THE NEW PENALTY REGIME: PROCEED WITH CAUTION!

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This article was originally published in The Tax Executive (Nov.-Dec. 2004) and is reprinted here with permission of the Tax Executives Institute. It reviews recently enacted penalties and related statutory provisions and administrative requirements designed to strengthen the government’s hand in its battle against abusive tax shelter transactions, particularly when required disclosure of those transactions is not made. Beller demonstrates that the new rules directly affect both the taxpayers and their advisers, and could in some instances result in significant changes in the nature and scope of the professional relationship between tax practitioners and their clients.

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We all knew it had to happen sooner or later. After several false starts over the past few years, Congress recently passed a robust package of anti-tax-shelter measures as part of the American Jobs Creation Act of 2004. 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, in some circumstances, their outside advisers as well.

I. Overview

New section 6707A 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 that transaction is successfully challenged by the IRS on the merits (the 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; that is, 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 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 so-called 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 Securities and Exchange Commission their required payment of any Nondisclosure Penalty regarding an LT. SEC reporting

1 P.L. 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 most recently amended.
also is required for increased accuracy penalties imposed for undisclosed LTs or RATs.

Additional new penalties apply to “material advisers” (MAs), who are now required to file special information returns for any RT advised on. 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. Treasury has already issued important interim guidance on some aspects of the MA rules.

The new rules are generally effective for transactions reportable in returns due after October 22, 2004. Taken together, they put real teeth into the RT disclosure regulations; place added pressure on companies to implement effective internal procedures for identifying and reporting RTs; and could 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 regarding whether the transaction is an RT or the adviser is an MA — and, if so, what disclosure responsibilities and potential penalties follow from that status.

II. The Nondisclosure Penalty

The Nondisclosure Penalty is imposed on 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 an LT or another type of RT, and also depending on the type of taxpayer involved (but not, as under the Senate bill, on the size or wealth of the taxpayer). The penalty is effective for RTs (LTs or otherwise) for which disclosure is required in returns or statements due after October 22, 2004 (the date of enactment).

A. 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 nonindividual taxpayers. It cannot be waived, rescinded, or abated under any circumstances, that is, 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 that are “substantially similar” to an LT. Those include transactions 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 as to substantially similar status by filing a protective disclosure under a procedure specifically permitted under the RT regulations. Some 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; imposition of a Nondisclosure Penalty regarding an 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 an LT in a tax year after the year in which the transaction was entered and 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 for 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 regarding the transaction is furnished.

B. Other Reportable Transactions

For RTs that are not LTs, the Nondisclosure Penalty drops to $50,000 for corporations and other nonindividual taxpayers. The categories of nonlisted RTs include:

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

Footnote continued in next column.

4Jobs Act, section 811(c). Returns due after that date on extension are presumably covered, but the act language is arguably ambiguous on that point.
5Section 6707A(d)(1)(A).
6Notice 2004-67, 2004-41 IRB 600, Doc 2004-19024, 2004 TNT 187-8, describes each of these transactions and references the
transactions of public companies, or nonpublic companies with gross assets of at least $250 million, that give rise to book-tax differences exceeding $10 million;\(^{13}\)

- transactions offered by promoters or other third parties under conditions designed to require confidentiality of the tax structure or treatment of the transaction;\(^{14}\)

- 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;\(^{15}\) and

- transactions that generate a tax credit exceeding $250,000 in connection with particular assets held by the taxpayer for less than 45 days.\(^{16}\)

For large companies, transactions involving substantial section 165 losses or book-tax differences are likely to be the most prevalent types of nonlisted 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 “angel lists” describing various loss transactions\(^{17}\) and book-tax differences\(^{18}\) that are exempted from disclosure, as well as other exceptions under the “contractual protection” and “brief asset holding period” RT triggers.\(^{19}\) 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 for 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.\(^{20}\)

A Nondisclosure Penalty imposed for a nonlisted RT can be waived, rescinded, or abated — but only by the IRS commissioner 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.\(^{21}\) The Jobs Act conference report states that, in exercising that 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.”\(^{22}\)

Within the limits of those criteria, the commissioner ought to be inclined to exercise his authority favorably in the case of corporations or other business entities who can demonstrate that they have attempted in good faith 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, occasional corporate foibles in this area are almost certain to occur. That is especially so in the case of large multinational

\(^{13}\)Treas. reg. section 1.6011-4(b)(6).

