The New Penalty Regime Finally Arrives — Proceed with Caution!

By Herbert N. Beller

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We all knew it had to happen sooner or later. After several false starts, Congress recently passed a robust package of anti-tax shelter measures as part of the American Jobs Creation Act of 2004 (the “Jobs Act”). The centerpiece of the tax shelter provisions is a quiver of stiff new statutory penalties tied to the nondisclosure of “reportable transactions” and aimed not only at offending taxpayers but their outside advisers as well.

Overview

New section 6707A of the Internal Revenue Code prescribes a fixed dollar penalty for each failure to adequately disclose any type of “reportable transaction” (RT), as identified in the Treasury regulations under section 6011, regardless of whether such transaction is successfully challenged by Internal Revenue Service on the merits (Nondisclosure Penalty). For corporate taxpayers, the penalty is $200,000 for so-called listed transactions (LTs), including transactions “substantially similar” to a listed transaction; and $50,000 for all other RT categories. For LTs, the Nondisclosure Penalty is absolute — there is no process for obtaining a waiver, rescission, or abatement based on a “reasonable cause” or other subjective standard. For undisclosed RTs other than LTs, only the Commissioner can waive or rescind the Nondisclosure Penalty and then only in very limited circumstances.

New section 6662A provides a more stringent set of accuracy-related penalty rules for RTs — increasing the ante from 20 percent to 30 percent for undisclosed LTs and “reportable avoidance transactions” (RATs); and more expansively calculating the “understatement” against which the penalty is applied. The accuracy penalty can now be avoided in the case of an RT only if it is disclosed and qualifies for dispensation under the “strengthened reasonable cause exception” described in new section 6664(d). What’s more, in the case of LTs and RATs, the circumstances in which taxpayers can avoid the accuracy penalty via reliance on an outside tax opinion have been narrowed considerably.

Public companies must report to the SEC their required payment of any Nondisclosure Penalty with respect to a LT. SEC reporting also is required for increased accuracy penalties imposed with respect to undisclosed LTs or RATs.

Additional new penalties apply to “material advisors” (MAs), who are now required to file special information returns with respect to any RT advised upon. Failure to file a required information return triggers a $50,000 penalty in the case of RTs other than LTs; and a $200,000 or possibly greater penalty in the case of an LT. Another new penalty — $10,000 per day — will be imposed on MAs who fail to furnish required RT “list maintenance” information requested by the IRS.

The new rules are generally effective for transactions reportable in returns due after the date of enactment (October 22, 2004). Taken together, they put real teeth into the RT disclosure regulations, place added pressure upon companies to implement effective internal procedures for identifying and reporting RTs, and potentially affect the nature and scope of relationships between companies and outside professionals. They also increase the importance of upfront communication between taxpayers and their advisers on whether the transaction is a RT or the adviser is a MA — and, if so, what disclosure responsibilities and potential penalties flow from such status.

On November 16, 2004, the IRS issued interim guidance relating to several aspects of the new legislation.

The Nondisclosure Penalty

The Nondisclosure Penalty is imposed upon taxpayers who fail to disclose any type of RT. Tied solely to nondisclosure, it has nothing to do with whether the IRS challenges (successfully or unsuccessfully) the taxpayer’s reported tax treatment of the underlying transaction. The amount of the penalty varies depending on whether the transaction is a LT or another type of RT, and also depending on the type of taxpayer involved (but not, as under the Senate bill, upon the size or wealth of the taxpayer). The penalty is effective with respect to RTs (LTs or otherwise) for which disclosure is required in returns or statements due after October 22, 2004.

Listed Transactions

For undisclosed LTs, the penalty is $100,000 in the case of any natural person, and $200,000 for corporations and all other non-individual taxpayers. It cannot be waived, rescinded, or abated under any circumstances; in other words, it is a “strict liability” penalty.

There currently are 30 LTs that Treasury and the IRS have identified as abusive tax shelters in notices or other published guidance. Disclosure is also required...
for transactions which are “substantially similar” to a LT. These include transactions that are based on a “similar tax strategy,” even if the transactional structure or fact pattern is dissimilar from that of the LT. The regulations warn that the “substantially similar” concept will be broadly construed.  

Given especially the strict liability nature of the Nondisclosure Penalty for LTs, taxpayers may opt to deal with potential uncertainty about “substantially similar” status by filing a protective disclosure pursuant to a procedure specifically permitted under the RT regulations. Some taxpayers may be reluctant to acknowledge that a transaction might be viewed as having LT overtones. Particularly for public companies, however, a protective disclosure will normally be advisable; for imposition of a Nondisclosure Penalty with respect to a LT must be reported to the SEC, and a failure to do that will trigger a separate, additional Nondisclosure Penalty. 

