court, namely the difference between the nominal refund request to the IRS, and the full refund request before the court. Whether a court would side with the IRS here is unknown. At least one writer, however, has noted that the strategy is "risky."[212]

## V. A BETTER REFUND PENALTY

Section 6676, which was enacted to deter Fraudsters and Gamers, fails miserably at meeting its intended targets. Instead, it created more work for the government, and, judging by the increase in bogus refund schemes, may have emboldened those seeking to cheat the government through the bogus refund schemes described in Part I.

Despite its failures, however, a properly implemented section 6676 penalty could fill the gap in the current penalty regime exposed by the *Rand* court. Absent section 6676, there would be no effective sanction on filing erroneous (as opposed to fraudulent) refund claims. Thus, at the margins, rational taxpayers would be encouraged to push the envelope by taking aggressive positions because there would be little sanction to such behavior. An effective penalty would seek to balance the IRS need

210. Treas. Reg. § 301.6402-2(b)(1). Courts have found that the requirement "is designed both to prevent surprise and to give adequate notice to the [IRS] of the nature of the claim and the specific facts upon which it is predicated, thereby permitting an administrative investigation and determination." Computervision Corp. v. United States, 445 F.3d 1355, 1363 (Fed. Cir. 2006) (quoting Alexander Proudfoot Co. v. United States, 454 F.2d 1379, 1383, 197 Ct. Cl. 219 (Ct. Cl. 1972)). *See also* Cencast Servs., L.P. v. United States, 729 F.3d 1352, 1367 (Fed. Cir. 2013); Union Pac. R.R. Co. v. United States, 389 F.2d 437, 443 (Ct. Cl. 1968) (citing *Felt & Tarrant Mfg. Co.*, 283 U.S. 269); Real Estate-Land Title & Trust Co. v. United States, 309 U.S. 13, 17-18 (1940); Int'l Curtis Marine Turbine Co. v. United States, 56 F.2d 708 (Ct. Cl. 1932); The Midvale Co. v. United States, 138 F. Supp. 269 (Ct. Cl. 1956); Williamson v. United States, 292 F.2d 524 (Ct. Cl. 1961)); Herrington v. United States, 416 F.2d 1029, 1032 (10th Cir. 1969) ("Thus, if the claim fairly apprises the Service of the ground on which recovery is sought or if the Service actually considers the ground later sought to be raised the claim will be held adequate for . . . bringing suit under § 7422."); Garvey, Inc. v. United States, 1 Cl. Ct. 108 (1983).

211. *See, e.g.*, Lockheed Martin Corp. v. United States, 210 F.3d 1366, 1371 (Fed. Cir. 2000); *Ottawa Silica Co*., 699 F.2d at 1139.

212. *See* Coder, *supra* note 109.

to discourage overly aggressive refund claims with taxpayers' freedom not to "pay more than the law demands."[213]

Fortunately, many of the problems associated with section 6676 can be corrected, and the IRS and Treasury can make the gravamen of the necessary changes without congressional intervention. However, to make section 6676 effective, Congress needs to step in.

In section IV.A, I will outline the steps the IRS and Treasury can take to correct the most glaring problems associated with the penalty. It is up to Congress to do the rest, and those steps are outlined in section IV.B.

### *A. Administrative Changes*

#### 1. Fix the First Amendment Issue

The government should first address the First Amendment issue by providing a mechanism to challenge section 6676 penalties prior to assessment. Section 6676 has two related First Amendment problems: (1) the reasonable basis standard is contrary to *PRE*, and (2) section 6676, lacking a right to a pre-assessment challenge, unduly burdens taxpayers' ability to petition the government. Although both problems touch on the constitutional issues, both do not necessarily need to be corrected. Rather, allowing a pre-assessment challenge (while retaining the reasonable basis standard) would likely be enough to pass constitutional muster. Moreover, such a change could be easily implemented and would not require an act of Congress.

