The Potential for Tax Enforcement Through Subregulatory Guidance

by Benjamin M. Willis and Michael J. Desmond

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In this article, Willis and Desmond argue that the growing pressure on the IRS to increase collections raises a concern that the IRS might turn to subregulatory guidance to stake out enforcement positions.

A recent IRS release elevated some FAQs above other subregulatory guidance by endorsing taxpayer reliance for accuracy-related penalty protection. The October 15 release, IR-2021-202, can be interpreted as the IRS merely acknowledging that at least some part of the large body of subregulatory guidance not published in the Internal Revenue Bulletin constitutes authority for purposes of penalty protection. It could also foreshadow an expanded role in enforcement for this type of guidance, which other federal agencies have pursued.

Some commentators have supported broader use of informal IRS guidance and even recommended excluding such guidance from the Administrative Procedure Act (APA) to further encourage its issuance.[1] While various points about the benefits of informal guidance are generally well taken, there are exceptions. Informal guidance that attempts to have the force and effect of law, particularly guidance that can be construed as imposing additional burdens or new taxes or penalties, should be subject to the scrutiny demanded by Congress through the APA.[2]

On January 20 President Biden issued Executive Order 13992 to reverse course on the Trump administration's deregulatory agenda. The order "empowers agencies" to "use available tools to confront the urgent challenges facing the Nation." Reacting in part to perceived enforcement overreach by some federal agencies, former President Trump's revoked Executive Order 13891, signed October 9, 2019, provides:

> Agencies may clarify existing obligations through non-binding guidance documents, which the APA exempts from

[1] Jasper L. Cummings, Jr., "Is Guidance Failing 'The Taxpaying Public'?" *Tax Notes Federal*, Aug. 17, 2020, p. 1247 ("The practical choice for taxpayers is this: Would you rather have been blindsided with the assessment or known it was coming early enough to maybe not do the transactions or take the reporting position?").

[2] Benjamin M. Willis and Javier R. Chipi, "Foreign Trust Penalties: Substance Over Forms," *Tax Notes Federal*, Aug. 30, 2021, p. 1425 (exploring the possibility for how Treasury and the IRS may have exercised their regulatory grant of authority to eliminate a reporting requirement through an IRS form and its instructions).

> notice-and-comment requirements. Yet agencies have sometimes used this authority inappropriately in attempts to regulate the public without following the rulemaking procedures of the APA. Even when accompanied by a disclaimer that it is non-binding, a guidance document issued by an agency *may carry the implicit threat of enforcement action* if the regulated public does not comply. [Emphasis added.]

That is consistent with Treasury's March 5, 2019, Policy Statement on the Tax Regulatory Process (which hasn't been revoked), which stated that Treasury would not argue that subregulatory guidance has the force and effect of law and that deference wouldn't be sought for that guidance in court. While deference has generally not been sought by the IRS for such guidance,[3] as a practical matter, deference isn't on the minds of most taxpayers when filing their returns. Enforcement is.

The prospect for an "implicit threat of enforcement action" through subregulatory guidance becomes significantly more pronounced in the context, likely to be soon realized, of a material increase in IRS enforcement activity. The November 3 updated draft of the Build Back Better Act provides for roughly $80 billion in additional long-term IRS funding, including more than $44 billion for enforcement.[4] The legislation is expected to be signed into law around Thanksgiving. The resulting expansion of IRS operations, along with related pressure to raise billions of dollars in revenue by narrowing the "tax gap," could portend an expansion of subregulatory guidance beyond its historical role of providing taxpayers with prompt and balanced — if legally nonbinding — compliance instructions. It could also shift the focus of such guidance to a greater role in enforcement by, for example, enabling the IRS to stake out taxpayer unfavorable positions and procedures.

