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New IRS Disclosure Requirements Carry Serious Penalties
By Thomas C. Welshonce and Julie E. McGuire*

Touted as one of the most substantial overhauls of the Internal Revenue Code in years, the American Jobs Creation Act of 2004, Pub. L. No. 108-357, ("Jobs Act") was signed by the President on October 22, 2004. Like any number of "omnibus" Congressional tax bills, the Jobs Act is a broad-reaching collection of miscellaneous tax provisions in eight titles.[1]

This article focuses on a new set of requirements which govern how certain transactions known as "reportable transactions" must be reported to the Internal Revenue Service. While reporting rules existed prior to the Jobs Act, these new requirements carry substantial penalties that should serve to encourage compliance and curb participation in abusive tax shelters.

A. What is a Reportable Transaction?

The Jobs Act defines a reportable transaction broadly as a transaction that the Secretary of the Treasury has determined to have the "potential for tax avoidance or evasion."[2] The six general categories of reportable transactions are:

Listed transactions

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Confidential transactions

Transactions with contractual protection

Loss transactions

Transactions with a significant book-tax difference

Transactions involving a brief asset holding period

Of these different types of reportable transactions, the so-called "listed transactions" are often singled out for special treatment. Listed transactions are those transactions that are the same or substantially similar to transactions that the IRS has already determined to be tax avoidance transactions.[3]

"Confidential transactions" are those transactions offered to a taxpayer under conditions of confidentiality, which limit the taxpayer's ability to disclose the tax treatment or structure of the transaction, for which the taxpayer paid an advisor a certain fee.

A "transaction with contractual protection" is a transaction where the taxpayer will be entitled to a return of fees if the intended tax consequence is not achieved, or where the fees are contingent on the tax consequence being achieved.

"Loss transactions" are transactions whereby a corporate taxpayer claims a loss of at least $10 million in any single taxable year or $20 million in any combination of taxable years. For individuals, the amount is reduced to $2 million for any single year and $4 million for any combination of taxable years.

A "transaction with a significant book-tax difference" is one where the amount for tax purposes of any item of income, gain, expense, or loss from the transaction differs by more than $10 million from the amount of the item for book purposes.

Finally, a "transaction involving a brief asset holding period" is any transaction whereby the taxpayer claims a tax credit in excess of $250,000 but holds the underlying asset giving rise to the credit for 45 days or less.[4]

B. By Whom Must a Reportable Transaction Be Reported?

Under the new requirements of the Jobs Act, both taxpayers and their advisors have some responsibility to report these transactions. Consequently, both are now subject to penalties for the failure to do so.

1. "Material" Advisors

Any "material advisor" to a reportable transaction -- generally a lawyer or accountant -- must file a return setting forth information identifying the transaction, describing potential tax benefits expected to result from the transaction, and must further include any additional information required by the Secretary. A material advisor is defined as any person who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction. That person must also directly or indirectly derive gross income in excess of a threshold amount (currently set at $50,000 for advice to individuals regarding reportable transactions and $250,000 in all other cases) for the advice.[5]

Any material advisor who fails to file the return as required -- or who files false or incomplete information -- faces a serious penalty. The default penalty for any failure is set at $50,000. As noted, listed transactions often receive special treatment, and in the case of a failure to file a return with respect to a listed transaction, the penalty is the greater of $200,000 or 50% of the gross income (75% if the failure is intentional) derived from the assistance provided for the listed transaction.[6]

Whether or not a material advisor fits within the new reporting requirements described above -- an advisor might not fit, for example, because the Secretary may prescribe regulations that provide certain exemptions from the reporting requirement -- all material advisors must now maintain a list identifying each person for whom the material advisor acted with respect to a reportable transaction. Upon request, the material advisor must provide this list to the IRS within twenty days. Failure to provide this list to the IRS within that twenty day period will result in a fine of $10,000 per day.[7]

2. Taxpayers

Under pre-Jobs Act rules, taxpayers were obligated to file a disclosure form any time they participated in a reportable transaction.[8] However, there was no direct penalty for failing to file the required disclosure. The only penalty associated with failing to file the disclosure was a potential underpayment penalty -- so if there was no underpayment, there was no penalty.