##### a. Provide a Pre-Assessment Challenge

To ameliorate the First Amendment concerns while retaining the reasonable basis standard, the IRS and Treasury should provide taxpayers with the right to challenge the penalty prior to assessment. Although section 6676 falls within the sections of the Code that permit immediately assessable penalties (Subtitle F, Chapter 68, Subchapter B: Assessable Penalties ("Subchapter B")), nothing in the Code precludes the IRS and Treasury from providing a pre-assessment challenge to the penalty.[214] In fact, one Subchapter B penalty permits a reasonable cause exception to the penalty, which implicitly recognizes a pre-assessment

213. Comm'r v. Newman, 159 F.2d 848, 851 (1947) (Hand, J., dissenting).

214. Section 6676 was enacted in Subchapter B of Chapter 68 of the Code. The rules for Subchapter B are found in section 6671. *See* I.R.C. §§ 6671, 6676 (2012).

right for taxpayers to challenge the penalty.[215]

What type of pre-assessment challenge? Some commenters have argued that section 6676 penalties should be subject to Deficiency Procedures, giving taxpayers the right to challenge the penalty as any other return-related penalty.[216] Others have argued that section 6664 be amended to include refundable tax credit disallowances in full, so 6662 penalties would apply in the *Rand*-type case.[217] The former, in addition to requiring an act of Congress,[218] is both unwarranted and unnecessary. The latter, as noted *infra*, would make section 6676 a better penalty.

Deficiency Procedures presuppose tax deficiencies and provide protections to taxpayers based on the positions they take on returns accepted by the IRS.[219] Unlike other tax penalties, however, section 6676 penalties are based on mere *claims* for refund.[220] There is no requirement that the claim for refund be based on a tax deficiency, as may be the case in frozen refund situations. Thus, Deficiency Procedures are inappropriate, as they would layer the penalty with additional and unnecessary requirements, and would require the introduction of a slew of procedures not required to address erroneous refund claims. More importantly, Deficiency Procedures would also significantly decrease the immediacy of the penalty, which could be a useful tool to discourage taxpayers from making overly aggressive erroneous refund claims.

215. The reasonable cause defense requires taxpayers to make an affirmative showing of all the facts the taxpayer contends provide reasonable cause. *See, e.g.*, Treas. Reg. § 301.6651-1(c)(1) (as amended in 2004).

216. *See, e.g.*, Sharon M. Fisk & Heather Kim Lee, *Section 6676 Erroneous Claim for Refund or Credit Penalty: The Penalty Has No Reasonable Basis*, 1 TAX DEV. J. 26 (2009).

217. *See* Carlton M. Smith, *IRS Wrongly Ignores the 20 Percent Excessive Refund Penalty*, TAX NOTES TODAY, Feb. 27, 2013, at 39-10.

218. Because section 6676 is in Subchapter B, to permit Deficiency Procedures, Congress would either have to renumber section 6676 to include it in Subtitle F, Chapter 63 (possibly by adding the penalty to section 6662) or change the law to allow taxpayers to challenge the penalty through Deficiency Procedures.

219. "Deficiency" is defined generally in the Code as the difference between the correct tax and the tax reported on a return. *See* I.R.C. § 6211(a). For individuals who fail to file returns, the Code permits the IRS to make a return, generally referred to as a "Substitute For Return" ("SFR"), which will be treated as that person's return for tax purposes. *See id.* § 6020(b)(1). It is not until after the SFR has been filed that the IRS can issue a Notice of Deficiency. *See* Leslie Book, *Notice of Deficiency in Substitute for Return Setting*, PROCEDURALLY TAXING (Dec. 5, 2013), http://www.procedurallytaxing.com/notice-of-deficiency-in-substitute-for-return-setting/ ("IRS generally cannot assess tax based upon the liability in the SFR until it issues a statutory notice of deficiency giving the taxpayer the right to petition the Tax Court."). *See also* Claudia Hill & Frank Degen, Nat'l Ass'n Enrolled Agents, Presentation at the IRS Nationwide Tax Forum: Dealing with SFRs and ASFRs -Substitutes for Returns—IRC 6020(b) (2013), *available at* http://www.irs.gov/pub/irs-utl/2013_NTF_Dealing_with_SFRs.pdf.

220. *See* I.R.C. § 6676.