It is important to keep in mind that disclosure is required for any transaction that becomes a LT in a taxable year subsequent to the year in which the transaction was entered, and further, that disclosure is required for each year that the taxpayer participates in and receives tax benefits from the transaction. Moreover, under new section 6501(c)(10), the statute of limitations for assessment of tax liability is extended with respect to undisclosed LTs until one year after the earlier of the date on which (i) the required disclosure is furnished to the IRS, or (ii) required “list maintenance” information with respect to the transaction is furnished.  

Other Reportable Transactions

For RTs that are not LTs, the Nondisclosure Penalty drops to $50,000 for corporations and other non-individual taxpayers. The categories of non-listed RTs include —  

- Transactions that generate section 165 losses exceeding specified one-year or multiple-year thresholds ($10 million/$20 million for corporate taxpayers). 

- Transactions of public companies, or non-public companies with gross assets of at least $250 million, giving rise to book-tax differences exceeding $10 million. 

- Transactions offered by promoters or other third parties under conditions designed to require confidentiality of the tax structure or treatment of the transaction. 

- Transactions in which the taxpayer’s obligation to pay fees to a promoter or tax adviser is contractually tied to whether the intended tax benefits are ultimately sustained or the taxpayer actually realizes tax benefits from the transaction. 

- Transactions that generate a tax credit exceeding $250,000 in connection with particular assets held by the taxpayer for less than 46 days. 

For large companies, transactions involving substantial section 165 losses or book-tax differences are likely to be the most prevalent types of non-listed RTs. The RT disclosure regulations provide that specific disclosure exceptions may be established from time to time via separate published guidance. The IRS has already issued four revenue procedures containing so-called angel lists describing various loss transactions and book-tax differences that are exempted from disclosure, as well as certain exceptions under the “contractual protection” and “brief asset holding period” RT triggers. Under another recent revenue procedure, corporations required to file the new Schedule M-3 — “Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More” — will be deemed to have satisfied the disclosure requirement of the RT regulations with respect to more than $10 million book-tax differences if the M-3 is completed in accordance with its instructions and is timely filed with the original return.  

A Nondisclosure Penalty imposed in respect of a non-listed RT can be waived, rescinded, or abated — but only by the IRS Commissioner in order to “promote compliance with the tax laws and effective tax administration,” and without any right of judicial appeal of a decision to deny penalty relief. The Jobs Act Conference Report states that, in exercising this discretion, the Commissioner should “take into account whether: (1) the person on whom the penalty is imposed has a history of complying with the tax laws; (2) the violation is due to an unintentional mistake of fact; and (3) imposing the penalty would be against equity and good conscience.”

Within these criteria, the Commissioner ought to be inclined to exercise this authority favorably in the case of corporations or other business entities that can demonstrate a good faith effort to implement effective internal procedures for detecting and reporting RTs, and that the failure to disclose the item in question was in no way deliberate. Even with an elaborate internal RT monitoring system, occassional corporate foot-faults in this area are almost certain to occur. This is especially so in the case of large multinational companies with numerous foreign subsidiaries or interests in noncorporate affiliates involving unrelated partners.  

Adequate Disclosure

The Nondisclosure Penalty will, of course, not apply if the RT has been adequately disclosed. For each RT in which the taxpayer has participated during the taxable year, disclosure must be made on an IRS Form 8886. This form is filed as an attachment to the tax return, and a copy must be sent to the Office of Tax Shelter Analysis in Washington. The form requests substantial information regarding the transaction, including (i) the type of RT (and the type of LT, if applicable); (ii) the names of any partnerships, foreign corporations, or other entities through which the RT may have been effectuated; (iii) the names and addresses of any transaction promoters or outside tax advisers; and (iv) a description of the facts and expected tax benefits of the transaction (including an estimate of expected tax benefits for each affected tax year). If the Form 8886 is filed late, or the IRS considers it to be incomplete in some material respect, the stage pre-
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sumably would be set for imposition of a Nondisclosure Penalty. Again, it is hoped that in such cases the IRS will act reasonably and with restraint, perhaps implementing procedures under which the reporting taxpayer could amend the originally filed Form 8886. Early guidance on this area of potential concern would be helpful.

The Modified Accuracy Penalty

The Jobs Act essentially leaves in place the old accuracy penalty regime for non-RTs and non-RATs, but adds a new regime for LTs and RATs.

Old Regime

Section 6662(a) imposes a 20-percent accuracy-related penalty with respect to a “substantial underpayment” of tax resulting from a successful IRS challenge, and various other triggers described in section 6662(b). It generally can be avoided if the taxpayer’s reported position (i) was supported by “substantial authority,” or (ii) was adequately disclosed and a “reasonable basis” existed for such position.

