



**SCHOOL OF LAW**  
TEXAS A & M UNIVERSITY

Texas A&M University School of Law  
**Texas A&M Law Scholarship**

---

Faculty Scholarship

---

1-2005

## Tax Shelter Disclosure and Penalties: New Requirements, New Exposures

Mary A. McNulty

Robert D. Probasco

Texas A&M University School of Law, [probasco@law.tamu.edu](mailto:probasco@law.tamu.edu)

Follow this and additional works at: <https://scholarship.law.tamu.edu/facscholar>



Part of the [Taxation-Federal Commons](#), and the [Tax Law Commons](#)

---

### Recommended Citation

Mary A. McNulty & Robert D. Probasco, *Tax Shelter Disclosure and Penalties: New Requirements, New Exposures*, 18 J. Tax'n & Reg. Fin. Institutions 22 (2005).

Available at: <https://scholarship.law.tamu.edu/facscholar/1227>

This Article is brought to you for free and open access by Texas A&M Law Scholarship. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Texas A&M Law Scholarship. For more information, please contact [aretteen@law.tamu.edu](mailto:aretteen@law.tamu.edu).

# TAXATION *and* REGULATION *of* FINANCIAL INSTITUTIONS

January/February 2005

Vol 18 / No 3

## FEATURES

---

### **5** The American Jobs Creation Act of 2004: Summary of Certain Provisions Affecting Investment Management

JAMES N. CALVIN AND EDWARD H. DOUGHERTY

*Although there is widespread agreement that the American Jobs Creation Act of 2004 was generally beneficial for businesses, there are some penalties in the tax shelter area that will come as a surprise to anyone who expected the Act to be favorable in all respects.*

---

### **15** Mutual Fund Share Distributions: the Changing Rules of the Game

PATRICK D. SWEENEY AND ISRAEL GRAFSTEIN

*Mutual funds must now disclose arrangements that result in sales load breakpoints, including a summary of eligibility requirements, the methods used to value accounts in order to determine whether a shareholder has met sales load breakpoints, whether a shareholder needs to provide information and records, such as account statements, to a mutual fund or financial intermediary, and whether breakpoint information is available on the mutual fund's website information.*

---

### **22** Tax Shelter Disclosure and Penalties: New Requirements, New Exposures

MARY A. MCNULTY AND ROBERT D. PROBASCO

*To uncover every abusive transaction, Congress drew the boundaries of the disclosure scheme so broadly that even legitimate tax planning transactions are covered.*

# Tax Shelter Disclosure and Penalties: New Requirements, New Exposures

To understand the dangers in the new rules, one must look at the broad range of transactions covered, the participants covered, and the harsh penalties for nondisclosure.

MARY A. MCNULTY and ROBERT D. PROBASCO

**T**he IRS attacks abusive tax-avoidance transactions by challenging the tax treatment in individual audits and enforcement actions and by closing the loopholes that allow them. To be effective, these approaches both require information about tax shelter activity. Many abusive transactions are difficult to identify, and audits and enforcement actions may be ineffective because examiners often do not know where to look. Further, as quickly as the IRS closes loopholes, ingenious accountants and lawyers find new ways to exploit the complexity of the Internal Revenue Code.

One of the primary weapons in the battle against tax shelters has been mandatory disclosure to the IRS. In 1984, Congress first required organizers to register tax shelters and to maintain investor lists. In 2000, Treasury imposed certain taxpayer disclosure requirements by regulation in an attempt to accumulate more information as part of annual tax returns. The American Jobs Creation Act of 2004 ("AJCA" or the "Act")<sup>1</sup> built on this approach, clarifying and making consistent the various disclosure

and list maintenance requirements and strengthening penalties for non-disclosure.

Unfortunately, to uncover every abusive transaction, Congress drew the boundaries of the disclosure scheme very broadly. As a result, the new rules cover legitimate tax planning transactions in addition to abusive tax shelters. This article focuses on three aspects of the new rules that make them particularly dangerous: the transactions covered, the participants covered, and the harsh penalties that apply for non-disclosure. The article begins with a discussion of the old disclosure, registration, and list maintenance rules and ends with a discussion of other significant provisions in the Act.

## THE OLD REGIME

Before the Act, the Code required three different types of disclosure. The Act builds on those disclosure requirements. To put the Act's changes into context, this article begins with a brief summary of the old disclosure regime.