A better solution would be to provide taxpayers with an explicit right to challenge the section 6676 penalty. Such a right could retain the reasonable basis standard (though, as argued *infra*, that is not the best standard), but provide a clear mechanism for taxpayers to make their case to the IRS. Such a right would likely solve the potential First Amendment issues, as it would give taxpayers a clear means to avoid the immediate imposition of the penalty. Such a right, coupled with a taxpayer's ability to utilize either CDP or Refund Procedures, should be enough to overcome the First Amendment concerns.

#### b. Reasonable Basis v. Objectively Baseless?

One possible First Amendment solution would be to change the law and adopt the objectively baseless standard, making only refund claims that fail the standard subject to penalty. The objectively baseless standard, consistent with *PRE*, would require the government to show that no reasonable taxpayer could expect success on the merits. The objectively baseless standard may well work for Fraudster refund claims; however, for claims based on errors of fact or law (i.e., Strivers and Gamers refund claims), that standard would not provide much deterrence, as any non-baseless claim would escape penalty.

The rules of eligibility for refundable tax credits are often complex, requiring taxpayers to make sometimes intricate determinations and tax calculations. A properly functioning refund claim penalty would ask taxpayers to determine carefully the merits of their claim before requesting a refund based on refundable credits. However, by lowering the bar to the objectively baseless standard, taxpayers would have less incentive to exercise care in determining their eligibility for credits. Thus, taxpayers who would otherwise have exercised more care (to avoid the penalty) will be dis-incentivized to exercise care if they would be penalized only for objectively baseless refund claims. Simply stated, changing the standard to objectively baseless is not the best option.

Adopting *PRE*'s objectively baseless standard, which would require an act of Congress, would be a waste of both time and effort. Providing a pre-assessment challenge, which fits into the IRS's mission to administer the tax laws, would allow the IRS to do its job while avoiding the First Amendment issues.

### *2. Clarify the Law in Regulations*

Treasury should adopt regulations that provide explicit rules regarding how section 6676 should be implemented. As the *Rand* case demonstrates, the absence of regulation can lead to unintended results, as demonstrated in the Three Stooges example above, with at least four different penalty combinations for what is essentially the same behavior. Such an outcome could have been avoided entirely had Treasury issued regulations mandating that refundable credits be included in underpayment calculations.

The power to issue those regulations is well within Treasury's purview.[221] Generally, if a statute is deemed ambiguous about a particular matter, a regulatory agency is free to issue regulations clarifying the ambiguity.[222] The fact that the Tax Court has ruled contrary to the IRS position should not be a hindrance to issuing regulations, because as long as regulation is entitled to *Chevron* deference (i.e., the statute does "directly address the precise question at issue"),[223] the regulation can overturn a contrary judicial decision.[224]

To make section 6676 more effective, two specific regulatory changes are warranted: (1) define underpayment to include refundable tax credits; and (2) exclude non-perfected refund claims from the penalty.

a. Underpayment Definition

The aftermath of *Rand* provided the IRS with a choice regarding how best to proceed in seeking to implement the section 6676 penalty: (1) appeal *Rand* and pursue what will likely be vexatious litigation around the country, or (2) issue regulations that include refundable credits in the underpayment calculation. One choice will be costly, time consuming, and wasteful; the other will likely resolve the issue once and

221. *See* Mayo Found. for Med. Educ. & Research v. United States, 562 U.S. 44, 55 (2011), in which the Supreme Court held that courts (1) apply *Chevron* deference to Treasury regulations and defer to such regulations if they reasonably resolve a statutory ambiguity, (2) defer to all Treasury regulations, whether issued pursuant to the general grant of rulemaking authority or pursuant to a more specific congressional grant of rulemaking authority, and (3) ignore the history of the regulation, such as whether it represents a reversal of Treasury policy or whether it was issued in response to government litigation losses, in determining whether a regulation is valid.

222. *See* Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Serv., 545 U.S. 967, 982 (2005) ("*Brand X*"). *See also* United States v. Home Concrete & Supply, LLC, 132 S. Ct. 1836, 1843 (U.S. 2013) (citing with approval *Brand X*'s holding that "it is for agencies, not courts, to fill statutory gaps." *Brand X*, 545 U.S. at 982.).

