REPORT #575

TAX SECTION

New York State Bar Association

COMMITTEE ON CRIMINAL AND CIVIL TAX PENALTIES

REPORT ON CIVIL TAX PENALTIES

December 22, 1987

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TAX SECTION
New York State Bar Association

December 23, 1987

BY FEDERAL EXPRESS

Hon. Lawrence B. Gibbs
commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Gibbs:

I enclose herewith a report on Civil Tax Penalties prepared by our Committee on Criminal and Civil Tax Penalties. The principal draftsman of the report was Charles M. Morgan III. Helpful Comments were received from Joanne Adlerstein, Renato Beghe, James S. Halpern, Ernest Honecker, Robert A. Jacobs, Arnold Y. Kapiloff, Barbara T. Kaplan, Sherry S. Kraus, Sherman Levey, Robert Plautz, Bernard Sherl And Ralph Winger. The report was approved at a meeting of our Executive Committee on December 10, 1987.

The report endorses the concept of the recently formed IRS Study Group to review the existing tax penalty provisions of the Internal Revenue Code with a view to making legislative recommendations to Congress by mid-1988. Recognizing that there may be no significant legislative changes to the tax penalty provisions of the Code until 1989 or later, the report makes a number of recommendations that could be implemented currently to improve the administration of the existing penalty provisions.

The report recommends that the Service publish one or more Revenue Rulings, Revenue Procedures, Publications or other appropriate documents which will:

(1) contain a listing of all the civil tax penalty provisions, with cross-reference to other relevant administrative pronouncements;

(2) illustrate the application/non-application of the resonable cause exception;

(3) outline the procedures the Service makes available to taxpayers seeking to avoid application of penalties asserted by the IRS Service Centers; and

(4) illustrate the operation of various overlapping penalty provisions.

The Tax Section of the New York State Bar Association would be pleased to assist you in connection with the efforts of the IRS Study Group and is planning to make recommendations on substantive changes to the existing penalty provisions of the Code at a later date.

Sincerely yours,

Donald Schapiro

Enclosure

Copies of this letter and report to the
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December 22, 1987

TAX SECTION
NEW YORK STATE BAR ASSOCIATION
COMMITTEE ON CRIMINAL AND CIVIL TAX PENALTIES
REPORT ON CIVIL TAX PENALTIES[1] [2]

I. INTRODUCTION

This report is being submitted at a time when the civil tax penalty provisions of the Internal Revenue Code of 1986 ("Code") are being criticized by government officials, private practitioners, academicians and others on several grounds, including multiplicity and complexity. The Committee believes that an effort to simplify or otherwise rationalize the statutory framework relating to civil tax penalties would be time consuming. However, if successful, the effort would serve to strengthen the confidence of taxpayers in our self-assessment income tax system and should therefore be undertaken.

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[1] This report is addressed exclusively to the civil tax penalty provisions of the Code. A discussion of the criminal tax penalty provisions might be an appropriate subject for a separate report.

[2] The principal draftsman of the report was Charles M. Morgan III. Helpful comments were received from JoAnne Adlerstein, Renato Beghe, James S. Halpern, Ernest Honecker, Robert A. Jacobs, Arnold Y. Kapiloff, Barbara T. Kaplan, Sherry S. Kraus, Sherman Levey, Robert Plautz, Bernard Sherl, and Ralph Winger.

Until such time as the statutory framework relating to civil tax penalties is simplified and/or rationalized, however, the Committee believes that there are steps that the Internal Revenue Service ("Service") can take that should have a beneficial impact on taxpayer understanding and compliance and thereby improve the administration of the system.

II. BACKGROUND

In reviewing the current state of affairs with respect to civil tax penalties, the year 1975 is a good place to start. In that year, the Administrative Conference of the United States commissioned a study of the Service by a distinguished group of tax experts, including academicians and practitioners.[3] An entire chapter (more than 100 pages) of the study concerned civil penalties. The following excerpt from that chapter demonstrates that the issue of multiplicity of tax penalty provisions is a serious one of long-standing:

The Internal Revenue Code contains a mind-numbing assortment of civil penalties. There are at least 64 of them.[4]

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[3] Report on Administrative Procedures of the Internal Revenue Service October 1975, to the Administrative Conference of the United States 623 (1976).