More stringent rules apply with respect to “tax shelters,” which since 1997 have been statutorily defined (in section 6662(d)(2)(C)(iii)) with reference to a “significant” (rather than “principal”) purpose of tax avoidance. Under the ground rules in effect prior to the Jobs Act, non-corporate taxpayers engaged in tax shelters had to meet both the substantial authority and disclosure requirements; and also had to “reasonably believe” that the asserted tax treatment was more likely than not (MLTN), that is to say, better than 50 percent, correct. For corporate taxpayers, however, the only way out of a penalty with respect to a tax shelter transaction was via the “reasonable cause/good faith” exception of section 6664(c). That exception often came to the rescue for taxpayers who obtained a MLTN (or higher level of confidence) opinion from an outside tax adviser.

Not all RTs are necessarily “tax shelters,” and not all “tax shelters” are necessarily RTs. Old-section 6662 did not address application of the accuracy penalty to “reportable transactions,” a concept first appearing in the disclosure and list maintenance regulations that were proposed in early 2000 and not finalized until early 2003. In late 2002 Treasury proposed to amend the section 6664 regulations to prevent, without exception, reliance on an outside tax opinion based on the “reasonable cause/good faith” exception for any undisclosed RT. The final regulations (issued early this year) leave some (but not much) wiggle room by characterizing nondisclosure of an RT as a “strong indication” that the taxpayer had not relied in good faith upon the outside opinion.

New Regime

The Jobs Act leaves old-section 6662 intact for (i) non-RTs and (ii) RTs other than LTs or RATs, except that a “substantial understatement” with respect to such transactions now exists for corporate taxpayers if the amount of the understatement for the taxable year exceeds the lesser of (i) 10 percent of the tax required to be shown on the return (or, if greater, $10,000), or (ii) $10 million. Thus, any understatement above $10 million will be considered substantial regardless of the total tax liability for the taxable year involved.

In addition, new section 6662A now provides more stringent rules for applying the accuracy penalty to LTs and RATs. For these transactions, if disclosed, a 20-percent penalty is assessed against the “reportable transaction understatement” (RTU), as defined in section 6662A(b). For undisclosed LTs and RATs, the penalty is increased to 30 percent. Public companies must report 30-percent penalties to the SEC. And under new section 163(m), no deduction is permitted for interest paid with respect to a RT arising out of an undisclosed RT.

The statutory description of a RTU is difficult to follow and hopefully will be clarified in forthcoming guidance through specific numeric examples. As explained in the Conference Report, it contemplates a three-step computation process —

1. determining the increase in taxable income resulting from the difference between the taxpayer’s treatment and the proper treatment of the transaction without regard to other items on the tax return;
2. multiplying such difference by the highest corporate tax rate; and
3. adding any decrease in tax credits resulting from the differences between the taxpayer’s treatment and the proper treatment of the transaction.

In effect, the RTU is simply the amount of the disallowance times the taxpayer’s highest marginal rate; and because other return items are disregarded, a penalty can result even in the absence of a positive tax liability for the year involved.

The penalty under section 6662A (whether 20 percent or 30 percent) cannot be avoided under the traditional “reasonable cause/good faith” exception of section 6664(c). Instead, all requirements of a “strengthened reasonable cause exception” (SRCE), as provided in new section 6664(d), must be satisfied in the case of any LT or RAT.

Reportable Avoidance Transactions

Not all non-listed RTs are subject to the more stringent penalty rules of new section 6662A — only those that have as “a significant purpose” the avoidance or evasion of federal income tax. In many instances, drawing the line between RATs and non-RATs may prove difficult, since most transactional structuring and planning is typically done with a view toward minimizing tax consequences.

There is no statutory definition of the “significant purpose” standard. Regulations under the now-repealed tax shelter registration rules of old-section 6111 state that a non-LT will generally be considered to have a significant purpose of tax avoidance if it “is structured to produce tax benefits that constitute an important part of the intended results of the arrangement” — but not if the transaction was entered in the “ordinary course of business” consistent with “customary commercial practice.” Moreover, the existing section 6662 regulations provide that a transaction...
will not be considered as having a “principal purpose” of tax avoidance (i.e., the pre-1997 statutory benchmark for “tax shelter” characterization) if its purpose is the claiming of exclusions from income, accelerated deductions, or other tax benefits in a manner consistent with the statute and Congressional purpose. 32

It remains to be seen whether the IRS will similarly construe the “significant purpose” concept in determining whether a particular transaction should be required to run the accuracy penalty traps as a RAT (under section 6662A), or merely as a mouse (under section 6662). The risk of RAT characterization is no doubt high for any RT that does not have a clear nexus to the taxpayer’s normal business operations, particularly if the idea to do the transaction was “brought to” the taxpayer as a tax-saving strategy by a promoter or outside adviser. This will most likely be the case where RT status attaches under the “contractual protection,” “confidentiality” or “brief holding period” triggers. But RTs involving section 165 losses or book-tax differences often may not be RATs, depending on the nature of the underlying assets and the context of the transaction.

