

**TO DISCLOSE OR NOT  
TO DISCLOSE:  
TAX SHELTERS,  
PENALTIES, AND  
CIRCULAR 230 IN 2015<sup>©</sup>**

**Linda Z. Swartz  
Jean Marie Bertrand  
Cadwalader LLP**

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# **TO DISCLOSE OR NOT TO DISCLOSE: TAX SHELTERS, PENALTIES, AND CIRCULAR 230 IN 2015\***

**Linda Z. Swartz and Jean Marie Bertrand  
Cadwalader, Wickersham & Taft LLP**

**June 1, 2015**

## **I. TAX SHELTER REGULATIONS**

### **A. Overview**

- Disclosure requirements for participants in “reportable transactions.”
- List-maintenance requirements for “material advisors” with respect to reportable transactions.
- Disclosure requirements for “material advisors” with respect to reportable transactions.<sup>1</sup>

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\* The authors are grateful to Karen Gilbreath and David Miller for their contributions to an earlier version of this outline and to Kathryn Harrington, Stanley Barsky, and Jennifer Wetzel for their excellent updates.

<sup>1</sup> On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004 (the “JOBS Act”), which substantially increased the penalties and sanctions for failing to comply with the tax shelter regulations. In addition, the JOBS Act repealed the tax shelter registration requirements and created new reporting requirements for material advisors.

## II. TAX SHELTER DISCLOSURE REQUIREMENTS FOR PARTICIPANTS

### A. Overview

- Categories of Reportable Transactions<sup>2</sup>
  - Listed Transactions
  - Confidential Transactions
  - Loss Transactions
  - Contractual Protection Transactions
  - Transactions of Interest entered into on or after November 2, 2006
  - Patented Transactions would constitute a new category of reportable transaction under proposed regulations.<sup>3</sup>
- Participant Reporting Obligations
  - Every taxpayer “participating” in a reportable transaction that is required to file a U.S. tax return must:<sup>4</sup>
    - Mail IRS Form 8886 to the IRS Office of Tax Shelter Analysis for the first year the taxpayer participates in the transaction,
    - Attach IRS Form 8886 to its tax return (and any amended return) for each year in which

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<sup>2</sup> The fact that a transaction is a reportable transaction does not affect the legal determination of whether the taxpayer’s treatment of the transaction is proper. Treas. Reg. § 1.6011-4(a).

<sup>3</sup> Prop. Treas. Reg. § 1.6011-4(b)(7), 72 Fed. Reg. 54615 (Sept. 25, 2007).

<sup>4</sup> Treas. Reg. § 1.6011-4(a), (d).

the taxpayer participates in the transaction,<sup>5</sup>  
and

- Retain a copy of all documents and other records related to the reportable transaction that are material to an understanding of the tax treatment and tax structure of the transaction until the statute of limitations runs.<sup>6</sup> However, taxpayers are not required to retain non-substantive emails and other documents that are not material to the tax treatment or tax structure of the transaction. Taxpayers are also not required to retain earlier drafts of a document if they retain a copy of the final document (or, absent a final document, the most recent draft of the document), and such final document (or most recent draft) contains all the information found in earlier drafts that is material to an understanding of the

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<sup>5</sup> If a reportable transaction results in a loss which is carried back to a prior year, the disclosure statement for the reportable transaction must be attached to the taxpayer's application for tentative refund or amended tax return for that prior year. Treas. Reg. § 1.6011-4(e)(1).

In addition, the taxpayer must include the "reportable transaction number" received from material advisors with respect to the transaction on the Form 8886. Treas. Reg. § 1.6011-4(d).

<sup>6</sup> Treas. Reg. § 1.6011-4(g). The term "transaction" includes all of the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement, and includes any series of steps carried out as part of a plan. Treas. Reg. § 1.6011-4(b)(1).

The documents may include (i) marketing materials related to the transaction, (ii) written analyses used in transaction related decision-making, (iii) transaction related correspondence and agreements between the taxpayer and any advisor, lender, or other party to the reportable transaction, (iv) documents discussing, referring to, or demonstrating the purported or claimed tax benefits arising from the reportable transaction, and (v) any documents referring to the business purposes for the reportable transaction. Treas. Reg. § 1.6011-4(g).