[4] In 1987, it is estimated that there are approximately 150 penalty provisions in the Code.

Although the 1975 study contained a number of recommendations for simplification and rationalization of the civil tax penalty provisions of the Code, some of those recommendations would have introduced new levels of complexity. For example, to address problems associated with what the study called the “excluded middle” of the then-existing penalty regime, the study proposed a system of three levels of penalties for incorrect tax returns: a 50 percent negligence penalty; a new 25 percent intermediate penalty; and a 50 percent civil fraud penalty. The new 25 percent intermediate penalty was recommended as a way of addressing the “endless array of cases” (i.e. the “excluded middle”) involving reckless or intentional errors that under then-existing practice failed to satisfy the 50 percent fraud penalty standard and hence were only subject to the relatively mild 5 percent negligence penalty. The study acknowledged, however, that one of the difficulties with such a recommendation was in distinguishing the activities subject to the new penalty from the activities that would trigger the negligence and fraud penalties.

A few years later, and with the specific objective of improving taxpayer compliance, the Economic Recovery Tax Act of 1981 (ERTA) and the Tax Equity and Fiscal Responsibility Tax Act of 1982 (TEFRA) added or increased the level of a substantial number of civil tax penalties. One of the TEFRA penalties, the substantial understatement penalty of Section 6661 of the Code, however, although enacted to improve taxpayer compliance, has also developed into one of the most controversial and complicated of all of the penalty provisions. The substantial understatement penalty, which is imposed at a 25 percent rate, overlaps the negligence penalty. However, the circumstances in which the overlaps occur are not clearly defined. In addition, certain tax reporting positions are not subject to the substantial

understatement penalty if they are supported by "substantial authority." However, this legal standard, which is central to the application of the substantial understatement penalty provision, is complex, did not exist in the law prior to enactment of the penalty and will require litigation to establish various aspects of its meaning.

In 1983, following enactment of ERTA and TEFRA, the Tax Section of the American Bar Association ("ABA") sponsored an Invitational Conference on Income Tax Compliance. The Conference dealt with several issues:

> What are the causes of noncompliance with the federal tax laws; what are the major types of noncompliance; and how much noncompliance is there; can conventional measures of enforcing tax compliance be improved; can additional methods of assuring compliance be derived with a reasonable expectation of success.[5]

One of the articles commissioned for the Conference, entitled "The Role of Sanctions on Taxpayer Compliance", dealt specifically with penalties and was written by Harry Mansfield, who had also been one of the group of experts that prepared the 1975 study report for the Administrative Conference of the United States, described supra. Although the article offered some thoughts on ways to simplify and rationalize the civil tax penalty provisions of the Code, it also confirmed at the outset

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[5] Income Tax Compliance, A Report of the ABA Section of Taxation Invitational Conference on Income Tax Compliance (1983) at 1.

that there had been few satisfactory studies of the cause and effect relationship between tax penalty provisions and taxpayer compliance.[6]

The American Bar Foundation, the research affiliate of the ABA, is currently compiling for publication a number of research papers on taxpayer compliance that may provide further insight into the effects of penalties on behavior and the underlying reasons for taxpayer noncompliance.[7]

Into this environment of proliferating tax penalty provisions and research on the causes of taxpayer noncompliance came the Tax Reform Act of 1986, without question the most comprehensive revision of the income tax laws in many years.[8] The Tax Reform Act of 1986 has, in addition, fueled growing concerns that the substantive and administrative complexities of the tax laws have become overwhelming for all but a few sophisticated taxpayers and their advisers.

III. DESCRIPTION OF THE PROBLEM

The foregoing background discussion illustrates that a number of the current problems with the civil tax penalty provisions of the Code have been problems for years and that

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[6] Also in 1983, the ABA formed a Commission on Taxpayer Compliance. The Commission released a report in July of 1987 in which numerous recommendations of ways to improve compliance with the federal income tax laws were made. The Commission considered and analyzed a wide assortment of factors thought to affect taxpayer compliance. The Commission, however, did not perform a specific review of and did not report on the civil penalty provisions of the Code. American Bar Association Commission on Taxpayer Compliance, Report and Recommendations (July 1987).