**Strengthened Reasonable Cause Exception**

In order to qualify for the SRCE, new section 6664(d)(2) requires that —

- the relevant facts affecting the taxpayer’s treatment of the transaction be “adequately disclosed” in accordance with the section 6011 regulations;
- such tax treatment “is or was” supported by “substantial authority”; and
- the taxpayer “reasonably believed” that such treatment was MLTN correct.

The adequate disclosure requirement presumably is met by timely filing a properly completed Form 8886 for the RT; but as noted earlier with respect to the Nondisclosure Penalty, disclosures that are late or lack sufficient detail may prevent application of the SRCE. 33 The existing section 6662 regulations list the types of authority that may be taken into account and require that “the weight of the authorities supporting the [taxpayer’s] treatment is substantial in relation to the weight of authorities supporting contrary treatment.” 34 The requirement can be satisfied by case law or other substantial authority existing when the return is filed, even if such authority may have arisen after the end of the taxable year to which the return relates. 35

The “reasonable belief” prong of the SRCE requires that the taxpayer’s belief be based on facts and law existing at the time the return is filed, and solely with respect to the chances of success on the merits of the transaction. 36 Although not required, a taxpayer’s reasonable belief may be demonstrated by good faith reliance upon an opinion of a professional tax adviser. Existing Treasury regulations elaborate upon the factual and legal due diligence requirements that outside opinions must satisfy in tax shelter contexts. 37 Such reliance will not be respected in the case of an LT or a RAT, however, if the opinion giver is a “disqualified tax advisor” (DTA) or the opinion is a “disqualified tax opinion” (DTO).

**Disqualified Tax Advisors and Disqualified Tax Opinions**

Under new section 6664(d)(3)(B)(ii), an outside tax adviser can be a DTA if he or she —

- is a “material advisor” and participates in the organization, management, promotion or sale of the transaction;
- is compensated directly or indirectly by a MA with respect to the transaction;
- has a fee arrangement wholly or partly contingent on the intended tax benefits of the transaction being sustained; or
- has a “disqualifying financial interest” in the transaction, as determined under forthcoming regulations.

An adviser who does not have any financial interest in the transaction apart from the right to professional fees, and whose fees are non-contingent and paid directly by the taxpayer, cannot be a DTA unless he or she is a MA. For corporate transactions, this requires the receipt of fees in excess of $250,000 for “material aid, assistance or advice” in connection with “organizing, managing, providing, selling, implementing, insuring or carrying out any RT.” 39

The Conference Report states that an adviser is considered as participating in the “organization” of a transaction if he or she performs acts relating to the “development” of the transaction, but not if the adviser’s only involvement is to render an opinion with respect to the tax consequences of the transaction. Any additional involvement by the adviser (or other persons in the same firm) with respect to the “structuring” or “documentation” of the transaction would render the adviser a DTA. 40 In order to preserve the value of the tax opinion for penalty protection purposes, the adviser (and anyone else in the adviser’s firm) may have to refrain from suggesting even small changes in the structure, terms or timing of the proposed transaction in an effort to solidify or improve its tax posture. That would represent a sea change in the way that tax practitioners traditionally operate in connection with the rendering of tax opinions; and it would require that taxpayers who desire a penalty protection opinion undertake the added cost of retaining separate outside advisers to handle the tax and non-tax aspects of the transaction. Forthcoming published guidance hopefully will permit at least some degree of flexibility in this regard.

Even if not a DTA, reliance on the MA’s tax opinion for penalty protection purposes will nonetheless be barred if the opinion is a DTO, as defined in section 6664(d)(3)(B)(iii). Under this restriction, disqualification occurs if the opinion —

- is based on unreasonable factual or legal assumptions (including concerning future events);
• unreasonably relies upon representations, statements, findings, or agreements of the taxpayer or any other person;
• fails to identify and consider all relevant facts; or
• fails to meet any other requirement prescribed by Treasury.

These diligence requirements apparently are designed to track those prescribed for tax shelter opinions by Circular 230, which governs practice before the Treasury Department. They also are similar to the opinion reliance criteria articulated in existing regulations that address application of the “good faith/reasonable” cause exception under section 6664(c).

To qualify for relief, the taxpayer’s reliance on an outside tax opinion must be “reasonable” and in “good faith.” At least for sophisticated taxpayers, this may not follow automatically from the mere fact that an opinion is sought and received from well-respected counsel. In this regard, a recent federal district court decision suggests that tax-savvy client personnel need to closely review the opinion in order to make sure that its analysis and conclusions are fully understood, and that substantial authority in fact exists for the position taken. Moreover, delivery of the final version of the opinion should in all events occur before the return is filed.

