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New IRS Disclosure Requirements Carry Serious Penalties

TOUTED AS ONE of the most substantial overhauls of the Internal Revenue Code in years, the American Jobs Creation Act of 2004 (Pub. L. No. 108-357, Jobs Act) was signed by the President on Oct. 22, 2004. Like any number of omnibus congressional tax bills, the Jobs Act is a broad-reaching collection of miscellaneous tax provisions in eight titles.¹

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

What is a Reportable Transaction?

The Jobs Act defines a reportable transaction broadly as a transaction that the secretary of the treasury has determined to have the “potential for tax avoidance or evasion.”² The six general categories of reportable transactions are the following:

- listed transactions,
- confidential transactions,
- transactions with contractual protection,
- loss transactions,
- transactions with a significant book-tax difference, and
- transactions involving a brief asset holding period.

Of these different types of reportable transactions, the so-called listed transactions are often singled out for special treatment. Listed transactions are transactions that are the same as or substantially similar to transactions that the IRS has already determined to be transactions conducted in order to avoid taxes.³ Confidential transactions are offered to a taxpayer under conditions of confidentiality and limit the taxpayer's ability to disclose the tax treatment or structure of the transaction for which the taxpayer paid an adviser a certain fee. A transaction with contractual protection is one that entitles a taxpayer to a re-

turn of fees if the intended tax consequence is not achieved or one that makes the fees contingent on the tax consequence being achieved.

Loss transactions are transactions whereby a corporate taxpayer claims a loss of either at least \$10 million in any single taxable year or \$20 million in any combination of taxable years. For individuals, the amount is reduced to \$2 million for any single year and \$4 million for any combination of taxable years. A transaction with a significant book-tax difference is one in which the amount for tax purposes of any item of income, gain, expense, or loss from the transaction differs by more than \$10 million from the amount of the item for book purposes. Finally, a transaction involving a brief period during which an asset is held is any transaction for which the taxpayer claims a tax credit in excess of \$250,000 but holds the underlying asset giving rise to the credit for a period of 45 days or less.⁴

Who Must Report a Reportable Transaction?

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

Material Advisers

A “material adviser” is defined as any person who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction. That person must also directly or indirectly derive gross income in excess of a threshold amount for the advice (currently set at \$50,000 for advice to individuals regarding reportable transactions and \$250,000 in all other cases).⁵

Any material adviser for a reportable transaction — generally a lawyer or an accountant — must file a return setting forth information that identifies the transaction and describes potential tax benefits expected to result from the transaction. The return must also include any additional information required by the secretary of the treasury. Any material adviser who *fails* to file the return as required or files false or incomplete information faces a serious penalty: the default penalty for any failure is set at \$50,000. As noted, listed transactions often receive special treatment, and in the case of failure to file a return with respect to a listed transaction, the penalty is *the greater of* \$200,000 or 50 percent of the gross

income (75 percent if the failure is intentional) derived from the assistance provided for the listed transaction.⁶

Whether or not a material adviser fits within these new reporting requirements — an adviser might not fit, for example, because the secretary of the treasury may prescribe regulations that provide certain exemptions from the reporting requirement — all material advisers must now maintain a list that identifies each person for whom the material adviser provided service with respect to a reportable transaction. Upon request, the material adviser must provide this list to the IRS within 20 days; failure to do so within that period will result in the imposition of a fine of \$10,000 per day.⁷

Taxpayers

Under regulations in effect before the Jobs Act, taxpayers were obligated to file a disclosure form any time they participated in a reportable transaction.⁸ However, there was no direct penalty for failing to file the required disclosure. The only penalty associated with failing to file the disclosure was a potential penalty imposed for underpayment; thus, if there was no underpayment, no penalty was imposed.

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

In addition to the direct penalty that results from failing to disclose participation in a reportable transaction, the Jobs Act also provides for the imposition of a new accuracy-related penalty that applies when an understatement results from either a listed transaction or from any other reportable transaction aimed at evading federal income tax. This penalty is equal to 20 percent of the amount of the understatement unless the transaction is not adequately disclosed, in which case the penalty is equal to 30 percent of the understatement.¹⁰

Additional Provisions Aimed at Minimizing the Benefits of Tax Shelters

Several other Jobs Act provisions are aimed at increasing compliance with disclosure requirements and minimizing the benefits of tax shelters. Under the new provisions, in some circumstances, written

communications between taxpayers and federally authorized tax practitioners¹¹ will no longer be entitled to “attorney-client” confidentiality protections if the communication involved promotion of or participation in a tax shelter.¹² In addition, 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 taxpayer or a material adviser provides the required information to the IRS.¹³