[7] Supra at Appendix A.

[8] The Tax Reform Act of 1986 made significant revisions, some simplifying, to the civil tax penalty provisions.

absent some successful remedies, these problems will continue to grow and become more serious. The Committee believes that the most significant problem areas relating to the existing civil tax penalty provisions of the Code are the following:

1. Multiplicity

However appropriately targeted or otherwise responsive the existing penalty provisions are to particular objectionable behavior, there are too many penalty provisions currently in effect.

2. Complexity

In recent years, economic activity in general and commercial and financial transactions in particular, as well as the laws governing or affecting such activity and transactions have continued to become more complex. Notwithstanding this general tendency towards greater complexity, there is a developing sense among practitioners that certain of the more recently-enacted tax penalty provisions are simply too complex for the Service to effectively administer and for most taxpayers to comprehend.

3. Overlaps and resulting confusion

Under the existing civil tax penalty provisions, there are a number of instances where the same taxpayer behavior can be subject to more than one tax penalty. In other words, a number of the tax penalty provisions overlap, increasing the possibility that unexpectedly large penalties will be imposed. The Committee believes that there is quite a bit of confusion and uncertainty surrounding the subject of overlapping penalty provisions,

attributable, in large measure, to the lack of legislative and administrative guidance on the subject.

4. Inadequate supply of published guidance concerning application of the penalty provisions

In the context of the ever-increasing volume of complex tax legislation in recent years, including the addition of and amendment to numerous tax penalty provisions, the Committee believes that there is an inadequate supply of published guidance from the Service concerning the application of the penalty provisions.

In a broader context, the Committee believes that the four problem areas just described raise more fundamental concerns: those relating to the administrability of the penalty provisions and to taxpayer compliance with the tax laws. It would seem reasonable to believe that if due to multiplicity, complexity, overlaps and an inadequate supply of administrative guidance, taxpayers lack a clear understanding of the penalty provisions of the Code, that they would be less likely to be influenced to comply with the tax laws by reason of the existence of specific penalty provisions. In addition, these problems would seem to present the National Office of the Service with substantial challenges to its ability to administer the penalty provisions on a uniform basis throughout the country.

IV. IRS STUDY GROUP

In October of this year, the Commissioner of Internal Revenue announced that the Service had formed a Study Group ("IRS Study Group") to review the existing tax penalty provisions, with a view to making legislative recommendations to Congress by mid-

1988. The Committee believes that this is an excellent time to establish such a study group to comprehensively review the entire statutory framework relating to civil tax penalties and commends the Commissioner for having taken this important first step.

As part of its undertaking to perform a comprehensive review of the existing statutory framework relating to tax penalties and to make recommendations to simplify and otherwise rationalize the system, the Committee recommends that the IRS Study Group consider the following matters:

1. Cause and effect relationship between penalties and behavior

There are apparently few satisfactory studies addressing the cause and effect relationship between the existence and enforcement of penalties and taxpayer compliance/noncompliance with the federal tax laws. Nevertheless, each of the dozens of existing tax penalty provisions has been enacted with some perceived cause and effect relationship between the provisions and taxpayer behavior. The Committee recommends that the IRS Study Group incorporate into its analysis any internal Service research as well as the writings of other experts, such as those published or to be published by the American Bar Foundation, supra, relating to the effects of sanctions on behavior.

2. The appropriate use of penalties

A recurring issue since enactment of the Tax Reform Act of 1986 relates to the appropriate use of penalties. To what extent should penalties be enacted or administered with a principal aim of raising revenue, rather than with a principal aim of deterring certain objectionable behavior? It is known that the Service has a policy that opposes the imposition of penalties for the purpose of collecting revenue. However, certain recently-enacted tax penalty provisions and the corresponding revenue estimates that were associated therewith have suggested to some that Congress may have intended the Service to impose the penalties for the purpose of collecting revenue. The IRS Study Group should solicit input on this issue from practitioner groups, from Congressional sources, and from other interested parties.

In addition, there are reports that large penalty and interest charges are increasingly impeding the settlement of certain cases. In this regard, the IRS Study Group should also consider what maximum levels of penalties are most consistent with the optimum administration of the tax system.