**Disclosure by Participating Taxpayers.** Section 6011 of the Code contains the general requirement for filing returns and authorizes the Secretary to prescribe regulations governing the information required to be filed. Pursuant to that authority, the IRS issued regulations in 2003 requiring taxpayers to file disclosure statements with their income tax returns describing their participation in six categories of "reportable transac-

---

*Mary A. McNulty is a partner and Robert D. Probasco is an associate in the Dallas office of Thompson & Knight L.L.P. Ms. McNulty specializes in IRS audits and appeals, tax litigation, and tax planning and is a Vice Chair of the Court Procedure and Practice Committee of the ABA Tax Section. She can be reached at 214-969-1187 or Mary.McNulty@tklaw.com. Mr. Probasco specializes in IRS audits and appeals, tax litigation, and tax planning and is a member of the Court Procedure and Practice Committee of the ABA Tax Section. He can be reached at 214-969-1503 or Robert.Probasco@tklaw.com.*

tions.”<sup>2</sup> This regulation is the cornerstone of the new disclosure regime and is discussed in detail below.

“Participation” in a reportable transaction includes receiving tax benefits from the transaction and reporting the tax consequences of the transaction. In addition, listed transaction notices may deem certain persons to be participants in the transaction.<sup>3</sup> In some circumstances, even a tax-exempt accommodation party may be required to file Form 8886.<sup>4</sup> The IRS Commissioner recently expressed concern about the misuse of tax-exempt entities in tax shelter transactions and announced that the IRS will review listed transactions to consider whether tax-exempt accommodation parties should be designated as “participants.”<sup>5</sup> The IRS may well extend that approach to other types of accommodation parties.

**Registration of Tax Shelters by Organizers.** Until amended by the Act, Section 6111 of the Code required “organizers” to register “tax shelters” before selling interests in the shelter. The definition of “tax shelter” was based on the cumulative tax benefits promised to investors. If an investor could infer from representations made in connection with the offering that the aggregate amount of deductions and 350% of tax credits through the first five years of the investment would be at least twice as much as the amount invested, the transaction was a tax shelter. Tax shelters also included transactions offered to corporations under conditions of confidentiality by promoters who may receive fees greater than \$100,000 if a significant purpose of the structure was the avoidance or evasion of Federal income tax.

The Treasury regulations defined “organizer” as a person who participated in the preparation of the prospectus, offering memoranda, financial statements, tax and legal opinions, documents establishing the shelter, and appraisals.<sup>6</sup> An organizer who did not make representations concerning tax benefits still fell under the definition of organizer if the person had reason to know that such representations were made.

The tax shelter organizer was required to register the tax shelter on Form 8264, Application for Reg-

istration of a Tax Shelter. Individual investors were then required to file Form 8271, Investor Reporting of Tax Shelter Registration Number, with their tax returns each year.

Because multiple persons might qualify as “organizers,” Section 6111 allowed Treasury to prescribe regulations requiring only one of the individuals to register. The regulations allowed a group of persons potentially subject to the registration requirements to enter into a written agreement designating one person to register the tax shelter. Others who signed the designation agreement were not liable for failing to register unless they had reason to know that the designated organizer did not register the shelter when required. The designated organizer was required to provide a copy of the registration notice within seven days of receipt from the IRS to everyone who signed the designation agreement. Accordingly, all organizers who did not receive a copy of the registration notice within 60 days after the first offering for sale were deemed to know that the designated organizer did not file the registration statement and

**The 6111 regulations allowed a group of persons potentially subject to the registration requirements to enter into a written agreement designating one person to register the tax shelter.**

were required to register the shelter as soon as practicable thereafter.<sup>7</sup>

The regulation made clear that the registration requirement applied only to those who (1) were related to the tax shelter or a principal organizer, or (2) participated in the entrepreneurial risks or benefits of the tax shelter.<sup>8</sup> Thus, most third-party advisors were not subject to the registration requirements, as long as they did not receive an interest in the tax shelter or fees based on the number or value of units sold.

**List Maintenance Requirements.** Until amended by the Act, Section 6112 of the Code required the “organiz-

<sup>1</sup> PL 108-357 (October 22, 2004).

<sup>2</sup> Reg. 1.6011-4.

<sup>3</sup> Reg. 1.6011-4(c)(3)(i)(A).

<sup>4</sup> See, e.g., Notice 2004-30, 2004-17 IRB 828. This is the “S corporation tax shelter,” in which an S corporation’s shareholders issue non-voting stock to an exempt party and warrants for non-voting stock to themselves. Significant income is allocated to the exempt party, but no distributions are made. The non-voting stock is later re-purchased at a price diluted by the existence of the warrants. Thus, the original shareholders obtain most of the economic

benefit while the exempt party is allocated most of the income. The IRS determined that exempt parties who facilitate such transaction would be treated as participants for purposes of the Section 6011 disclosure requirements.

<sup>5</sup> IRS News Release 2004-81 (June 22, 2004) (Commissioner’s comments to the Senate Finance Committee).

<sup>6</sup> Reg. 301.6111-1T.