While taxpayers could choose to not follow such guidance and risk audit and litigation, the vast majority won't. The increased focus on enforcement could also encourage the IRS to disavow or distinguish on audit or in litigation taxpayer *favorable* positions set forth in nonbinding subregulatory guidance. Ultimately, these approaches could generate more revenue, not from "closing the gap" but from adopting an enforcement-focused approach to and use of unpublished guidance. Unless carefully monitored, draping subregulatory guidance in the sheep's clothing of "penalty protection" may serve to only encourage these practices.

CC-2003-014 provides that chief counsel attorneys may not take a position less favorable to the taxpayer than the position set forth in published guidance. As an example, CC-2003-014 says, "If a revenue ruling provides that a particular expense may be currently deducted, Chief Counsel attorneys should not challenge the deduction." FAQs, forms, instructions, publications, and guidance not published in the Internal Revenue Bulletin aren't bound by such constraints. Such non-IRB guidance could, under IR-2021-202 or otherwise, endorse penalty protection but take entirely taxpayer *unfavorable* positions so that the "protection" does nothing for the merits of the taxpayer's reporting position.

FAQs that tax cryptocurrency forks, prevent section 199A deductions, deny employee retention credits, or characterize carried interests as generating ordinary income may be couched in terms of penalty protection to give a superficial gloss of authority, leading most taxpayers to conform to the position even if there are good arguments that it may be incorrect. Cloaking taxpayer favorable FAQs with penalty protection while keeping the door open for the IRS to disavow the merits of those positions on audit or in litigation would also be problematic. And it wouldn't be the first time that non-IRB guidance seemingly offering refuge lacked any true comforts when ultimately put to the test in litigation.

[3] Although the IRS has consistently refrained from arguing in the Tax Court that revenue rulings and other guidance published in the IRB are entitled to anything more than a low level of *Skidmore* or "power to persuade" deference, until 2011 the Justice Department didn't always share this view. *See* Marie Sapirie, "ABA Section of Taxation Meeting: DOJ Won't Push Chevron Deference for Revenue Rulings," *Tax Notes*, May 16, 2011, p. 674.

[4] Doug Sword, "House Edges Toward Vote on 'Solidly Paid For' Reconciliation Bill," *Tax Notes Federal*, Nov. 8, 2021, p. 835. The updated version of H.R. 5376, the Build Back Better Act, released November 3, appropriates to the attorney general $498 million for the Department of Justice Tax Division "for purposes of enforcing Federal laws against tax evasion, including by pursuing civil cases or prosecuting criminal violations" and "$44,887,500,000 to the IRS for enforcement."

One Key Example

In *Bobrow*,[5] the taxpayer relied on non-IRB guidance that stated that a second tax-free IRA rollover within the same year was allowable. The Tax Court held that this was contrary to section 408(d)(3)(B). The court further found that the taxpayer's reliance on proposed regulations and a version of Publication 590 that had been in effect for decades reflecting that position didn't protect the taxpayer from the imposition of accuracy-related penalties. The court noted that IRS publications generally aren't binding and won't protect against penalties. And while the IRS generally cannot penalize taxpayers for *failing* to follow proposed regulations, *Bobrow* highlights that *following* proposed regulations doesn't provide similar protection.

The *Bobrow* holding was noteworthy enough that the Board of Regents of the American College of Tax Counsel, a group of 700 prominent tax lawyers, asked permission to file a rare friend of the court brief supporting the taxpayers' request that it be vacated or revised.[6] The amicus curiae brief argues that it undermines public confidence in the tax system to tell taxpayers who have followed the IRS's own subregulatory guidance that they "have made an error with potentially catastrophic financial consequences."[7]

While perhaps an outlier, *Bobrow* highlights the punitive consequences that statements made in subregulatory guidance could have when the door remains open for the IRS to disavow them on audit and in litigation.