3. How many types of behavior should be proscribed and how many different legal standards should be used

Suggestions have been made that civil tax penalty provisions would operate more effectively if there were a very small number (such as two or three) of general fault standards that governed all taxpayer errors. The thinking has been that, to the extent taxpayers could be made to clearly understand the degree of fault and level of penalty involved for each standard, the penalty provisions would be more likely to operate with the intended aim of discouraging objectionable behavior. The

Committee includes this matter for consideration, while recognizing that it will be a central focus of the IRS Study Group, to emphasize its importance. The previously described problem areas of multiplicity, complexity, overlaps and inadequate supply of published guidance could be largely overcome to the extent the law is changed to substantially reduce the number of penalties and the legal fault standards applicable thereto.

4. Relationship between the complexity of the substantive tax law and the administration of the penalty provisions

The IRS Study Group should carefully assess what it believes to be the proper relationship between the complexity of the substantive tax law and the administration of the penalty provisions. Should the penalty provisions themselves or the policy of administering them be less severe or rigorous in an environment where the substantive tax law is becoming increasingly more complex and difficult to understand and comply with?

5. What steps need to be taken to ensure the uniform administration of the penalty provisions.

The Committee recognizes that the uniform treatment of taxpayers in the assertion of penalties is an important objective of the Service.[9] The IRS Study Group should examine the degree to which it believes the existing penalty provisions are, in fact, being applied on a uniform basis, both geographically as within

[9] This objective is specifically described in Internal Revenue Manual provisions relating to the administration of the ERTA and TEFRA penalties. IRM 4563.61.

the different branches of the Service (i.e., Examination, Appeals and Chief Counsel). The Committee believes that it will be more and more difficult for the Service to achieve its objective of uniform administration of the tax laws if the penalty provisions remain as many in number, as complex and as unsupported by adequate guidance as those currently in the Code.

V. SPECIFIC RECOMMENDATIONS TO IMPROVE ADMINISTRATION OF CIVIL PENALTY PROVISIONS

As indicated above, the Committee believes that a thorough review of the existing statutory framework relating to civil tax penalties is necessary. The current efforts of the IRS Study Group and other practitioner groups will certainly produce recommendations to simplify and otherwise rationalize the tax penalty provisions of the Code. However, as it is likely that there will be no significant legislative changes to the tax penalty provisions of the Code until at least 1989, the Committee has included below a listing of several recommendations that could be implemented currently to improve the administration of the existing tax penalty provisions.

Underlying each of the recommendations set forth below is the viewpoint that one of the essential objectives of administering the tax laws is to ensure that taxpayers clearly understand the law and how it will be administered by the Service. This is a viewpoint that the Committee knows is shared by the Service.

The Committee believes that the tax laws are currently so complex and so incredibly detailed in their application that any steps, including those recommended below, that can be taken by the Service to promote a clearer understanding of the penalty

provisions and the relevant Service administrative positions and procedures would be welcomed by taxpayers and their advisers. In addition, whereas each of the following recommendations calls for the publication of a Revenue Ruling or Revenue Procedure, it may also be appropriate for the Service to consider alternatives, such as the use of Publications and Announcements, in an effort to effectively communicate the described information to the widest possible audience.

1. Publish a Revenue Procedure that contains a listing of all the civil tax penalty provisions, with cross-references to other relevant administrative pronouncements.

One of the striking aspects of any current discussion of tax penalties among most practitioners is their lack of awareness of the actual number of existing penalty provisions, of the ways in which they overlap and of the full extent to which specifically targeted penalty provisions have been enacted to address particular taxpayer errors. The Committee believes that a relatively simple but important step in the direction of demystifying the subject of civil tax penalties would be publication of a Revenue Procedure which would:

a. Catalogue the existing penalty provisions, making use, where possible, of common groupings such as information reporting and tax shelter/valuation;

b. Indicate the degree of overlap among the numerous penalty provisions[10]; and

[10] The Internal Revenue Manual contains an exhibit that illustrates, to a limited extent, the coordination of a selected grouping of penalty provisions. IRM Exhibit 4560-8.

c. Provide cross references to key Revenue Rulings, Revenue Procedures or other Service pronouncements relating to the penalty provisions.