purported tax treatment or tax structure of the transaction.<sup>7</sup>

- A taxpayer's failure to properly disclose a reportable transaction is a strong indication that the taxpayer did not act in good faith with respect to the transaction for purposes of the general reasonable cause and good faith exception to the accuracy related penalty.<sup>8</sup> Moreover, a taxpayer that has not adequately disclosed a reportable transaction in accordance with the tax shelter regulations may not rely on the adequate disclosure exception to the accuracy related penalty for disregard of rules and regulations.<sup>9</sup> Finally, the regulations deny the "realistic possibility" defense for a taxpayer that disregards a revenue ruling or notice with respect to a reportable transaction.<sup>10</sup>
- If a taxpayer requests a ruling on the merits of a specific transaction on or before the date disclosure would otherwise be required, and receives a favorable ruling as to the transaction, the disclosure rules will be satisfied if the ruling request fully discloses all relevant facts relating to the transaction which would otherwise be required to be disclosed.<sup>11</sup>
- If a taxpayer requests a ruling as to whether a specific transaction is a reportable transaction on or before the date that disclosure would otherwise be required, the IRS commissioner in his discretion may determine that the request satisfies the disclosure rules if the ruling request fully discloses all relevant facts relating to the

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<sup>7</sup> Treas. Reg. § 1.6011-4(g).

<sup>8</sup> Treas. Reg. § 1.6664-4(d).

<sup>9</sup> Treas. Reg. § 1.6662-3(a).

<sup>10</sup> Treas. Reg. § 1.6662-3(a).

<sup>11</sup> Treas. Reg. § 1.6011-4(f)(1).

transaction which would otherwise be required to be disclosed.<sup>12</sup>

- However, the taxpayer's potential disclosure obligation is not suspended while the ruling request is pending.<sup>13</sup>
- A protective disclosure filed with respect to a potentially reportable transaction that complies with all disclosure requirements would satisfy a taxpayer's potential obligation to disclose the transaction.<sup>14</sup>
- In the case of a taxpayer who is a partner in a partnership, a shareholder in an S corporation, or a beneficiary of a trust, the disclosure statement must be attached to the entity's return for each taxable year in which the entity participates in a reportable transaction.<sup>15</sup>
- If a taxpayer receives a timely Schedule K-1 less than 10 calendar days before the due date of the taxpayer's return (including extensions), the taxpayer must file the disclosure statement with the OTSA within 60 calendar days after the due date of the taxpayer's return (including extensions).<sup>16</sup>
- If a transaction becomes a listed transaction (discussed in Section II.B., below) or a transaction of interest (discussed in Section II.F., below) after the filing of a taxpayer's return (including an amended return), but before the end of the period of limitations for the taxpayer's final return reflecting the listed transaction, the taxpayer must file a disclosure statement with the OTSA within 90

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<sup>12</sup> Treas. Reg. § 1.6011-4(f)(1).

<sup>13</sup> Treas. Reg. § 1.6011-4(f)(1).

<sup>14</sup> Treas. Reg. § 1.6011-4(f)(2).

<sup>15</sup> Treas. Reg. § 1.6011-4(e)(1).

<sup>16</sup> Treas. Reg. § 1.6011-4(e)(1).

calendar days after the date on which the transaction became a listed transaction or transaction of interest, whether or not the taxpayer participated in the transaction in that subsequent year.<sup>17</sup>

- If a transaction becomes a loss transaction (discussed in Section II.D., below) because the losses equal or exceed the threshold amounts, a disclosure statement must be filed as an attachment to the taxpayer's tax return for the first taxable year in which the threshold amount is reached and to any subsequent tax returns that reflect any amount of loss from the transaction.<sup>18</sup>

## **B. Listed Transactions**

- A listed transaction is defined as any transaction the IRS designates as a tax avoidance transaction and

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<sup>17</sup> Treas. Reg. § 1.6011-4(e)(2)(i).

The statute of limitations on assessment of tax is generally three years after the later of the due date for filing a tax return or the date on which the taxpayer files its return. I.R.C. § 6501(a). Section 6501(c)(10) provides an exception to the general three-year period of limitations for certain listed transactions.

If the obligation to disclose a post-filing listed transaction arises after the expiration of the period of limitations on assessment for a taxable year in which the taxpayer participated in the post-filing listed transaction, section 6501(c)(10) will not reopen or extend the limitations period. However, if the limitations period on assessment has not expired, and the taxpayer fails to disclose the post-filing listed transaction as required by the regulations under section 6011, Section 6501(c)(10) provides that the limitations period on assessment with respect to the undisclosed listed transaction will not expire earlier than one year after the taxpayer discloses the transaction. See generally, Rev. Proc. 2005-26, 2005-1 C.B. 965.

Section 6404(g)(1) generally suspends the imposition of interest, penalties, additions to tax, or additional amounts if the IRS does not contact a taxpayer with possible adjustments to the taxpayer's liability within a certain time period. However, the suspension generally does not apply to interest, penalties, etc. with respect to a listed transaction or an undisclosed reportable transaction. I.R.C. § 6404(a)(2); Treas. Reg. § 301.6404-4(b)(5).