IR-2021-202 Penalty Protection for FAQs

IR-2021-202 detailed a new process for FAQs first previewed earlier this year.[8] The release provides that:

> The IRS is updating this process to address concerns regarding transparency and the potential impact on taxpayers when these FAQs are updated or revised. At the same time, the IRS is also addressing concerns regarding the potential application of penalties to taxpayers who rely on FAQs by providing clarity to taxpayers as to their ability to rely on FAQs for penalty protection.
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> The release goes on to provide that:
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> Notwithstanding the non-precedential nature of FAQs, a taxpayer's reasonable reliance on an FAQ (even one that is subsequently updated or modified) is relevant and will be considered in determining whether certain penalties apply. . . . In addition, FAQs that are published in a Fact Sheet that is linked to an IRS news release are considered authority for purposes of the exception to accuracy-related penalties that applies when there is substantial authority for the treatment of an item on a return. See Treas. Reg. section 1.6662-4(d) for more information.

What's unclear is the implicit effect of IR-2021-202 on other subregulatory guidance not published in the IRB, including the enormous volume of "guidance" issued every year through forms, instructions, and publications. Guidance published in the IRB generally binds the government.[9] Subregulatory guidance not published in the IRB is used when the IRS wishes to preserve enforcement flexibility without a detailed analysis of its position or a full exposition of nuanced iterations of that position. Of course, taxpayers generally benefit from this flexibility in the form of prompt compliance directives. In fact, most taxpayers and return preparers don't go beyond this guidance in researching reporting positions and historically have had little reason to do so.

The IRS plans on releasing "significant" FAQs on new tax statutes in fact sheets. The

[5] *Bobrow v. Commissioner*, T.C. Memo. 2014-21.

[6] "Brief Amicus Curiae of American College of Tax Counsel" (Mar. 20, 2014).

[7] Janet Novack, "Gotcha! Tax Court Penalizes IRA Rollover That IRS Publication Says Is Allowed," *Forbes*, Mar 25, 2014.

[8] Kristen A. Parillo, "Desmond Foresees More IRS Transparency on FAQs," *Tax Notes Federal*, Feb. 1, 2021, p. 802; Nathan J. Richman, "IRS Announces New FAQ Process With Penalty Protection," *Tax Notes Federal*, Oct. 25, 2021, p. 567; *see also* Richman, "More Formal Process Aims to Address Concerns on IRS Use of FAQs," *Tax Notes Federal*, June 28, 2021, p. 2166 (IRS announcement regarding its use of FAQs to answer substantive tax questions and addressing access to prior versions of FAQs).

[9] *See* Mitchell Rogovin and Donald L. Korb, "The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View From Within," 46 *Duq. L. Rev.* 323 (2008).

announcement doesn't go as far as fully updating either reg. section 1.6664-4 or 1.6662-4 — as some tax professionals hoped[10] — but it states that FAQs published in fact sheets will satisfy both the reasonable cause defense to tax penalties that allow it and can be part of a taxpayer's assertion of substantial authority in defense of a return position.

Regarding fact sheet FAQs, the IRS says it will include cautionary language (or a "legend," as the IRS calls it) that is meant to address penalty protection and reliance positions, which could be valuable. But if the effect of the release is to increase the government's ability to advance broader policy goals of reducing the tax gap and increasing recovery from enforcement efforts despite statements within subregulatory guidance, that guidance provides much less certainty to the taxpayer. The consequences of even a minor shift in the focus of subregulatory guidance from balanced compliance instructions to less taxpayer-friendly enforcement could be significant both on the merits of taxpayers' reporting positions and for assertions of penalties.

Arguably, the Taxpayer Bill of Rights, particularly the "right to be informed" and the "right to a fair and just tax system," would seem to be violated if the IRS can tax and penalize through positions that run contrary to the informal guidance it puts out. While perhaps a largely theoretical concern, cases like *Bobrow* make clear that the concern is real.

Should FAQs Be Elevated Above Other Guidance?

For penalty protection purposes, a strong case can be made that the IRS should go beyond simply allowing reliance on some "significant" FAQs and follow this practice for all written guidance. The national taxpayer advocate has recommended that the IRS decline to impose a penalty for a position taken in reliance on an FAQ.