223. Chevron USA Inc. v. Natural Res. Def. Council Inc., 467 U.S. 837, 843 (1984). *Chevron* deference requires courts to defer to an administrative agency's regulations if Congress has not "spoken directly to the precise question at issue" and the regulation is based on a "permissible construction of the statute." Richard Lipton & Russell Young, *COURTS SPLIT ON VALIDITY OF SECTION 6501(E)(1)(A) REGULATIONS AFTER MAYO FOUNDATION*, 115 J. TAX'N 21, 26 (2011).

224. Lipton & Young, supra note 223, at 27.

for all.

Assuming the IRS chooses to appeal *Rand* and wins (i.e., the court allows the IRS to include refundable credits in the underpayment calculation), little will be resolved. Pursuant to the *Golsen* rule, the Tax Court will follow its own precedent unless a case is appealable to a U.S. Circuit Court of Appeals that disagrees with it on a legal issue.[225] Thus, the IRS would have to determine penalties on a circuit-by-circuit basis unless and until all circuits are in agreement or the Supreme Court resolves the issue. Such a strategy would unnecessarily burden both taxpayers and the IRS. In addition, based on its prior actions enforcing the section 6662 penalties, the IRS could choose simply to apply the penalty broadly and ask the courts to figure it out, generating vexation, and unnecessary litigation.[226]

If Treasury instead issued regulations stating that any refundable credits should be included in "the amount shown as the tax by the taxpayer on his return" (the "X" in the underpayment calculation)[227] and that such amount could be negative, the issue could be resolved. In fact, the Tax Court almost invited Treasury to draft a regulation, noting that the court was "not resolving the question of whether the Secretary may promulgate a regulation that is inconsistent with this Opinion."[228]

#### b. Penalize Only Valid Refund Claims

The IRS should explicitly remove informal claims from the purview of section 6676 penalties. As noted above, the IRS has claimed in internal guidance (albeit without providing a legal basis) that informal claims for refund are subject to section 6676 penalties,[229] and it has not

225. Golsen v. Comm'r, 54 T.C. 742, 756-58 (1970), *aff'd on another issue*, 445 F.2d 985 (10th Cir. 1971). *See also* Moosally v. Comm'r, 142 T.C. 10, 16 n.7 (2014) (citing *Golsen*, 54 T.C. at 757) (holding *Golsen* "established the rule that this Court will 'follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals'").

226. *See* TAXPAYER ADVOCATE SERV., *supra* note 124, at 187 (report on improper section 6662 penalty assessment after the 2012 guidance). To be fair, the IRS appears to be directing its attorneys handling refundable credit cases with section 6662 penalties to notify the taxpayer if the IRS is pursuing a larger penalty than what would apply under *Rand*. *See* 2013 TIGTA REPORT, *supra* note 9; *see also* Carl Smith, *Another Update on* Rand *Cases in Tax Court*, PROCEDURALLY TAXING (Feb. 6, 2014), http://www.procedurallytaxing.com/another-update-on-rand-cases-in-tax-court/.

227. *See* Treas. Reg. § 1.6664-2(a)(1)(i) (as amended in 2007).

228. Rand v. Comm'r, 141 T.C. 376, 384-85 (2013). In a footnote, the court also stated that "[i]f the Secretary should promulgate such a regulation, we may be called upon to revisit that question, but judicial restraint dictates that we not resolve that question now." *Id* at 385 n.6 (citations omitted).

229. *See* Part IV.B.

publicly stated whether the penalty applies to protective claims. Neither informal nor protective claims should be penalized under section 6676.