\(^{14}\)Treas. reg. section 1.6011-4(b)(3). As originally proposed and finalized, 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 generally could be avoided in those instances only by resort to a carefully worded “tax carveout” provision, or by reliance on certain other exceptions the application of which was often uncertain. In response to continuing widespread taxpayer and practitioner group criticism of these rules after the RT regulations were finalized in February 2003, Treasury agreed that a narrower confidentiality trigger was appropriate. On December 30, 2003, the final regulations were amended accordingly.

\(^{15}\)Treas. reg. section 1.6011-4(b)(4). The preamble to the RT regulations 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.

\(^{16}\)This category focuses principally on foreign tax credits in respect of dividends received on briefly held stock, like those that two federal appeals courts have sustained. \(\text{Compag Computer Corp. and Subsidiaries v. Commissioner, 277 F.3d 778, Doc 2002-184, 2002 TNT 1-3 (5th Cir. 2001), rev’g 113 T.C. 17 (1999); IES Industries, Inc. v. U.S., 253 F.3d 350, Doc 2001-16769, 2001 TNT 116-12 (8th Cir. 2001), rev’g 999 W.L. 973538, Doc 1999-32487, 1999 TNT 196-60 (N.D. Iowa 1999).}\)

\(^{17}\)Rev. Proc. 2004-66, 2004-50 IRB 966, Doc 2004-22049, 2004 TNT 222-10 (Nov. 16, 2004), modifying and superseding Rev. Proc. 2003-24, 2003-11 IRB 599, Doc 2003-5359, 2003 TNT 40-12, protects losses arising, for example, out of market-to-market and hedging transactions, bulk sales of inventory, and the abandonment of depreciable 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 (Footnote continued in next column.)
companies with numerous foreign subsidiaries or interests in noncorporate affiliates involving unrelated partners.

C. 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 tax year, disclosure must be made on an IRS Form 8886. That 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 presumably would be set for imposition of a Nondisclosure Penalty. Again, it is hoped that in those 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.

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

A. Old Regime
Section 6662(a) imposes a 20 percent “accuracy-related” penalty for 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 that position.

More stringent rules apply 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 before the Jobs Act, noncorporate 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, better than 50 percent, correct. For corporate taxpayers, however, the only way out of a penalty for 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 that first appeared in the disclosure and list maintenance regulations that were proposed in early 2000 and not finalized until early 2003. However, 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 on the outside opinion.

B. New Regime
The Jobs Act leaves old section 6662 intact for (i) non-LTs and (ii) RTs other than LTs or RATs, except that a “substantial understatement” regarding those transactions now exists for corporate taxpayers if the amount of the understatement for the tax 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 tax year involved.

Also, 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.30 Public companies must report 30 percent penalties to the SEC.31 And under new section 163(m), no deduction is permitted for interest paid regarding an RTU arising out of an undisclosed RT.

The statutory description of an 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 that 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.32

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.

Drawing the line between RATs and non-RATs may prove to be a difficult exercise, because most transactional structuring and planning is typically done with a view toward minimizing tax consequences.

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.

C. Reportable Avoidance Transactions

Not all nonlisted 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 to be a difficult exercise, because 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.”33 Moreover, the existing section 6662 regulations provide that a transaction will not be considered as having a “principal purpose” of tax avoidance (that is, 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.34

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. That will most likely be the case when 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.

D. Strengthened Reasonable Cause Exception

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;

30Section 6662A(c).
31Section 6707(a)(2)(B). SEC reporting also is required for any 40 percent “gross valuation penalty misstatements” penalty (per section 6662(h)(2)) for 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 LTs. Section 6707(a)(2)(C).
32Conference report at 377. For purposes of step (1), any reduction in (i) the excess of allowable deductions over gross income for the tax year or (ii) the amount of capital losses that would be allowed for the year is treated as an “increase in taxable income.” Section 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 opening of an IRS audit of the return or (ii) such other date prescribed by regulations. Section 6662A(e)(3).
33Treas. reg. section 301.6111-2(b)(3)(i).
34Treas. reg. section 1.6662-4(g)(2)(ii). The regulation goes on to cite several obvious examples of tax benefits expressly sanctioned by the code — including, among others, purchasing tax-exempt bonds; electing S corporation status; claiming accelerated depreciation deductions; and establishing a qualified retirement plan.
that 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 regarding the Nondisclosure Penalty, disclosures that are late or lack sufficient detail may prevent application of the SRCE.35 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.”36 The requirement can be satisfied by case law or other substantial authority existing when the return is filed, even if that authority may have arisen after the end of the tax year to which the return relates.37

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.38 Although not required, a taxpayer’s reasonable belief may be demonstrated by good faith reliance on an opinion of a professional tax adviser. Existing Treasury regulations elaborate on the factual and legal diligence requirements that outside opinions must satisfy in tax shelter contexts.39 However, that reliance will not be respected in the case of an LT or a RAT if the opinion giver is a “disqualified tax adviser” (DTA) or the opinion is a “qualified tax opinion” (DTO).

