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Tax Shelters: New IRS Disclosure Requirements Carry Serious Penalties

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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, was signed by the President on Oct. 22, 2004. Like any number of omnibus Congressional tax bills, the "Jobs Act" is a broad-reaching collection of miscellaneous tax provisions.

Title VIII of the Act, in Subtitle B — "Provisions Relating to Tax Shelters," contains new provisions that limit the benefits of tax shelters. A "tax shelter" includes any plan or arrangement that has as a significant purpose the avoidance or evasion of federal income tax. *IRC §6662(d)(2). [Except as noted, IRC references are to the Code as amended by the Jobs Act.]*

Among these new provisions are requirements that govern how certain transactions must be reported to the IRS. While reporting rules existed prior to the Jobs Act, these new requirements carry substantial penalties to encourage compliance and curb participation in abusive tax shelters.

Reportable Transactions

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." *IRC §6707A(c).*

The Jobs Act specifies six general categories of reportable transactions:

- *"Listed" transactions*, often singled out for special treatment, are those substantially similar to transactions the IRS has already determined to be aimed at tax avoidance. IRS Notice 2004-67, 2004-41 I.R.B. 600 contains the most recent compilation of listed transactions.
- *Confidential transactions* are those offered by the advisor to the taxpayer for a fee under conditions of confidentiality that limit the taxpayer's ability to disclose the tax treatment or structure of the transaction.
- *Transactions with contractual protection* are transactions 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 an individual taxpayer, the claimed loss is at least $2 million for any single year or $4 million for any combination of taxable years.
- *Transactions with a significant book-tax difference* are those 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.
- *Transactions involving a brief asset holding period* are those whereby the taxpayer claims a tax credit in excess of $250,000 but holds the underlying asset (that gave rise to the credit) for 45 days or less.

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

Reporting by Material Advisors

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.

A "material advisor" is defined as a person who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction. The advisor must also directly or indirectly derive gross income for that advice, in excess of a threshold

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amount. Currently the threshold is set at $50,000 for advice to individuals regarding reportable transactions, and $250,000 in all other cases. *IRC §6111.*

Any material advisor to a reportable transaction — generally a lawyer or accountant — must file a return that identifies the transaction, describes the potential tax benefits expected to result from the transaction, and provides any additional information required by the Secretary.

A 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, however, listed transactions often receive special treatment. For failing 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. *IRC §6707.*

Although regulations may exempt some material advisors from filing a return, *all* material advisors must 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 20 days — or face a fine of $10,000 per day. *IRC §6112; IRC §6708.*

Reporting by Taxpayers

Under rules prior to the Jobs Act, taxpayers were obligated to file a disclosure form any time they participated in a reportable transaction. *IRC §6011 prior to amendment by Jobs Act, and Treasury Regulations thereunder.* 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 of $10,000 for an individual and $50,000 in any other case. If the transaction is "listed," the penalty is increased to $100,000 for an individual and $200,000 in any other case. For non-listed transactions only, the IRS has the authority to rescind (or reduce) a penalty if rescinding the penalty would promote compliance and effective tax administration. *IRC §6707A.*

In addition to the direct penalty that results from failing to disclose participation in a reportable transaction, a new accuracy-related penalty applies if an understatement results from either a listed transaction or any other reportable transaction aimed at evading federal income tax. This penalty equals 20% of the understatement, or 30% if the transaction was not adequately disclosed. *IRC §6662A.*

Other Provisions and Penalties

Under the new provisions, in some circumstances, written communications between taxpayers and federally authorized tax practitioners are no longer entitled to "attorney-client" confidentiality protection if the communication relates to promotion of or participation in a tax shelter. *IRC §7525(b).* Generally, a "federally authorized tax practitioner" is a person authorized under federal law to practice before the IRS. *IRC §7525(a)(3)(A).*

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. *IRC §6501(c).*

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. *IRC §163(m).*

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. *IRC §6404.*

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 already found in several of the new requirements.

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

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

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.

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