Such a Revenue Procedure could serve as a centralized source of reference for taxpayers and practitioners as well as a convenient focal point for debate and discussion on the subject of tax penalties. In addition, such a Revenue Procedure should tend to simplify the task of identifying particular penalty provisions corresponding to the numerous requirements of the Code. The Committee does not suggest that the proposed Revenue Procedure serve as a substitute for taxpayer review of the actual penalty provisions, or that taxpayers be able to rely on the Revenue Procedure where its contents happen to be inconsistent with the contents of the Code itself. The Committee is suggesting, from the perspective of simplicity and clarity, that it would be beneficial for the Service to publish and periodically update such a Revenue Procedure.

2. Publish a Revenue Ruling or Revenue Procedure that illustrates the application/ non-application of the reasonable cause exception.

A significant number of tax penalty provisions do not apply to the extent the taxpayer failure to comply is due to reasonable cause and not due to willful neglect. The so-called “reasonable cause exception” applies as an exception to the application of the failure to pay/failure to file penalties of Section 6651 of the Code, many of the information reporting penalties and other penalty provisions of the Code.

The reasonable cause exception has been part of the Code since 1916, has been the subject of hundreds of decided cases,

and is referred to in numerous sections of the Income Tax Regulations. Section 301.6651-1(c), a representative section of the Regulations, first published in 1957, indicates that if the taxpayer exercies "ordinary business care and prudence," but nevertheless fails to comply with the applicable provisions, the reasonable cause exception will be deemed satisfied. This representative section of the Regulations, however, provides little in the way of helpful examples illustrating the application of the exception.[11] In addition, notwithstanding the existence of certain Internal Revenue Manual provisions that provide some very extreme illustrations of when the reasonable cause exception applies[12] (e.g. reasonable cause for failure to file a timely return is satisfied if the failure is attributable to the destruction by fire of the taxpayer's business records) and a limited number of Revenue Rulings and Procedures that address some very narrow applications of the exception, the Service has never published a Revenue Ruling or Revenue Procedure that illustrates in a more generic fashion the type of showing that must be made by taxpayers in common factual settings in order for the Service to apply the reasonable cause exception.

The Committee recommends that the Service publish a Revenue Ruling or Revenue Procedure that illustrates the application/nonapplication of the reasonable cause exception in a significant number of recurring factual settings. The Committee

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[11] In constrast to most sections of the Regulations, however, Section 1.6661-6(b), relating to the substantial understatement penalty, does contain a number of helpful examples illustrating the specific application of the exception.

[12] IRM Policy Statement PS:P-2-7; IRM 4562.2.

believes that publication of the Service position on application/nonapplication of the reasonable cause exception, even if publication is limited to those cases where the Service is extremely confident of the proper response, would add significantly to taxpayer and practitioner understanding of the Service administrative positions and should promote more uniformity in the application of the penalty provisions.

The Service, which has had more than 70 years of experience in administering the reasonable cause exception, is in the best position to identify the most typical and recurring fact patterns in which the reasonable cause exception has been asserted by taxpayers and has then either been applied or not applied by the Service. The Committee recommends that the Service review its current internal positions on application of the reasonable cause exception and follow that review with the publication of the recommended Revenue Ruling or Procedure. The result would be a much more helpful listing of cases where the reasonable cause exception would and would not apply than the scattered listing of extreme cases currently contained in various sections of the Internal Revenue Manual.

The Committee believes that there is another good reason to support publication of what the Service believes are its well-established positions. As these positions become more widely known, through the publication of a Revenue Ruling or Procedure, and to the extent taxpayers agree that the positions represent reasonable interpretations of the law, such positions are more likely to influence taxpayer behavior in the manner intended by the Service. To the extent that taxpayers believe the published positions represent unreasonable interpretations of the law, publication will hopefully serve to focus attention on the

subject and lead to a more timely resolution of Service/taxpayer disputes than would otherwise occur.