As a preliminary matter, the requirements for a valid claim for refund can be found in the Code and Treasury regulations, which set forth, in detail, what the IRS should consider a valid claim for refund. On the opposite spectrum are informal claims, where there are no statutory or regulatory definitions.[230] What has emerged for informal claims, in the place of explicit laws and regulations, are equitable principles permitting taxpayers to extend the applicable statute of limitations in cases in which they failed to meet the requirements of a formal claim.[231]

The problem for the IRS, if it seeks to impose penalties on informal claims, is that a taxpayer may, as noted above, point out that "claim for refund," as set forth in the Code and Treasury regulations, has a precise definition, and that definition necessarily excludes informal claims. Thus, the IRS has no authority to penalize informal claims, because a plain reading of section 6676 excludes anything other than valid refund claims. Allowing the IRS to penalize informal claims gives it too much unchecked power against taxpayers who may lack the ability and wherewithal to challenge what would likely be viewed by a court as an illegal penalty.

### *B. Change the Law*

If Congress could be moved to change section 6676 in order to make it a better penalty, at least three changes are warranted. The first, providing a reasonable cause defense, would make the penalty more fair for unsophisticated taxpayers while not impacting the IRS's ability to penalize Fraudsters. The second, eliminating the economic substance penalty, would benefit the IRS generally by avoiding unnecessary, and potentially harmful, litigation. The last, providing a three year statute of limitations for non-fraudulent refund claims, would provide clarity for the Strivers, yet give the IRS the same ability to pursue Fraudsters it has with others forms of tax fraud.

#### 1. Provide a Reasonable Cause Defense

As noted above, a reasonable cause defense was originally provided

230. *See* [Tax Practice and Procedure] Tax Prac. Series (BNA) ¶ 3890.01.C.3.

231. *See* Neilson, *supra* note 197, at 149 ("informal claim doctrine has been subjected to numerous interpretations, and courts have been inconsistent in determining what actually qualifies as an informal claim for refund").

in the 2007 JCT Report, but was left out of the final bill.[232] Generally, reasonable cause allows for legal and factual mistakes, whereas reasonable basis requires reliance on persuasive legal authority.[233] As noted by the IRS, "the reasonable cause and good faith exception in [Treas. Reg.] § 1.6664-4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard."[234]

For taxpayers seeking to navigate the rules regarding refundable credits, reasonable basis is too rigid a standard. When reasonable basis is first introduced in Treasury Regulation § 1.6662-3, it is in the context of the negligence definition, and is defined as the opposite of negligence, noting that "a return position that has a reasonable basis . . . is not attributable to negligence."[235] That language captures the essence of the problem with the reasonable basis standard in the section 6676 context: it is a black and white solution to a problem with shades of gray, and will ensnare too many taxpayers in its net.

### 2. Remove the Economic Substance Penalty

> *"The rich hire lawyers and accountants for a reason—to slip the tab and stick you with the bill."*
>
> *—Pres. George W. Bush*[236]

The second change is to remove subsection (c), the penalty applicable to refunds based on transactions lacking economic substance. While arguably well-intentioned, more effective procedures exist to combat tax shelters, and the likely result of enforcing this portion of section 6676 will be to create bad precedent for the IRS.

As a preliminary matter, section 6676(c) is ill-targeted. Generally, as noted above, taxpayers enter sophisticated tax shelters not to generate refunds but to avoid tax.[237] That tax avoidance is generally done by

232. *See supra* note 103.

233. *See* I.R.C. § 6664(c)(1) (2012); Treas. Reg. § 1.6662-3(a) (as amended in 2003); *id.* § 1.6664-4(a).

234. *See* I.R.S. Chief Couns. Mem. 20125201F (Dec. 28, 2012).

235. Treas. Reg. § 1.6662-3(b)(1).

236. President George W. Bush, Campaign Remarks in Mason City, Iowa (Oct. 20, 2004), *available at* http://www.presidentialrhetoric.com/campaign/speeches/bush_oct20.html. For a list of other quotes, see DUBYASPEAK.COM, http://www.dubyaspeak.com/campaigner (last visited Apr. 5, 2015).