E. Disqualified Tax Advisers/Opinions

Under new section 6664(d)(3)(B)(ii), an outside tax adviser can be a DTA if he or she:
- is a “material adviser” and participates in the organization, management, promotion, or sale of the transaction;
- is compensated directly or indirectly by an MA regarding 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 noncontingent and paid directly by the taxpayer, cannot be a DTA unless he or she is an MA. For corporate transactions, that requires the receipt of fees in excess of $250,00040 for “material aid, assistance or advice” in connection with “organizing, managing, providing, selling, implementing, insuring, or carrying out all or any portion of” the transaction.41

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 in the tax consequences of the transaction. Any additional involvement by the adviser (or other persons in the same firm) in the “structuring” or “documentation” of the transaction would render the adviser a DTA.42 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 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 want a penalty protection opinion undertake the added cost of retaining separate outside advisers to handle the tax and nontax aspects of the transaction. Forthcoming published guidance hopefully will permit at least some degree of flexibility in that 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 that restriction, disqualification occurs if the opinion:
- is based on unreasonable factual or legal assumptions (including as to future events);
- 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 any other requirement prescribed by Treasury.

Those diligence requirements apparently are designed to track those prescribed for tax shelter opinions by Circular 230, which governs practice before the Treasury Department.43 They also are similar to the opinion reliance

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35 The adequate disclosure requirement is deemed satisfied if a Nondisclosure Penalty regarding the transaction was rescinded by action of the commissioner. Section 6664(d)(2)(C).
36 Treas. reg. sections 1.6662-4(d)(3)(i) and (iii).
38 Section 6664(d)(3)(A). The possibility of no audit, or settlement if the reported treatment is challenged, may not be considered.
39 Treas. reg. sections 1.6662-4(g)(4), and 1.6664-4(c) and (e).
40 A $50,000 fee threshold applies if substantially all the tax benefits from the RT are provided to natural persons. Section 6111(b)(1)(B). Although not entirely clear, recent interim guidance appears to drop the MA fee threshold to $25,000 for corporate LTs ($10,000 for noncorporate). See Notice 2004-80, supra note 3; Treas. reg. section 301.6112-1(c)(3)(ii).
41 Section 6111(b)(1)(A)(i). The fee threshold calculation includes fees attributable to tax or nontax work performed by anyone in the tax adviser’s firm. See Notice 2004-80, supra note 3; Treas. reg. section 301.6112-1(c)(2)(ii).
42 See conference report at 378-379.
43 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. (The latter two sanctions were added by section 822 of the Jobs Act, which also “clarifies” that Treasury’s authority to regulate “practice” before the IRS extends to the providing of tax opinions or advice to taxpayer-clients.)
criteria articulated in existing regulations that address application of the "good faith/reasonable" cause exception under section 6664(c).44

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, that may not follow automatically from the mere fact that an opinion is sought and received from well-respected counsel. In that regard, a recent federal district court decision45 suggests that tax-savvy client personnel need to closely review the opinion 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.46

F. Reportable Transactions Other Than RATs

Transactions that are RTs, but not RATs, remain subject to a 20 percent accuracy-related penalty under the rules of section 6662. Because those 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.47

G. Nonreportable 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 those cases only via the "old" good faith/reasonable cause exception of section 6664(c). When 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 IRS might still seek to challenge the quality of the opinion for penalty avoidance purposes based on similar concepts.48

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 those 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.

IV. 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 advisers" regarding any RT must file (within 30 days after becoming an MA) an information return which provides information identifying and describing the transaction, any potential tax benefits expected to result therefrom, and any other information Treasury may require.49 Those returns will essentially replicate the RT information 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 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 that date.