Non-Reportable Avoidance Transactions

Transactions that are RTs, but not RATs, remain subject to a 20-percent accuracy-related penalty under the rules of section 6662. Because such transactions, by definition, do not have a significant purpose of tax avoidance, they presumably cannot be “tax shelters” for purposes of the more stringent penalty avoidance provisions of those “old” rules. Accordingly, no penalty should attach if the non-RAT is adequately disclosed (on a Form 8886) and the taxpayer had at least a reasonable basis for the reported tax treatment.

Non-Reportable Transactions

Transactions that are not RTs (and therefore not RATs) could still have a significant purpose of tax avoidance and thus be considered “tax shelters” for accuracy penalty purposes. For corporate taxpayers, the penalty could be avoided in such cases only via the “old” good faith/reasonable cause exception of section 6664(c). Where reliance on this exception is based on an outside opinion, the opinion would have to be at the MLTN level. While the new DTA and DTO requirements under section 6664(d) would not technically apply, the Service might still seek to challenge the quality of the opinion for penalty avoidance purposes based on similar concepts.

If a non-RT is not a tax shelter, a showing of either “substantial authority” or “adequate disclosure/reasonable basis” will suffice to call off the accuracy penalty. In such cases, there is no need to resort to the good faith/reasonable cause exception; but an outside opinion that the reported tax treatment satisfies the “substantial authority” or “reasonable basis” thresholds may be helpful.

Material Adviser Information Returns

The Jobs Act repeals the tax shelter registration provisions of old-section 6111 and replaces them with a new statutory requirement that all “material advisors” with respect to any RT must file an information return within 30 days after becoming an MA, providing information identifying and describing the transaction, any potential tax benefits expected to result therefrom, and any other information that Treasury may require. These returns will essentially replicate the RT information that the taxpayer is required to disclose on Form 8886, as well as information that MAs are still required to maintain and furnish to the IRS on request pursuant to the list maintenance regulations under section 6112. The MA information return requirement applies with respect to any RT for which material aid, assistance or advice is provided after October 22, 2004, and presumably covers RTs for which MA advice was given both before and after such date.

Definition of “Material Advisor”

First introduced in the list maintenance regulations, the term “material advisor” is now statutorily defined (in section 6111(b)(1)) to include any person who provides “material aid, assistance or advice” in connection with various types of activity, including “organizing, managing, promoting, selling, implementing, insuring, or carrying out” any RT. In addition, such person must derive fees or other gross income in excess of a prescribed threshold amount — $250,000 in the case of RTs involving corporate or other non-individual taxpayers.

Recent interim guidance (IRS Notice 2004-80) announced that certain aspects of the existing list maintenance regulations will be applied for purposes of the new statutory MA rules. In particular, all fees received for services provided in connection with the RT by any person in the MA’s firm (whether or not tax-related) will count toward the dollar threshold; the adviser must make a “tax statement” with respect to the RT, and the fee threshold for corporate LTs will be only $25,000 (not $250,000).

In addition, Notice 2004-80 provides that the rendering of tax advice with respect to a transaction that is an RT solely by reason of the “book-tax difference” trigger will not cause the adviser to become an MA unless the adviser makes a statement relating to the financial accounting treatment of the items giving raise to the book-tax difference. This rule also excuses such advisers from the list maintenance obligation. It does not, however, vitiate the taxpayer’s responsibility for disclosing a book-tax difference on Form 8886 or Schedule M-3.

Failure to File

The penalties for failure to file a required MA information return are by no means chicken-feed. The baseline is $50,000 for RTs that are not LTs. The stakes are much higher for LTs (including transactions substantially similar to an LT): the greater of (i) $200,000, or (ii) 50 percent of the fees derived by the MA (75 percent if the MA inten-
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Apart from the penalty for failure to file an MA informa-
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penalty on MAs who fail to furnish required RT “list main-
tenance” information upon expiration of the 20-day grace
period following a request by the IRS. A “reasonable cause”
exception is available with respect to this penalty.

Potential Client Tension

Given these substantial penalty exposures, the MA
information return requirement is not likely to be taken
lightly by any firm that believes it clearly is or may be
subject to the filing obligation. In some instances, the
client may have a different view — for example, it may
believe that the transaction is not an RT and therefore not
intend to file a Form 8886. It is thus very important that
the subject of disclosure be candidly discussed up front,
so that the taxpayer knows for sure whether the adviser
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RT. In this regard, it likely will become common for firms
to include language in client engagement letters to the effect
that the firm (i) reserves sole discretion to decide whether
the transaction is a RT subject to the list maintenance and
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harmless for additional tax liability, penalties or other fi-
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furnishing of information pursuant to such requirements.