<sup>7</sup> Reg. 301.6111-1T, Questions 38 and 39.

<sup>8</sup> Reg. 301.6111-1T, Question 30.

ers and sellers" of "potentially abusive tax shelters" to keep lists of investors in those shelters. The organizer or seller was required to provide the list to the IRS within 20 days of a written request. Regulations further defined who qualified as organizers and sellers and what qualified as a potentially abusive tax shelter.<sup>9</sup>

Organizers and sellers included any "material advisor." Material advisors included not only those persons required to register the tax shelter under Section 6111, but also those who (1) expected to receive a fee over a minimum threshold (\$50,000, or \$250,000 if all the taxpayers investing in the transaction, either directly or through a partnership or trust pass-through entity, were C corporations<sup>10</sup>), and (2) made a "tax statement" to investors or organizers.<sup>11</sup> A tax statement was defined broadly as any statement that related to an aspect of a transaction that caused it to be either a reportable transaction or a Section 6111 tax shelter. For purposes of the mini-

The required investor list included any person to whom the material advisor made a statement concerning the potential tax consequences and who invested in that transaction or a substantially similar transaction. Investor lists had to be maintained for ten years and furnished to the IRS within 20 business days of a written request.

Because multiple persons might meet the "material advisor" definition, Section 6112 provided that the IRS could prescribe regulations requiring only one of the persons to maintain the investor list. The regulations allowed a group of persons potentially subject to the list maintenance requirements to enter into a written agreement designating one person to maintain the list. If the designated material advisor failed to furnish the list to the IRS, however, the designation agreement did not relieve the other material advisors from their obligation under Section 6112.<sup>13</sup> In effect, therefore, *all* material advisors had to be prepared to create investor lists and provide them to the IRS on 20 days' notice.

**Most third-party advisors were not subject to the registration requirements, as long as they did not receive an interest in the tax shelter or fees based on the number or value of units sold.**

imum threshold, the fees received by the material advisor included fees for analyzing, implementing, or documenting the transaction, plus unreasonable return preparation fees. Fees did not include amounts paid for the use of capital or the sale or use of property.<sup>12</sup>

"Potentially abusive tax shelters" included any:

1. Tax shelter required to be registered under Section 6111.
2. Listed transaction as defined in the Section 6011 regulations
3. Other transaction if a potential material advisor had reason to know the transaction would qualify as a reportable transaction under the Section 6011 regulations.

<sup>9</sup> Reg. 301.6112-1.

<sup>10</sup> The threshold amounts would be only \$10,000 and \$25,000, respectively, if the transaction at issue were a listed transaction. Reg. 301.6112-1(c)(3)(ii).

<sup>11</sup> Reg. 301.6112-1(c)(2).

<sup>12</sup> Reg. 301.6112-1(c)(3)(iii).

<sup>13</sup> Reg. 301.6112-1(h).

<sup>14</sup> Reg. 1.6011-4(b)(2) to (7).

<sup>15</sup> Notice 2004-67, 2004-41 IRB 600 (September 24, 2004).

#### **THE NEW REGIME: WHICH TRANSACTIONS MUST BE DISCLOSED**

Like the old regime, the new regime requires disclosures by a participating taxpayer in certain transactions and the maintenance of investor lists. The old registration requirements have been replaced by new disclosure requirements that apply to material advisors. All of the disclosure and list maintenance requirements now apply to the same transactions — the listed transactions and other reportable transactions set forth in the regulations under Section 6011.<sup>14</sup>

Listed transactions are transactions that the IRS has identified in published guidance as abusive tax avoidance transactions. The other five categories of reportable transactions are not necessarily abusive but have certain characteristics that are often associated with abusive tax shelters. The IRS reviews these transactions to identify new types of tax shelters. The six categories of transactions that must be disclosed are as follows:

1. *Listed Transactions.* Listed transactions are transactions that are the same as or substantially similar to transactions the IRS has identified by notice, regulation, or other published guidance as abusive tax avoidance transactions. The most recent IRS notice lists thirty specific types of transactions, along with references to the earlier notices where each is described in detail.<sup>15</sup>

2. *Confidential Transactions.* Confidential transactions are transactions meeting the following two requirements: (1) an advisor is paid a minimum fee of \$50,000, or \$250,000 if the taxpayer is a corporation or pass-through entity 100% owned by corporations; and (2) the taxpayer's disclosure of the tax treatment or tax structure of the transaction is limited to protect the confidentiality of the advisor's tax strategies. Disclosure is required even if the confidentiality requirement is not legally binding.<sup>16</sup>

3. *Transactions with Contractual Protection.* Transactions with contractual protection are transactions for which the taxpayer receives some form of protection against the possibility that the intended tax consequences will not be upheld, such as rescission rights, a full or partial refund of fees, contingent fees, insurance protection, or a tax indemnity.