National Taxpayer Advocate Erin Collins stated in a July 7, 2020, blog post: "It is neither fair nor reasonable for the government to impose a penalty against a taxpayer who follows information the government provides on its website." Further, she recommended that for penalty relief purposes, "the Treasury Department and the IRS should clarify that the information presented in FAQs constitutes 'Internal Revenue Service information' under Treasury Regulation section 1.6662-4(d)(3)(iii)."

Some argue that the announcement in IR-2021-202 does too little because it respects taxpayer reliance for penalty purposes only.[11] The same reliance problem raised by FAQs arises whenever a taxpayer relies on a statement the IRS makes in one of its publications, instructions to forms, fact sheets, and even in correspondence or other documents addressed specifically to the taxpayer. Of course, there is also the prospect for incorrect direction from IRS telephone assistance or "guidance" provided by employees of IRS Taxpayer Assistance Centers, which are more frequently relied on by a wide range of taxpayers (particularly since the onslaught of pandemic-related relief and stimulus).

Section 6662(b)(2) and (d) imposes an accuracy-related penalty on any portion of an underpayment attributable to any substantial understatement of income tax. The penalty can be limited if there is substantial authority for a filing position taken by a taxpayer under section 6662(d)(2)(B). The "substantial authority" standard is an objective standard, based on an application of the law to relevant facts, and the weight of authorities supporting the tax treatment must be substantial in relation to contrary authorities. The weight to be accorded an authority depends on its relevance, its persuasiveness, and the type of document providing the authority under reg. section 1.6662-4(d)(3)(ii). The IRS understands this and in IR-2021-202 is choosing to elevate some guidance, which many appreciate for expediency.

One cannot deny that in standardizing and embracing the broader use of FAQs, the IRS has reconciliation legislation and the need for its practical implementation in mind given the certainty of change it creates for taxpayers.[12]

[10] Richman, "Adding FAQs to Penalty Protection Regs Isn't a Panacea," *Tax Notes Federal*, Sept. 13, 2021, p. 1821.

[11] Alice Abreu and Richard Greenstein, "IRS Recent Guidance on FAQs: Too Little, Too Narrow," Procedurally Taxing, Oct. 21, 2021.

[12] Willis, "Embracing the Certainty of Change," *Tax Executive*, Nov.-Dec. 2021, at 39.

Conclusion

Subregulatory guidance that doesn't go through the formal process needed to publish in the IRB has long served an important role in tax administration. The thousands of pages of forms, publications, instructions, and, to an increasing extent, FAQs issued each year are the most meaningful direction the IRS can provide, and most taxpayers and return preparers have no reason to look beyond this guidance in taking return reporting positions.

The expected ramp-up in IRS enforcement activity and growing pressure on the IRS to increase collections, however, raise a concern that the IRS might turn to subregulatory guidance to stake out enforcement positions through taxpayer unfavorable positions or the disavowal of taxpayer favorable positions on audit and in litigation.[13] This would follow the path of other agencies in using subregulatory guidance as a de facto enforcement tool, without going through a notice and comment rulemaking process. ■

[13]For more equitable treatment among taxpayers generally, see *Tax Analysts v. IRS*, 117 F.3d 607 (D.C. Cir. 1997) ("If the Office of Chief Counsel renders an interpretation of a certain section in the tax code, whether in an FSA [field service advice] or elsewhere, that interpretation should apply to all other taxpayers who are, in material respects, similarly situated. Treating like cases alike is, we have said, 'the most basic principle of jurisprudence.' . . . The principle fully applies to those who administer the federal tax laws. The IRS itself recognizes that to fulfill its mission it must ensure 'uniform interpretation and application of the tax laws.' When Congress amended the tax code in 1976 to require the IRS to disclose Private Letter Rulings and Technical Advice Memoranda, of which more hereafter, it did so because 'the secrecy surrounding' these written determinations 'has generated suspicion that the tax laws are not being applied on an evenhanded basis.' . . . the public can only be enlightened by knowing what the national office believes the law to be." (Citations omitted.))