The Road Ahead

One of the main strategies of the government in its
battle against abusive tax shelters is to shine an early spot-
light on defined categories of RTs, by requiring detailed
disclosures with respect to the participants (including tax
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the same time, fails to reach many that are. In any event,
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with enactment of the Nondisclosure Penalty, the modified
accuracy penalty and the other new statutory restrictions,
the non-compliance stakes are now quite substantial and
difficult to ignore.

Even without nondisclosure penalties, most large
companies have been trying in earnest to develop effective
systems for identifying and reporting RTs. The new pen-
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It also changes the groundrules for relying upon outside
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of services that tax advisers and others in their firms can
safely provide.

The enhanced penalty threat, moreover, is apt to have
a deterrent effect upon taxpayer behavior. Any inclination
that a taxpayer might have to refrain from disclosing a RT
would seem especially foolhardy in the case of LTs or RATs,
or where disclosure will otherwise be made via a required
MA information return.

At least for publicly held and other large companies,
there appears to be little continuing interest in marketed
tax products that bear no real relationship to the taxpayer’s
normal business operations. The Jobs Act tax shelter pro-
visions will no doubt solidify that trend, but they could
have the effect as well of dampening the desire to engage
in legitimate creative tax planning. Treasury and the IRS
optimally will seek to administer the RT disclosure rules
and the new penalty regime in a reasonable manner, so as
to prevent that from happening.

And finally, it ought not be forgotten that a number of
significant anti-shelter legislative proposals were ultimately
left on the cutting room floor — including, most notably,
provisions that would have (i) codified certain definitional
elements of the “economic substance” doctrine (and imposed
a related 40-percent penalty), and (ii) required CEO certifi-
cation of corporate tax returns. Congressional attempts to
resurrect these or other measures in the tax shelter area
may well be forthcoming, particularly if the government
is unable to consistently win shelter cases in court.

In the meantime, the new statutory penalties undoubtedly
strengthen the IRS’s hand in the shelter war; and they give
firm notice to taxpayers and their advisers that decisions
to engage in aggressive tax-motivated transactions could
prove to be very costly, especially if such transactions are
not properly disclosed.

1 Public Law L. No. 108-357, signed into law by President Bush
on October 22, 2004.
2 Unless otherwise indicated, all statutory references are to the
Internal Revenue Code of 1986, as amended.
3 Jobs Act, § 811(c). Returns due after such date on extension
are presumably covered, but the statutory language is arguably
ambiguous on that point.
5 Recently released Notice 2004-67, 2004-41 I.R.B. 600, de-
scribes each of these transactions and references the particular
published guidance item in which their LT status was announced.
The current list of LTs can be viewed on the IRS website.
6 Treas. Reg. § 1.6011-4(c)(4). Apart from triggering a Nondis-
closure Penalty, a “substantially similar” characterization could
also have adverse consequences under the Service’s current policy
with respect to seeking “tax accrual workpapers” which support
the taxpayer’s tax reserve for financial accounting purposes. If
the taxpayer has more than one LT (including of the “substantially
similar” variety), even if disclosed, the IRS may ask for
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are presumably covered, but the statutory language is arguably
ambiguous on that point.
5 Recently released Notice 2004-67, 2004-41 I.R.B. 600, de-
scribes each of these transactions and references the particular
published guidance item in which their LT status was announced.
The current list of LTs can be viewed on the IRS website.
6 Treas. Reg. § 1.6011-4(c)(4). Apart from triggering a Nondis-
closure Penalty, a “substantially similar” characterization could
also have adverse consequences under the Service's current policy
with respect to seeking “tax accrual workpapers” which support
the taxpayer's tax reserve for financial accounting purposes. If
the taxpayer has more than one LT (including of the "substantially
similar" variety), even if disclosed, the IRS may ask for all work-
papers (instead of only those relating to LTs).
8 I.R.C. § 6707A(e).
The New Penalty Regime Finally Arrives: Proceed with Caution!