4. *Loss Transactions.* Loss transactions are transactions expected to result in a substantial Section 165 loss deduction in the year in which the transaction is entered into or the subsequent five taxable years, of at least the following amounts:

- \$10 million in a single year, or \$20 million in any combination of years, for a corporation or a partnership with only corporate partners;
- \$2 million in a single year, or \$4 million over any combination of years, for other taxpayers; or
- \$50,000 in a single year, if arising from a Section 988 foreign currency transaction.

5. *Transactions with a Significant Book-Tax Difference.* Transactions with a significant book-tax difference are transactions where the tax treatment differs from the book treatment by more than \$10 million in any year. This category applies only to taxpayers that are reporting companies under the Securities

Exchange Act of 1934 or business entities with \$250 million or more in gross assets.

6. *Transactions Involving a Brief Asset Holding Period.* Transactions involving a brief asset holding period are transactions resulting in a tax credit exceeding \$250,000 that arises from an asset held by the taxpayer for less than 46 days.

Some of these categories are exceptionally broad and encompass legitimate tax planning transactions in addition to potentially abusive transactions. For example, Section 165 losses include losses on the sale or exchange of partnership interests or stock, and many legitimate transactions have a substantial tax loss within the first six years. Also, the Code is full of provisions that routinely allow tax treatment that may vary substantially from book treatment.

The IRS wants to obtain meaningful and useful information from the disclosure of potentially abusive transactions. However, the IRS also wants to avoid the disclosure of clearly legitimate transactions and not place undue burdens on taxpayers. Conse-

### **The old registration requirements have been replaced by new disclosure requirements that apply to material advisors.**

quently, the regulations allow the IRS to provide exceptions to the reportable transaction categories for certain transactions.<sup>17</sup> Pursuant to that regulation, the IRS issued published guidance on November 16, 2004, commonly referred to as "angel lists," excluding certain types of transactions from disclosure:

- Rev. Proc. 2004-65 (transactions with contractual protection, listing three exceptions).<sup>18</sup>
- Rev. Proc. 2004-66 (loss transactions, listing 12 exceptions).<sup>19</sup>
- Rev. Proc. 2004-67 (transactions with a significant book-tax difference, listing 35 exceptions).<sup>20</sup>

<sup>16</sup> An explicit exception to the confidential transactions category, for restrictions reasonably necessary to comply with federal or state securities law, was included in the temporary regulations issued in 2002, at Reg. 1.6011-4T(b)(3)(iii), and initially in the final regulations issued in February 29, 2003, at Reg. 1.6011-4(b)(3)(ii)(A). In TD 9108 (December 29, 2003), Reg. 1.6011-4(b)(3) was modified to limit this category to situations in which an advisor is paid a large fee and imposes a limitation on disclosure that protects the confidentiality of the advisor's tax strategies. The category does not apply to transactions in which confidentiality is imposed by a party to the transaction acting in such capacity. The

exceptions, including that for securities law restrictions, were removed as no longer necessary under the narrower rule.

<sup>17</sup> Reg. 1.6011-4(b)(8).

<sup>18</sup> 2004-50 IRB 965.

<sup>19</sup> 2004-50 IRB 966, superceding Rev. Proc. 2003-24, 2003-1 CB 599 (February 27, 2003), which listed nine exceptions to this category of reportable transaction.

<sup>20</sup> 2004-50 IRB 967, superceding Rev. Proc. 2003-25, 2003-1 CB 601 (February 27, 2003), which listed thirty exceptions to this category of reportable transaction.

- Rev. Proc. 2004-68 (transactions involving a brief asset holding period, listing four exceptions).<sup>21</sup>

These Revenue Procedures are reassuring because they reduce the scope of the disclosure requirements. But they also are alarming because they illustrate the broad nature of the provisions before the exceptions. Undoubtedly, there are many other legitimate exceptions not yet identified by the IRS. Until then, participants and material advisors should err on the side of caution in disclosing transactions.

Unless clearly not a "participant" or "material advisor," as discussed below, anyone involved in a substantial transaction should obtain sufficient information about the transaction to determine whether it is reportable. We recommend that anyone involved inquire about the proposed accounting treatment of the transaction by other parties to the transaction and obtain information about the terms of the taxpayer's contract with the organizer or promoter. At a minimum, anyone involved should ask

be made by every taxpayer who participated in the reportable transaction and is required to file a tax return.<sup>23</sup> The Act did not change this requirement but strengthened the penalties for failure to comply, as discussed below.

**Material Advisors.** The old registration requirement applied to "organizers." The old list maintenance requirement applied to "organizers and sellers," defined in the regulations as "material advisors." The new disclosure regime and the list maintenance requirements both apply now, under the statutory language itself, to "material advisors."