237. *See U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals: Hearings Before the Subcomm. on Investigations of the S. Comm. on Gov't Affairs*, 108th Cong. 146 app. (2003) ("In the broadest sense, a tax shelter is a device used to reduce or eliminate the tax liability of the tax shelter user. . . . These transactions have no economic substance

creating or inflating losses or deductions, not generating refunds.[238] Moreover, taxpayers who participate in tax shelter activity often have high incomes or large gains to shelter, and are generally ineligible for refundable tax credits, which often have income limits.[239]

The originally-enacted section 6676 was narrowly tailored to address refund fraud. Extending the reach of the penalty to tax shelter transactions, done as a sort-of kitchen sink amendment in 2010, adds nothing to the IRS's ability to combat bogus refund schemes, and may cause more harm than good. That harm would be in the form of bad precedent for the IRS regarding section 6676, generated by sophisticated taxpayers challenging the numerous flaws in the law. As Justice Oliver Wendell Homes stated long ago, "Great cases like hard cases make bad law."[240]

Section 6676 is particularly open to such bad precedent, because so many of the relevant terms in the penalty are undefined. This Article has identified a number of those issues: can the IRS penalize informal claims? what is the relevant statute of limitation? potential First Amendment issues? how should an "excessive amount" be calculated if there are multiple penalties? etc. The armies of lawyers representing the Gamers will find more, all at the government's expense.

The risk is even greater in this circumstance, because litigation of a section 6676(c) economic substance penalty would give taxpayers an added ability to define the contours of the codified economic substance doctrine. To date, the IRS has been cautious in its approach to applying economic substance penalties.[241] Such caution is understandable, as economic substance has so much overlap with the other common law doctrines.[242] Seeking to impose the section 6676(c) penalty would throw that caution to the wind. Moreover, as I hope to argue in an upcoming paper, the "any similar rule of law" language, if the IRS decides to take it off the shelf, gives the IRS ample tools to combat tax shelters.

or business purpose other than to reduce or eliminate a person's tax liability.").

238. The U.S. General Accounting Office reported to Congress in 2003 that the tax losses from abusive tax shelters totaled $85 billion. *See id.* at 10 (statement of Sen. Frank Lautenberg).

239. In 2013, the income limit for the EITC was $46,227 for an individual with three or more qualifying children. *See* I.R.C. § 32(b)(3)(A) (2012). The FTHBC limit for individuals was $145,000. *See id.* § 36(b)(2).

240. N. Sec. Co. v United States, 193 U.S. 197, 400 (1904) (Holmes, J., dissenting).

241. The IRS requires the economic substance penalties under section 6662(b)(6) to be approved by the Director of Field Operations before the penalty can even be proposed. *See* I.R.S. Guidance LMSB-20-0910-024 (Sept. 14, 2010), *available at* http://www.irs.gov/Businesses/Codification-of-Economic-Substance-Doctrine-and-Related-Penalties; I.R.S. Guidance LB&I-4-0711-015, *supra* note 87.

242. *See supra* note 58.

### 3. Create a Three Year Statute of Limitations for Non-Fraudulent Refund Claims

A three year statute of limitations gives the IRS ample opportunity to address non-fraudulent refund claims. Moreover, it would provide clear guidelines for Strivers regarding the rules applicable to refund claims, and be consistent with the IRS's own internal guidance. However, because taxpayers cannot rely upon that guidance, the statute of limitations should be formalized in law.

Unlike Strivers refund claims, Fraudster refund claims do not deserve a defined statute of limitations. Current law and regulations provide that proof of fraud prevents the running of the statute of limitations.[243] Consistent with that principle, penalties for fraudulent refund claims pursuant to section 6676 penalties should not be subject to a statute of limitations.

## VI. CONCLUSION

Section 6676 could be an effective penalty, giving the IRS the ability to discourage aggressive taxpayer behavior. However, poor drafting and implementation have hamstrung the IRS, and rendered the penalty relatively useless. The steps identified above would benefit both taxpayers and the IRS in fairly administering the penalty and avoiding many of the uncovered (and soon-to-be discovered) problems with the penalty.

243. *See* I.R.C. § 6501(c), providing that in cases of false and fraudulent returns, taxes may be assessed "at any time." *See also* Evans v. Comm'r, 100 T.C.M. (CCH) 215 (2010); Hicks Co. v. Comm'r, 56 T.C. 982, 1030 (1971), *aff'd* 470 F.2d 87 (1st Cir. 1972).