10 I.R.C. § 6707A(b)(1). The threshold drops to $10,000 for "natural persons."
11 Treas. Reg. § 1.6011-4(b)(5).
12 Treas. Reg. § 1.6011-4(b)(6).
13 Treas. Reg. § 1.6011-4(b)(3). As originally proposed and final-
ized, the RT confidentiality trigger was much stricter, because it
extended to commonplace confidentiality restrictions imposed by
the parties in the negotiation and documentation of many kinds
of commercial and financial transactions. RT disclosure gener-
ally could be avoided in such instances only by resort to a care-
fully worded "tax carve-out" provision, or by reliance upon certain
other exceptions the application of which was often uncertain.
In response to continuing criticism of these rules after the RT regu-
lations were finalized in February of 2003, Treasury agreed that a
narrower confidentiality trigger was appropriate. On December 30,
2003, the final regulations were amended accordingly.
14 Treas. Reg. § 1.6011-4(b)(4). The preamble to the RT regula-
tions indicates that the "contractual protection" RT trigger will not
come into play if, under the transaction agreement, a subsequent
change in the tax law entitles the taxpayer to a tax gross-up, a tax
indemnity, tax insurance or a right to rescind the transaction.
15 This category focuses principally upon foreign tax credits in
respect of dividends received on a briefly held stock, i.e., like those
that two federal appeals courts have sustained. Compaq Computer
Corp. and Subsidiaries v. Commissioner, 277 F.3d 778 (5th Cir.
2001), rev’g 113 T.C. 17 (1999); and IES Industries, Inc. v. United
States, 253 F.3d 350 (8th Cir. 2001), rev’g 1999 W.L. 973538 (N.D.
Iowa 1999).
16 Rev. Proc. 2004-66 (November 16, 2004) modifying and sus-
ing, for example, out of market-to-market and hedging trans-
actions, bulk sales of inventory, and the abandonment of depre-
ciable property. It also provides a more generic exception for loss
transactions associated with any asset that has a "qualified tax
basis" because it was acquired by the taxpayer (i) solely for cash
(including with borrowed funds), or (ii) in certain types of non-tax-
able transactions (including tax-free reorganizations, spin-offs and
like-kind exchanges). Under the updated revenue procedures, this
exception is now available for cash-purchased stock that is subject
to the deemed stock basis adjustment rules of the consolidated return
regulations and the subpart F provisions.
17 Rev. Proc. 2004-67 (November 16, 2004) modifying and sus-
exceptions to the book-tax trigger, including differences arising out
of financing transactions booked as "sales" or "leases," intercom-
pany dividends, tax-exempt income, computed interest income or
deductions, tax-free reorganizations and spin-offs, foreign currency
and losses, and LIFO or obsolescence-related inventory valu-
ation differences.
17A See Rev. Proc. 2004-65 (November 16, 2004) (contractual pro-
tection) and Rev. Proc. 2004-68 (November 16, 2004) (brief asset
holding period).
18 Rev. Proc. 2004-45, 2004-31 I.R.B. 140. This procedure also
permits corporations and other taxpayers who are not required to
file a Schedule M-3 to nonetheless elect to do so and thereby
satisfy the RT book-tax disclosure requirement. In general, how-
ever, the Schedule M-3 reporting of book-tax differences is more
comprehensive and detailed than the RT reporting (which is done
on Form 8866).
19 I.R.C. § 6707A(d).
ference Report).
21 RTs engaged in by a foreign affiliate may be "passed through"
or otherwise be attributed to a U.S. corporate parent or partner.
See Treas. Regs. §§ 1.6011-4(b)(6)(ii)(E) and (G).
22 These include negligence or disregard of rules of regulations; a
substantial valuation misstatement (as defined in section 6662(e));
a substantial overstatement of pension liabilities; and a substantial
capital gain or gift tax valuation understatement. The penalty increases
to 40 percent for any "gross valuation misstatement," as defined in
section 6662(h)(2). A 40-percent penalty was recently sustained by a
distinct district court in Long-Term Capital Holdings, Inc. v.
United States, 330 F. Supp. 2d 122 (D. Conn. 2004), involving a
disallowed loss on a purported sale of stock that had an inflated
basis derived from a tax shelter transaction.
25 See Treas. Regs. §§ 1.6664-4(c) and (e), which set forth mini-
imum factual and legal diligence requirements that any such pen-
alty protection opinions or advice must satisfy. The regulations
warn that "depending on the circumstances, satisfaction of the
minimum requirements may not be dispositive if the taxpayer’s par-
ticipation in the tax shelter lacked significant business purpose, if
the taxpayer claimed benefits that are unreasonable in comparison
to the taxpayer’s investment on the tax shelter, or if the taxpayer
agreed with the organizer or promoter of the tax shelter that the
taxpayer would protect the confidentiality of the tax aspects of the
26 Treas. Reg. §1.6664-4(d).
27 I.R.C. § 6662(d)(1)(B). The old definition rendered an under-
statement "substantial" if the correct tax liability for the taxable
year exceeded the reported liability by the greater of (i) 10 percent
of the correct amount of tax, or (ii) in the case of most corporations,
$10,000. Old-I.R.C. § 6662(d)(2).
28 I.R.C. § 6662A(c).
29 I.R.C. § 6707A(e)(2)(B). SEC reporting also is required for
any 40-percent "gross valuation penalty misstatements" penalty
(per section 6662(h)(2)) with respect to undisclosed transactions.
As is the case for failure to report a Nondisclosure Penalty to the
SEC, a failure to do the same for a 30-percent accuracy penalty or
a gross valuation misstatement penalty will trigger an additional
penalty in an amount equal to the Nondisclosure Penalty for the
30 Conference Report, at 377. For purposes of step (1), any reduc-
tion in (i) the excess of allowable deductions over gross income for
the taxable year, or (ii) the amount of capital losses that would be
allowed for the year, is treated as an "increase in taxable income."
I.R.C. § 6662A(b)(1)(B). Moreover, unless otherwise provided in
regulations, the RTU amount cannot be computed based on an
amended or supplemental tax return filed after the earlier of (i) the
date on which the taxpayer was first contacted regarding the open-
ing of an IRS audit of the return, or (ii) such other date prescribed
by regulations. I.R.C. § 6662A(e)(3).
32 Treas. Reg. § 1.6662-4(g)(2)(ii). This regulation goes on to cite
certain obvious examples of tax benefits expressly sanctioned by the
Internal Revenue Code — including, among others, purchasing tax-
free savings bonds; electing tax-exempt depreciation deductions; and
establishing a qualified retirement plan.
33 The adequate disclosure requirement is deemed satisfied if a
Nondisclosure Penalty with respect to the transaction was re-
34 Treas. Reg. §§ 1.6662-4(d)(3)(i) and (iii).
36 I.R.C. § 6664(d)(3)(A). The possibility of no audit, or settlement
if the reported treatment is challenged, may not be considered.
37 Treas. Regs. §§ 1.6662-4(g)(4), 1.6664-4(c) and (e).
38 A $50,000 fee threshold applies if substantially all the tax
benefits from the RT are provided to natural persons. I.R.C. §
6111(b)(1)(B). Although not entirely clear, recent interim guidance
appears to eliminate the MA fee threshold to $25,000 for corporate LTs ($10,000 for non-corporate) See Notice 2004-80 (November 16, 2004); Treas. Reg. § 301.6112-1(c)(3)(ii).  