The new statutory definition of "material advisor" is broader than the definition of "tax shelter organizer" under the old regime. Section 6111 now defines "material advisor" as any person "who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction," and receives a certain amount of income for the advice or assistance.<sup>24</sup> The threshold income level generally equals \$250,000 but can be as low as \$50,000 if substantially all of the tax benefits from the transaction flow to a natural person rather than a business entity.<sup>25</sup> The old definition of "tax shelter organizer" included only those who assisted with organizing, managing, promoting, and selling a tax shelter. The new definition of material advisor also picks up accommodation parties and parties who finance or insure a transaction, so long as they receive a significant amount of fees or other income from the transaction.

Interim guidance issued by the IRS on November 16, 2004, clarifies that the definition of "material advisor" set forth in the Section 6112 regulation applies to both the disclosure statement requirement in Section 6111 and the list maintenance requirement in Section 6112.<sup>26</sup> A person is a material advisor under the Section 6112 regulation if the person expects to receive fees equal to the threshold income level set forth above and makes a tax statement to or for the benefit of certain persons. Thus, to be a material advisor under the Section 6112 regulation, a person must make a "tax statement," excluding post-filing advice and publicly-filed statements.

The Section 6112 regulation generally defines a tax statement as a statement that relates to a *tax* aspect of a transaction that causes the transaction to be a reportable transaction. The regulation also provides specific definitions of tax statements for most of the categories of reportable transactions.<sup>27</sup> The specific definitions for tax statements about confidential transactions and transactions with contractual

**L**isted transactions are transactions that the IRS has identified in published guidance as abusive tax avoidance transactions.

whether anyone else involved in the transaction considers it to be reportable. Representations concerning the reporting obligations should perhaps be included in the transaction documents.

## THE NEW REGIME: WHO MUST DISCLOSE

**Participating Taxpayers.** As discussed above, the Section 6011 regulations require taxpayers to disclose reportable transactions on Form 8886, Reportable Transaction Disclosure Statement.<sup>22</sup> Disclosure must

<sup>21</sup> 2004-50 IRB 969.

<sup>22</sup> For transactions with a significant book-tax difference, the taxpayer may instead use Schedule M-3, Net Income (Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More. See Rev. Proc. 2004-45, 2004-31 IRB 140.

<sup>23</sup> Reg. 1.6011-4(a).

<sup>24</sup> Section 6111(b)(1). Section 6112(a) incorporates the same definition by reference.

<sup>25</sup> The lower threshold for listed transactions, as noted above, apparently is no longer applicable.

<sup>26</sup> Notice 2004-80, 2004-50 IRB 963.

<sup>27</sup> Reg. 301.6112-1(c)(2)(iii).

protection both reference statements about tax benefits related to the transaction. A tax statement for a loss transaction is one that "concerns an item that gives rise to a loss." A tax statement for a transaction involving a brief asset holding period is one that "concerns an item that gives rise to a tax credit."

The interim guidance clarifies that, to be a material advisor with respect to transactions with a significant book-tax difference, a person must make a statement concerning an item that gives rise to a book-tax difference *and* make a statement that relates to the financial accounting treatment of the item that gives rise to a significant book-tax difference.<sup>28</sup>

As amended, Sections 6111 and 6112 permit, but do not require, the Secretary to issue regulations that would require only one material advisor to comply with the requirements on behalf of multiple material advisors. Notice 2004-80 states that the applicable Section 6111 regulation regarding designation agreements<sup>29</sup> still applies. However, the Notice does not address the issue with respect to the Section 6112 list maintenance requirement. As discussed above, even with a written agreement designating one material advisor to comply with the requirements, other material advisors may still find themselves obligated to file disclosure statements and maintain investor lists.

Unless a transaction clearly is not reportable, anyone involved in a substantial transaction should carefully evaluate whether they are a material advisor. At a minimum, persons who potentially are subject to the disclosure and list maintenance requirements should be careful not to make any "tax statements" to potential investors. Those involved in a reportable transaction with multiple material advisors should also seek written designation agreements and monitor the designated advisor's compliance.

## THE NEW REGIME: PENALTIES

**Taxpayer Penalties.** Taxpayer penalties involve failures to disclose and the accuracy-related penalty.

**Failure to Disclose.** Before the Act, no direct penalty applied to taxpayers who failed to disclose a reportable transaction as required by the Section 6011 regulations. A taxpayer was only indirectly penalized if the IRS eventually disallowed the tax treatment of the transaction and determined a substantial understatement of tax. The taxpayer then was subject to an accuracy-related penalty equal to 20% of the understatement under Section 6662(d). The penalty could be avoided under Section 6664 if the taxpayer

demonstrated reasonable cause and good faith, but the failure to disclose a reportable transaction strongly indicates a lack of good faith.<sup>30</sup> Thus, a taxpayer was likely to be subject to an accuracy-related penalty if it failed to disclose the reportable transaction.