A. Definition of 'Material Adviser'

First introduced in the list maintenance regulations, the term "material adviser" is now statutorily defined (in section 6111(b)(1)) to include any person who provides "material aid, assistance or advice" in connection with

44See Treas. reg. sections 1.6662-4 and 1.6664-4.
46That was not the case in 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.
47The failure to adequately disclose a non-RAT would in all events attract a Nondisclosure Penalty.
48Treasury may at some point amend the regulations to specifically require that only Circular 230-compliant opinions can be relied on to avoid a penalty under either section 6662 or section 6662A.
49Section 6111(a); Notice 2004-80, supra note 3. As also prescribed by Notice 2004-80, the filing date deadline is extended to February 1, 2005, if the adviser becomes an MA between October 22 and December 31, 2004; and at least temporarily, the MA information return is to be filed using a modified IRS Form 8264 (the old tax shelter registration application form).
various types of activity, including “organizing, managing, promoting, selling, implementing, insuring, or carrying out” any RT. Also, the 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 nonindividual taxpayers.\(^{50}\)

Recent interim guidance (IRS Notice 2004-80) announces that some aspects of the existing list maintenance regulations will be applied for purposes of the new statutory MA rules. In particular, (i) 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;\(^{51}\) (ii) the adviser must make a “tax statement” regarding the RT;\(^{52}\) and (iii) the fee threshold for corporate LTs will be only $25,000 (not $250,000).\(^{53}\)

Also, Notice 2004-80 provides that the rendering of tax advice regarding 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 he or she also makes a statement relating to the financial accounting treatment of the item(s) that give rise to the book-tax difference. That rule also excuses those advisers from the list maintenance obligation, but it does not eliminate the taxpayer’s responsibility for disclosing a book-tax difference on a Form 8886 or Schedule M-3.

B. Failure to File

The penalties for failure to file a required MA information return are by no means chicken feed. The baseline amount 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 intentionally disregarded the disclosure requirement).\(^{54}\)

The penalty applies to transactions reportable in returns due after October 22, 2004, but only if the MA has provided material aid, assistance, or advice regarding the transaction after that date.

No waiver of the penalty is possible for LTs. For other types of RTs, rescission or abatement authority can be exercised only by the commissioner, and only in the same limited circumstances that might permit waiver, rescission, or abatement of the Nondisclosure Penalty.\(^{55}\)

Apart from the penalty for failure to file an MA information return, new section 6708(a) imposes a $10,000 per day penalty on MA’s who fail to furnish required RT “list maintenance” information on expiration of the 20-day grace period following a request by the IRS. A “reasonable cause” exception is available for this penalty.\(^{56}\)

C. Potential Client Tension

Given those 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 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 upfront, so that the taxpayer knows for sure whether the adviser intends to file an MA information return, as well as the potential penalty exposure for its own failure to disclose an RT. In that 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 an RT subject to the list maintenance and MA information return requirements; and (ii) shall be held harmless for additional tax liability, penalties, or other financial damage that may result to the taxpayer from any furnishing of information pursuant to those requirements.

V. The Road Ahead

One of the main strategies of the government in its battle against abusive tax shelters is to shine an early spotlight on defined categories of RTs, by requiring detailed disclosures regarding the participants (including tax advisers), structures, and purported tax benefits of such transactions. To be sure, the current universe of RTs includes many transactions that are not tax-abusive and at the same time fails to reach many that are. In any event, the taxpayer disclosure rules that evolved in regulations over the past few years had no real teeth, because the code imposed no monetary penalty for nondisclosure alone. But with enactment of the Nondisclosure Penalty, the modified accuracy penalty and the other new statutory restrictions, the noncompliance 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 penalty regime places added pressure on the need to continue those efforts and to make them as foolproof as possible. It also changes the ground rules for relying on outside penalty protection opinions, including the scope and mix 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 on taxpayer behavior. Any inclination

\(^{50}\) A $50,000 threshold applies when substantially all the tax benefits from the RT are provided to natural persons. Section 6111(b)(1)(B).

\(^{51}\) See Treas. reg. section 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 when multiple MAs are involved.

\(^{52}\) For list maintenance purposes, a “tax statement” may be oral or written and must relate to a tax aspect of the transaction that causes it to become an RT. Treas. reg. section 301.6112-1(c)(2)(iii).

\(^{53}\) This reduction is apparently authorized by the parenthetical in section 6111(b)(1)(A)(ii) that defines “threshold amount” as “such other amount as may be prescribed by the Secretary.”

\(^{54}\) Section 6707(b). The penalty applies to both a complete failure to file and a filing of “false or incomplete information” regarding the RT. Section 6707(a).

\(^{55}\) Section 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.305.
that a taxpayer might have to refrain from disclosing an RT would seem especially foolhardy in the case of LTs or RATs, or when 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 provisions 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 reasonably, so as to prevent that from happening.

And finally, it ought not be forgotten that a number of significant antishelter 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 certification of corporate tax returns. Congressional attempts to resurrect those 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 those transactions are not properly disclosed.