41 A violation of Circular 230 subjects the practitioner to professional sanction by the IRS Office of Professional Responsibility, including possible suspension, disbarment, public censure or monetary fine. See Notice 2004-80 (November 16, 2004).


44 That was not the situation in the cited case (Long Term Capital Holdings). The court was unsympathetic to claims that a preliminary memorandum and asserted discussions with an officer of the taxpayer regarding relevant facts and legal issues were sufficient to satisfy the good faith reliance requirements.

45 The failure to adequately disclose a non-RAT would in all events attract a Nondisclosure Penalty.

46 Treasury may at some point amend the regulations to specifically require that only Circular 230-compliant opinions can be relied upon to avoid a penalty under either section 6662 or section 6662A.

47 I.R.C. § 6111(a); Notice 2004-80 (November 16, 2004). Notice 2004-80 also provides that the filing deadline is extended to February 1, 2005, if the adviser becomes an MA between October 22 and December 31, 2004. At least temporarily, the MA information return is to be filed using a modified IRS Form 8264 (the old tax shelter registration form).

48 A $50,000 threshold applies where substantially all the tax benefits from the RT are provided to natural persons. I.R.C. § 6111(b)(1)(B). The same “minimum fee” dollar thresholds apply under the list maintenance regulations, but not with reference to a “natural persons” concept. See Treas. Reg. § 301.6112-1(c)(3)(i).

49 See Treas. Reg. § 301.6112-1(c)(2)(ii). Amended section 6111(c) authorizes Treasury regulations that provide specific exemptions from the information return filing requirement, including special rules where multiple MAs are involved.

50 For list maintenance purposes, a “tax statement” may be oral or written and must relate to a tax aspect of the transaction which causes it to become a RT. Treas. Reg. § 301.6112-1(c)(3)(ii).

51 This reduction is apparently authorized by the parenthetical expression in section 6111(b)(1)(A)(ii), which defines “threshold amount” as “such other amount as may be prescribed by the Secretary.”

52 I.R.C. § 6707(b). The penalty applies to both a complete failure to file and a filing of “false or incomplete information” with respect to the RT. I.R.C. § 6707(a).

53 I.R.C. § 6708(a)(2). The MA’s failure to maintain the list information in the first instance cannot serve as a basis for this exception. See Conference Report, at 388 n.505.

54 Four recent cases demonstrate continuing differences in the way that courts interpret and apply the economic substance doctrine to shelter transactions. Three of these were won by the taxpayer and two involved LTs. See Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004); Black & Decker Corp. v. United States, 2004 WL 2375610 (D. Md. 2004); Coltec Industries, Inc. v. United States, 2004 WL 2480664 (Fed. Cl. 2004); TIFD III-E Inc. v. United States, 2004 WL 2471581 (D. Conn. 2004).