The Act added a specific penalty for a taxpayer's failure to disclose a reportable transaction. Under new Section 6707A, a taxpayer who fails to disclose a reportable transaction is subject to a \$50,000 penalty, except that natural persons are subject to a lesser penalty of \$10,000. If the undisclosed transaction is a listed transaction, the penalties increase to \$200,000 and \$100,000 respectively. Unlike the accuracy-related penalty, these penalties do not depend on there being an understatement of tax. Even if the taxpayer's return position for the transaction ultimately is sustained, the failure to disclose penalty still applies.

**Confidential transactions occur when (1) an advisor is paid a minimum fee of \$50,000, or \$250,000 if the taxpayer is a corporation or pass-through entity 100% owned by corporations, and (2) the taxpayer's disclosure of the tax treatment or tax structure of the transaction is limited to protect the confidentiality of the advisor's tax strategies.**

Congress intended that taxpayers be excused from these penalties only rarely. For listed transactions, the Section 6707A penalty cannot be rescinded or abated under any circumstances. For other reportable transactions, the Commissioner or his delegate can rescind penalties *only* if doing so would promote compliance with the Code and effective tax administration.<sup>31</sup> Congress intends for the Commissioner to take into account whether:

- the person on whom the penalty is imposed has a history of complying with the tax laws
- the violation is due to an unintentional mistake of fact

<sup>28</sup> Notice 2004-80.

<sup>29</sup> Reg. 301.6111-1T, Questions 38 and 39.

<sup>30</sup> Reg. 1.6664-4(d).

<sup>31</sup> The Senate amendment to the original bill was even harsher and essentially imposed strict liability penalties. It limited the authority to rescind the penalty to the IRS Commissioner personally or the head of the Office of Tax Shelter Analysis. The Senate Amendment was not adopted.



- imposing the penalty would be against equity and good conscience.<sup>32</sup>

In the few cases in which the penalty is rescinded, the Commissioner must prepare an opinion for the file setting forth the violation, the reason for the rescission, and the amount of the penalty rescinded. Further, the Commissioner must report to Congress each year the aggregate number and amount of the disclosure penalties imposed and a description of each penalty rescinded.<sup>33</sup>

The Commissioner's decision not to rescind the failure to disclose penalty is not subject to judicial review. However, a taxpayer may challenge whether a penalty is legally appropriate. For example, a taxpayer may litigate the issue whether a transaction is a reportable transaction and thus subject to the penalty if not disclosed.

Congress has also indirectly enlisted corporate directors and stockholders, and the financial press, in the battle against the failure to disclose. Section 6707A requires taxpayers who file periodic reports with the SEC to disclose in such reports any Section

valuation misstatements. The Act broadened the application of the accuracy-related penalty for substantial understatements by deeming an understatement of more than \$10 million to be substantial for a corporate taxpayer, regardless of the proportion it represents of the taxpayer's total tax liability, and removing the exception for tax shelters.<sup>35</sup>

Previously, the accuracy-related penalty for substantial understatements was not imposed on items for which the taxpayer had substantial authority. That exception was available for items attributable to "tax shelters" (defined as arrangements for which a significant purpose is the avoidance or evasion of tax) only if the taxpayer was not a corporation and reasonably believed the treatment on the return more likely than not was proper. The exception was not available for tax shelter items for corporate taxpayers. The Act amended Section 6662(d) to remove the exception for all items attributable to tax shelters.

The Act also added Section 6662A, which imposes a new, separate 20% penalty on "reportable transaction underpayments." Reportable transaction underpayments are understatements attributable to listed transactions or to other reportable transactions if a significant purpose is tax avoidance or evasion.<sup>36</sup> If the transaction is not disclosed, the penalty increases to 30%. This is a stand-alone penalty, and underpayments will not be subject to both this penalty and related penalties, such as the fraud penalty of Section 6663 or the accuracy-related penalties for significant understatements (Section 6662(d)), substantial valuation misstatements (Section 6662(e)), or gross valuation misstatements (Section 6662(h)).

The Act added a reasonable cause exception in Section 6664(d) for the new reportable transaction understatement accuracy-related penalty. The Section 6662A penalty will not be imposed if there is reasonable cause and the taxpayer acted in good faith. Those conditions require that:

to establish that a \$10,000,000 understatement would always qualify as substantial. This change will only affect a limited number of taxpayers for whom the total correct tax liability for the year exceeds \$100,000,000. For example, a taxpayer whose correct tax liability is \$120,000,000, but who understates its liability by \$11,000,000, would not have been subject to the Section 6662(d) penalty before the Act, but will be now.