Furthermore, 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 from an undisclosed reportable transaction that is done to evade taxes.¹⁴ Finally, interest and penalties can now accrue with respect to reportable transactions even if the IRS does not notify the taxpayer of the basis for these additions within the normally required time frame.¹⁵

Further Considerations

Three additional

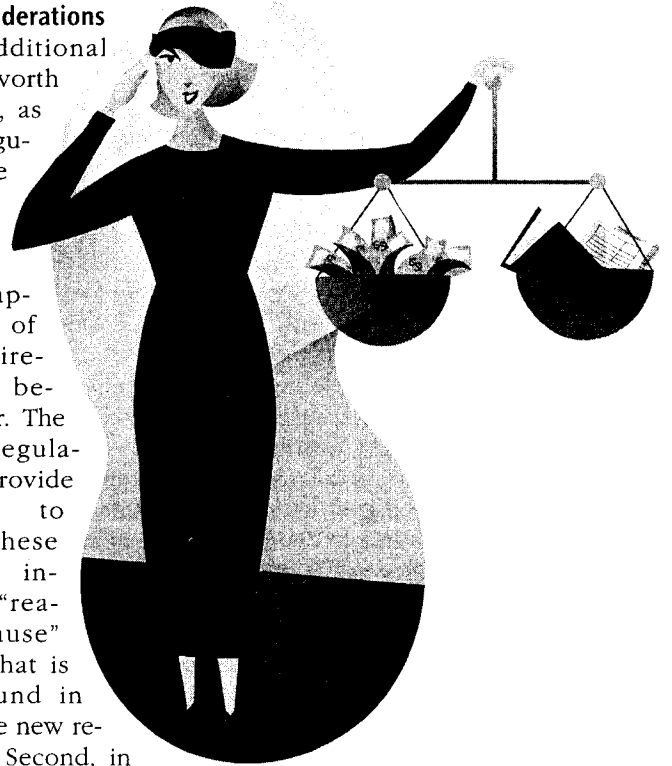
points are worth noting. First, as

Treasury regulations are developed under these

new provisions, the application of these requirements will become clearer. The Treasury regulations will provide exceptions to many of these provisions, including a “reasonable cause” exception that is already found in several of the new requirements. Second, in

some situations, multiple

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



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Habeas corpus, deference to state courts

Bell v. Cone, Jan. 24

The Sixth Circuit's conclusion that the Tennessee Supreme Court failed to cure the constitutional deficiency in a statutory "aggravating circumstance" justifying imposition of the death penalty failed to comport with the deference required by 28 U.S.C. § 2254(d). The Sixth Circuit based its decision overturning the respondent's death penalty on the state's reliance on the unconstitutionally vague "especially heinous, atrocious, or cruel" aggravating circum-

stance. Such instructions are unconstitutional without a narrowing construction. Although the Tennessee Supreme Court did not mention a narrowing construction, it is clear that it applied one. Because the state court had previously construed the "heinous, atrocious, or cruel" circumstance narrowly "and had followed that precedent numerous times, we must presume that it did the same thing here." Even without the presumption, however, it is clear that the court had applied the narrower construction. The facts on which the court relied to describe the brutal

beating murder of an elderly couple were sufficient to satisfy "the torture prong" of the narrowed construction, which requires evidence that the defendant inflicted torture on the victim before his or her death. The narrowing construction itself was not unconstitutionally vague. 9-0. Per curiam. Concurring opinion by Ginsburg, joined by Souter and Breyer. **TFL**

These summaries are prepared by George Costello of the Congressional Research Service for use by Congress.

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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. **TFL**



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Endnotes

¹The Jobs Act — an early version of which was known as the Jumpstart Our Business Strength Act — is perhaps most widely known for eliminating the extraterritorial income exclusion, which, according to the World Trade Organization, violated international trade agreements. Even though Title I of the Jobs Act accomplishes that goal, the Jobs Act goes further. The remaining sections are Title II, "Business Tax Incentives"; Title III, "Tax Relief for Agriculture and Small Manufacturers"; Title IV, "Tax Reform and Simplification for U.S. Businesses"; Title

V, "Deduction of State and Local General Sales Taxes"; Title VI, "Fair and Equitable Tobacco Reform"; Title VII, "Miscellaneous Provisions"; and Title VIII, "Revenue Provisions." This article focuses primarily on Title VIII, Subtitle B, "Provisions Relating to Tax Shelters."

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

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

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

⁵See I.R.C. § 6111.

⁶See I.R.C. § 6707.

⁷See I.R.C. § 6112 and § 6708.

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

⁹See I.R.C. § 6707A.

¹⁰See I.R.C. § 6662A.

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

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

¹³See I.R.C. § 6501(c).

¹⁴See I.R.C. § 163(m).

¹⁵See I.R.C. § 6404.