Since the passage of the Jobs Act, the existing disclosure requirements now have teeth in the form of substantial penalties for failing to properly disclose participation in a reportable transaction. Under the new provisions, failing to include information about a reportable transaction will result in a penalty in the amount of $10,000 for an individual and $50,000 in any other case. For an individual, if the transaction is a "listed transaction," the penalty is increased to $100,000 -- or $200,000 in any other case. The IRS has the authority to rescind any or all of such penalty -- but only if the transaction is not a listed transaction and if rescinding the penalty would promote compliance and effective tax administration.[9]

In addition to the direct penalty that results from failing to disclose participation in a reportable transaction, there is also a new accuracy-related penalty that applies when an understatement results from either a listed transaction or any other reportable transaction aimed at evading federal income tax. This penalty is equal to 20% of the amount of the understatement

-- unless the transaction is not adequately disclosed -- in which case the penalty is equal to 30% of the understatement.[10]

C. Additional Provisions Aimed at Minimizing the Benefits of Tax Shelters

Several other Jobs Act provisions are aimed at increasing compliance with disclosure requirements and minimizing the benefits of tax shelters. Under the new provisions, in some circumstances, written communications between taxpayers and federally authorized tax practitioners[11] will no longer be entitled to "attorney-client" confidentiality protections if the communication is in connection with the promotion or participation in a tax shelter.[12] Additionally, the general three year statute of limitations that applies to tax returns will not apply if a taxpayer fails to include, on any return or statement, information about a listed transaction that is required to be disclosed. In such a case, the statute of limitations will not expire until one year after the required information is provided to the IRS by the taxpayer or a material advisor.[13]

Further, corporations will no longer be able to deduct interest paid on any portion of an underpayment of tax that results from either an undisclosed listed transaction or an undisclosed tax-evasive reportable transaction.[14]

Finally, interest and penalties can now accrue with respect to reportable transactions even if the IRS does not notify the taxpayer of the basis for these additions within the normally-required time frame.[15]

D. Further Considerations

Three additional points are worth noting.

First, as Treasury Regulations are developed under these new provisions, the application of these requirements will become more clear. The Treasury Regulations will provide exceptions to many of these provisions, including a "reasonable cause" exception that is already found in several of the new requirements.

Second, in some situations, multiple penalties can result from one transaction.

Finally, a party subject to reporting requirements of the Securities and Exchange Commission may be required to disclose to the SEC certain penalties imposed by the IRS. Failure to disclose the penalty to the SEC can subject the party to additional penalties from the IRS.

E. Conclusion

The Jobs Act is a major overhaul of the Internal Revenue Code, and it will affect many taxpayers and tax practitioners alike. In particular, practitioners dealing with reportable transactions need to pay close attention to these new requirements -- or face serious penalties for failing to do so.[16]

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1. The Jobs Act -- an early version of which was known as the Jumpstart Our Business Strength Act -- is perhaps most widely known for eliminating the extraterritorial income exclusion, which, according to the World Trade Organization, violated international trade agreements. While Title I of the Jobs Act accomplishes that goal, the Jobs Act goes further: Title II - Business Tax Incentives; Title III - Tax Relief for Agriculture and Small Manufacturers; Title IV - Tax Reform and Simplification for United States Businesses; Title V - Deduction of State and Local General Sales Taxes; Title VI - Fair and Equitable Tobacco Reform; Title VII - Miscellaneous Provisions; Title VIII - Revenue Provisions.

This article focuses primarily on Title VIII, Subtitle B - "Provisions Relating to Tax Shelters."

2. See I.R.C. § 6707A(c) (unless otherwise noted, all references to the Internal Revenue Code are to the Code as amended by the Jobs Act).

3. For the most recent compilation of listed transactions, see IRS Notice 2004-67, 2004-41 I.R.B. 600.

4. For more information on what constitutes a "reportable transaction," see Treas. Reg. § 1.6011-4.

5. See I.R.C. § 6111.

6. See I.R.C. § 6707.

7. See I.R.C. § 6112; I.R.C. § 6708.

8. See I.R.C. § 6011 (prior to amendment by Jobs Act) and the Treasury Regulations thereunder.

9. See I.R.C. § 6707A.

10. See I.R.C. § 6662A.

11. Generally, a "federally authorized tax practitioner" is a person authorized under federal law to practice before the IRS. See I.R.C. § 7525(a)(3)(A).

12. See I.R.C. § 7525(b). A "tax shelter" includes any plan or arrangement if a significant purpose of the plan or arrangement is the avoidance or evasion of federal income tax. See I.R.C. § 6662(d)(2).

13. See I.R.C. § 6501(c).

14. See I.R.C. § 163(m).

15. See I.R.C. § 6404.

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