<sup>36</sup> For purposes of Section 6662A, the amount of the understatement attributable to the transaction, is (the difference in taxable income due to the different treatment of the transaction x the highest tax rate in Section 1 or 11) + (the difference in tax credits due to the different treatment of the transaction).

**The IRS issued published guidance on November 16, 2004, commonly referred to as "angel lists," excluding certain types of transactions from disclosure.**

6707A penalty imposed with respect to a listed transaction.<sup>34</sup> This disclosure requirement applies regardless of whether the taxpayer considers the penalty to be material. Failure to disclose the penalty to the SEC will itself be subject to the same \$200,000 penalty as failure to disclose a listed transaction to the IRS.

*Accuracy-Related Penalty.* Prior to the Act, Section 6662 imposed a 20% accuracy-related penalty for various types of understatement, including substantial understatements and substantial valuation misstatements. Section 6662 imposed a 40% penalty for gross

<sup>32</sup> H.R. Conf. Rep. No. 108-755.

<sup>33</sup> AJCA, § 811(d).

<sup>34</sup> The SEC disclosure requirement also applies to the 30% Section 6662A penalties for undisclosed reportable transaction underpayments, discussed below, as well as underpayments to which the 30% Section 6662A penalty would apply if not for application of the 40% Section 6662(h) penalty instead.

<sup>35</sup> Previously, an understatement was "substantial" for purposes of Section 6662(d) if the amount of the understatement exceeded the greater of \$5,000 (or \$10,000 for C corporations) or 10% of the total tax liability. The Act amended Section 6662(d)

1. The reportable transaction was adequately disclosed in accordance with the Section 6011 regulations.
2. There was substantial authority for the taxpayer's treatment
3. The taxpayer reasonably believed that its return treatment was more likely than not proper.

The "reasonable belief" requirement is carefully circumscribed. The taxpayer's conclusion must be based on the facts and law at the time the tax return is filed. In addition, the taxpayer must assume that the issue will be raised in an audit and decided on the merits, rather than resolved through settlement.

Section 6664(d) limits the protection offered by opinions from tax advisors. The taxpayer's "reasonable belief" cannot be based on a tax advisor's opinion if either the tax advisor or the opinion is "disqualified." A disqualified tax advisor includes any tax advisor who:

- is a material advisor and participates in (or is related to anyone who participates in) the organization, management, promotion, or sale of the transaction;
- is compensated directly or indirectly<sup>37</sup> by a material advisor;
- receives a fee that is contingent on all or part of the intended tax benefits; or
- has other disqualifying financial interest with respect to the transaction, as determined by regulations.

Thus, to avoid penalties, a taxpayer cannot rely on the opinion of a tax advisor who has incentives that might inordinately bias its opinion.

Even if the tax advisor is not disqualified, a taxpayer cannot rely on a disqualified opinion. An opinion is disqualified if it either:

- is based on unreasonable factual or legal assumptions;
- unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person;
- fails to identify and consider all relevant facts; or
- fails to meet other requirements prescribed by the Secretary.

The narrowing of the reasonable cause exceptions addresses Congressional concern about overly aggressive tax opinions.<sup>38</sup> Although a taxpayer is not

required to obtain a tax opinion to demonstrate reasonable cause, any opinion relied on by a taxpayer will be subject to careful scrutiny.

*Comparison of Taxpayer Penalties.* The failure to disclose and accuracy-related penalties discussed above differ in key respects, as follows:

- The failure to disclose penalty applies even if the taxpayer's position is ultimately sustained and there is no underpayment. By contrast, the accuracy-related penalties apply only when there is an underpayment.
- The failure to disclose penalty applies only if the reportable transaction is not disclosed. The accuracy-related penalties may apply even if the reportable transaction is disclosed.<sup>39</sup>
- The Section 6662(d) accuracy-related penalty applies only to "substantial" underpayments, while the Section 6662A accuracy-related penalty applies regardless of the amount of the underpayment.

**The new statutory definition of "material advisor" is broader than the definition of "tax shelter organizer" under the old regime.**

- The Section 6662A accuracy-related penalty applies only to reportable transaction underpayments,<sup>40</sup> while the Section 6662(d) accuracy-related penalty applies to underpayments that are not related to reportable transactions.
- If the Section 6662A accuracy-related penalty is applied, the Section 6662(d) accuracy-related penalty will not be imposed on the

<sup>37</sup> As an example of indirect compensation, the Conference Report noted an arrangement or understanding that the material advisor will recommend or refer potential investors to the tax advisor for an opinion. H.R. Conf. Rep. No. 108-755, at 589, n.474.

<sup>38</sup> See, e.g., *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004).

