Notice 2005-11 – Interim Guidance on Tax Shelter Penalties

Our focus in this issue of Tax Controversy Trends is Notice 2005-11, the interim guidance for the new failure to disclose penalty that was enacted in October 2004. These disclosure rules are part of the Government’s effort to shut down abusive tax shelters, but they affect all taxpayers, including those who believe that they have never engaged in an aggressive deal. The new failure to disclose penalty includes substantial penalty amounts, possible SEC reporting, and very limited defenses. All taxpayers need to familiarize themselves with the disclosure rules and how the IRS intends to administer the penalty.

This discussion of Notice 2005-11 is provided by Julian Kim, a member of the Tax Controversy Practice Group at Latham & Watkins. Julian returned to the firm in November 2004, after spending the last two years as the acting Deputy Tax Legislative Counsel at the Treasury Department.

McGee Grigsby
Chair, Tax Controversy Practice Group

IRS Issues Penalty Guidance for Tax Shelters Disclosure Rules

The American Jobs Creation Act of 2004 created a new penalty for taxpayers who fail to disclose “reportable transactions” on their returns. Volume 1, Number 1 of this Newsletter discussed the new penalty and the six types of reportable transactions. Reportable transactions include not only specifically identified tax avoidance transactions but also broader categories of transactions such as those that give rise to large tax losses or significant book-tax differences. (Please contact us at tax.controtrends@lw.com if you would like a copy of that issue.)

This issue looks at Notice 2005-11, the interim guidance for the new penalty issued by the IRS on January 19, 2005. The Notice provides some rules for the new penalty, but many important questions remain unanswered.

The Failure To Disclose Penalty

Prior to the Act, no penalty was imposed on a taxpayer’s failure to disclose a reportable transaction. The Act added teeth to the existing regulatory requirements by imposing a substantial penalty for each failure to disclose. For natural persons, the penalty is $100,000 for each failure to disclose a “listed transaction” (i.e., a specifically identified tax avoidance transaction) and $10,000 for each failure to disclose any other reportable transaction. For all other taxpayers, such as corporations and partnerships, the penalty amounts are increased to $200,000 for listed transactions and $50,000 for other reportable transactions. The penalty does not depend on whether the transaction was otherwise properly reported by the taxpayer.

Notice 2005-11

Notice 2005-11 outlines the existing regulatory disclosure rules and the new failure to disclose penalty. Under the disclosure rules, a disclosure (Form 8886) must be filed with each income tax return reflecting the taxpayer’s “participation” in the reportable transaction. In addition, a copy of the Form 8886 must be sent to the IRS Office of Tax Shelter Analysis (OTSA) the first time it is filed with a return. The Notice then addresses the following aspects of the penalty.

Effective Date – Original and Amended Returns Filed after
October 22, 2004

The Notice clarifies that the new penalty applies to any failure to attach a Form 8886 to a return (including an amended return) that is filed after October 22, 2004. Prior to the Notice, it was unclear whether the penalty would apply to a late tax return – e.g., a Form 1120 due before October 22, 2004, but filed after October 22, 2004. The rule in the Notice is based on the Treasury regulations, which provide that the Form 8886 is due whenever the related tax return is filed, regardless of due date for that return. Accordingly, even if a tax return is filed late, the attached Form 8886 will be treated as having been submitted timely.

**Imposition of the Section 6707 Penalty**

The Notice confirms that the IRS will impose the failure to disclose penalty whenever a taxpayer fails to comply fully with Treasury regulations governing the disclosure of reportable transactions. As noted above, a new reportable transaction must be disclosed twice: by attaching the Form 8886 to the return for the first year in which the taxpayer participated in the transaction and by sending a copy of the form to OTSA. The Notice states that a taxpayer’s failure to do either, such as forgetting to send a copy to OTSA, will be treated as a failure subject to the new penalty.

A taxpayer must continue to disclose a reportable transaction as long as the taxpayer participates in the transaction. The Treasury regulations provide that a taxpayer participates in a reportable transaction if the return for the taxable year reflects “tax benefits” from the transaction. Tax benefits are defined very broadly (see sidebar), and a reportable transaction therefore may be subject to disclosure for years after it occurs.

**Rescission Authority**

There is very limited relief available to a taxpayer once the new failure to disclose penalty is asserted. The penalty is a strict liability penalty for any listed transaction that a taxpayer fails to disclose. Moreover, the usual “reasonable cause” defense does not apply to failures involving other reportable transactions. The Notice discusses the IRS’ limited rescission authority in these cases.

The Act provides that the IRS Commissioner may rescind all or part of the penalty if doing so would promote compliance and effective tax administration. The Notice states that the Commissioner’s decision (or the decision of the Commissioner’s delegate) will be based on “all of the relevant facts and circumstances,” including those specified in the legislative history (see sidebar). There is no judicial appeal of a decision by the Commissioner not to rescind a penalty, although the legislative history does state that a taxpayer may challenge the IRS’ determination that a transaction is a reportable transaction. The Notice emphasizes that the Commissioner’s decision is not subject to review by the IRS Appeals Division.

The Notice does not provide any additional guidance on the procedures or standards that will apply to the Commissioner’s rescission authority for the new penalty. Concepts such as effective tax administration, mistake of fact, and history of compliance are found in other parts of the tax code and the Treasury regulations, and the Treasury Department and the IRS may look to this existing authority in developing guidance for the new penalty. The Notice also requests comments on additional factors that should be considered by the Commissioner. In that regard, the Notice asks for comments on how a late, but voluntary, disclosure should be treated for purposes of the penalty. If the Treasury Department and the IRS want to encourage the voluntary disclosure of reportable transactions, late disclosures could be addressed in several ways. For instance, the regulatory rules for when a disclosure is due could be modified to take into account an inadvertent failure that a taxpayer later corrects by voluntarily filing the required disclosure. A far less attractive alternative for taxpayers would be to make voluntary disclosure a factor in the Commissioner’s rescission determination.

**Looking Ahead**

The Treasury Department and the IRS are working on several items of guidance in this area, including guidance on the requirement that “material advisors” also disclose reportable transactions to the IRS. These material advisor rules are important because they reach beyond those who give tax advice. They may cover, for example, a financial advisor who discusses tax issues or strategies with a client even if both the advisor and the client understand that the advisor is not giving tax advice. The new material advisor disclosure rules, and some of the questions that have been raised, will be discussed in the next issue of this Newsletter.
Latham & Watkins Tax Controversy Practice Group

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