The issue before the court in U.S. v. Boyle, 469 U.S. 241 (1985), a Supreme Court decision involving the reasonable cause exception, is the type of issue that the Committee believes should be published in a Revenue Ruling or Procedure so as to alert taxpayers to the operation of the exception and thereby simplify the administration of the penalty provisions. In Boyle, the Supreme Court held that reliance on an attorney does not satisfy the reasonable cause exception to the failure to timely file penalty, in a case where the taxpayer was aware of the requirement to file a return. Prior to this decision by the Supreme Court, the issue in Boyle had been considered by several Circuit Courts of Appeals over a period of several years. Notwithstanding this background, the Service has never published a Revenue Ruling or Procedure setting forth its position on the specific question addressed by the Court in Boyle or on several other recurring questions relating to advice of counsel as a basis for applying the reasonable cause exception.[13] In Boyle, the Supreme Court said:

> When faced with a recurring situation, such as that presented by the instant case, the Courts of Appeals should not be reluctant to formulate a clear rule of law to deal with that situation.

The Committee believes that this view expressed by the Supreme Court when referring to the Courts of Appeals is equally applicable to the Service. Publication of informal Service

[13] The Service has not completely avoided the publication of Revenue Rulings concerning the relationship between advice of counsel and the reasonable cause exception. See Rev. Rul. 72-27, 1972-1 C.B. 226; Rev. Rul. 172, 1953-2 C.B. 226.

positions on the reasonable cause exception that have been taken on a consistent basis over a long period of time would clearly convey to taxpayers, practitioners and Service personnel important information that should promote simplification and uniformity in the administration of the tax laws.

3. Publish a Revenue Procedure that outlines the procedures the Service makes available to taxpayers seeking to avoid application of penalties asserted by the IRS Service Centers.

A majority of the civil tax penalties are generated by the IRS Service Center computers.[14] Particularly in connection with attempts to abate the assertion of the failure to timely file/failure to pay penalties and the Federal tax deposit penalties, the Committee believes that there is continuing taxpayer frustration in dealing with IRS Service Centers. As the penalties are generated by computer and as taxpayers often experience difficulty in communicating with IRS Service Center personnel, the Committee recommends that the Service publish a Revenue Procedure that outlines in some detail the procedures the Service makes available to taxpayers seeking to avoid application of these computer-generated penalties.[15] The Committee believes that publication by the Service of such a Revenue Procedure, which might also include reference to the Problem Resolution Program for use in cases not otherwise resolved in the normal course, would be extremely useful to Service personnel, taxpayers and practitioners: it would (1) clearly set forth in a single

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[14] From a discussion paper prepared by the Service for the Commissioner's Advisory Group Meeting, December 10-11, 1986; Topic 5. Penalties.

[15] Although there are references to existing procedures in the Statement of Procedural Rules (§601.106) and the Internal Revenue Manual (IRM 5175 and 8(11)20), none are sufficiently comprehensive or self-contained.

document widely referred to by taxpayers and practitioners the actual administrative procedures available and (2) focus attention, both within and without the Service, on exactly what the procedures are and on whether they can be improved. As taxpayers become more aware of what the procedures are and how they are designed to operate, and as both the Service and taxpayers consider ways to make them operate more effectively, it is inevitable that there will be an improvement in the administration of the relevant penalty provisions, including the abatement procedures.

4. Publish a Revenue Ruling that illustrates the operation of various overlapping penalty provisions.

One of the most controversial aspects of the current penalty provisions of the Code is that several of the provisions can apply to the same taxpayer error, thereby substantially increasing the magnitude of the penalties to the erring taxpayer, sometimes beyond a level that could have been reasonably anticipated or predicted. The Committee believes that there is no better illustration of this point than a taxpayer error that causes the simultaneous application of the negligence, substantial understatement, penalty interest and interest provisions.

Until the law is changed to simplify or otherwise rationalize the penalty provisions of the Code, the Committee recommends that a Revenue Ruling be published that illustrates the operation of various overlapping penalty provisions. Failure to publish such a Revenue Ruling would leave most taxpayers unaware of the extent of overlap of the existing penalty provisions and the potential dollar amounts of their simultaneous application. The Committee, which shares the perspective of those

who believe that penalty provisions are most effective in deterring objectionable taxpayer behavior when the scope and magnitude of their application is clearly understood, believes that publication of such a Revenue Ruling would serve an extremely beneficial purpose by clearly demonstrating to taxpayers the magnitude of penalties and interest that can apply to a single taxpayer error.