<sup>39</sup> See Reg. 1.6662-4(e)(2); compare Section 6662A(a) with Section 6662A(c). Disclosure is still important under Section 6662A because the penalty is increased for, and the reasonable cause exception does not apply to, undisclosed transactions. Similarly, in some circumstances, disclosure will allow the taxpayer to avoid the Section 6662(d) penalty.

<sup>40</sup> As noted above, "reportable transaction underpayments" exclude reportable transactions that are not listed transactions and do not have a significant purpose of tax avoidance.

same portion of the underpayment. However, the failure to disclose penalty may be imposed in addition to either penalty.

**Material Advisor Penalties.** The material advisor penalties involve failures to disclose and failures in maintaining investor lists.

*Failure to Disclose.* Before amendment, Section 6707 imposed a penalty for failure to register a tax shelter equal to the greater of 1% of the aggregate amount invested or \$500. Section 6707 now provides a penalty for a material advisor's failure to file the information return, or filing of a false or incomplete return, equal to \$50,000 for a reportable transaction. For listed transactions, the penalty is the greater of \$200,000 or 50% of the material advisor's gross income before the date the information return is filed. If the material advisor intentionally disregards the requirement to disclose a listed transaction, the min-

**Congress has also indirectly enlisted corporate directors and stockholders, and the financial press, in the battle against the failure to disclose by requiring taxpayers to disclose in periodic reports filed with the SEC any IRC Section 6707A penalty imposed for a listed transaction.**

imum penalty increases to 75% of gross income. The Commissioner has the same limited authority to rescind this penalty as the failure to disclose penalty discussed above for taxpayers.

*Failure to Maintain Investor Lists.* Before amendment, the Section 6708 penalty for failure to comply with the list maintenance requirement was \$50 for each name omitted, up to a maximum penalty of \$100,000 per year. The Act has strengthened this penalty by increasing it to \$10,000 for each day that a material advisor does not make available a complete investor list after 20 days of a written request from the IRS.

#### **OTHER SIGNIFICANT PROVISIONS OF THE ACT.**

A number of other provisions of the Act are significant and are summarized here:

1. *Privilege.* The tax practitioner privilege set forth in Section 7525 previously did not apply

<sup>41</sup> Section 6501(c)(10).

to communications regarding corporate tax shelters. The Act further restricts the privilege by making it unavailable with respect to communications regarding all tax shelters.

2. *Statute of Limitations.* If a taxpayer fails to disclose information with respect to a listed transaction, as required by the Section 6011 regulations, the statute of limitations for assessment is extended for that transaction. The statute will remain open until at least one year after the IRS is first notified of the transaction, whether by the taxpayer's late disclosure or a material advisor providing the investor list maintained pursuant to Section 6112.<sup>41</sup>
3. *Injunctions.* Section 7408 authorizes civil actions to enjoin anyone from promoting abusive tax shelters or aiding or abetting the understatement of tax liability. The Act expands the scope of injunction authority and allows an injunction to be sought against a material advisor to enjoin the advisor from (a) failing to file an information return with respect to a reportable transaction, or (b) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction. Because promoters were blatantly ignoring the rules regarding registration and list maintenance requirements, Congress wanted to make promoters subject to a public proceeding under court order.
4. *Practice Before the IRS.* 31 U.S.C. 330(b) provides for the suspension or disbarment from practice before the IRS of persons who violate the standards of professional conduct. The Act modified the statute to permit censure and monetary penalties as additional sanctions. Monetary penalties can be imposed both on the representative and on the employer or other entity on whose behalf the representative is acting. The Act also affirmed the Secretary's authority to impose standards for tax opinions with respect to tax shelters with a potential for tax avoidance or evasion.
5. *Penalty for False or Fraudulent Statements.* Section 6700 imposes a penalty on tax shelter organizers for making false or fraudulent statements as to any material matter with respect to a tax shelter. The previous penalty was the lesser of \$1,000 or 100% of the gross income that the organizer derived. The Act increases the penalty to 50% of the organizer's gross income.

6. *Interest on Underpayments.* The Act makes two changes with respect to interest on underpayments attributable to listed transactions or other reportable transactions with a significant tax-avoidance purpose, if not disclosed. First, underpayment interest is not suspended under Section 6404(g) if the IRS does not provide notice to an individual taxpayer specifically stating the taxpayer's liability and the basis for the liability within 18 months after the return

is filed. Second, any underpayment interest paid is not deductible under Section 163.

#### **CONCLUSION**

The new tax shelter disclosure and list maintenance requirements are complex, with significant penalties for non-compliance. The IRS is likely to apply them strictly and aggressively. Anyone involved in virtually any capacity in any substantial transaction will need to evaluate their exposure carefully. ■