<sup>18</sup> Treas. Reg. § 1.6011-4(e)(2)(ii).

identifies in published guidance as a listed transaction (and any “substantially similar” transaction).<sup>19</sup>

- A “substantially similar” transaction is any transaction that is either factually similar to or based on a tax strategy that is the same as or similar to a transaction described in published guidance and is expected to obtain the same or similar types of tax consequences. The regulations provide that the term “substantially similar” must be broadly construed in favor of disclosure. Receipt of an opinion concluding that the tax benefits from the taxpayer’s transaction are allowable is disregarded in determining whether the taxpayer’s transaction is the same as, or substantially similar to, a listed transaction.<sup>20</sup>
- A taxpayer “participates” in a listed transaction if the taxpayer’s tax return reflects tax consequences or a tax strategy associated with a listed transaction (or the taxpayer “knows or has reason to know” that its tax benefits are derived directly or indirectly from a listed transaction).<sup>21</sup> “Tax benefits” include any deduction, deferral, basis adjustment, or any other tax reduction achieved by affecting the amount, timing, character, or source of any item of income, gain, expense, loss, or credit.<sup>22</sup>
- The IRS periodically publishes a notice in the Internal Revenue Bulletin that updates the compiled

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<sup>19</sup> Treas. Reg. § 1.6011-4(b)(2).

<sup>20</sup> Treas. Reg. § 1.6011-4(c)(4). The regulations also contain examples of transactions that are the same or substantially similar to listed transactions.

<sup>21</sup> Treas. Reg. § 1.6011-4(c)(3)(i)(A).

<sup>22</sup> Treas. Reg. § 1.6011-4(c)(5); Treas. Reg. § 1.6011-4(c)(6).

list of all transactions it has identified as “listed transactions.”<sup>23</sup>

### C. Confidential Transactions

- Prior regulations broadly defined a confidential transaction to include any transaction offered to a taxpayer under conditions of confidentiality, but also presumed that a transaction was not a confidential transaction if the transaction documents contained a “tax confidentiality waiver.”<sup>24</sup>
- In response to significant criticism regarding the breadth of the confidential category of reportable transactions,<sup>25</sup> the IRS issued regulations in 2004 that significantly narrowed the definition of a confidential transaction.<sup>26</sup>

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<sup>23</sup> For the current list of all identified “listed transactions,” see Notice 2009-59, 2009-31 I.R.B. 170.

<sup>24</sup> Treas. Reg. § 1.6011-4(b)(3) (revised Dec. 29, 2003).

Our firm’s standard tax confidentiality waiver provided as follows:

Notwithstanding anything to the contrary contained in this Agreement, all persons may disclose to any and all persons, without limitations of any kind, the U.S. Federal, state or local tax treatment of the Transaction, any fact that may be relevant to understanding the U.S. Federal, state or local tax treatment of the Transaction, and all materials of any kind (including opinions or other tax analyses) relating to such U.S. Federal, state or local tax treatment, other than the name of the parties or any other person named herein, or information that would permit identification of the parties or such other persons, and any pricing terms or other nonpublic business or financial information that is unrelated to the U.S. Federal, state or local tax treatment of the Transaction to the taxpayer and is not relevant to understanding the U.S. Federal, state or local tax treatment of the Transaction to the taxpayer.

<sup>25</sup> See, e.g., *Bond Market Association’s Comments on the Final Tax Shelter Regulations*, 2003 TNT 108-16 (June 5, 2003).

<sup>26</sup> For comments addressing the revisions to the confidentiality provisions, see *NYSBA Comments on Disclosure Regulations*, 2004 TNT 33-18 (Feb. 18, 2004); Udrys, Reeder and Church, *The Revised Confidentiality Filter: Top 12 Practical Implications*, 2004 TNT 46-8 (Mar. 8, 2004).

- A transaction is not treated as a confidential reportable transaction solely by reason of confidentiality limitations imposed by a principal to a transaction acting as such.<sup>27</sup> Instead, a transaction is treated as a confidential reportable transaction only if (i) an “advisor” limits the taxpayer’s ability to disclose the tax treatment, or the tax structure, of the transaction, (ii) the advisor imposing the limitation is paid a fee of at least \$50,000 (\$250,000 if the taxpayer is a corporation or a partnership or trust with solely corporate owners or beneficiaries), and (iii) the limitation on disclosure protects the confidentiality of the advisor’s “tax strategies.”<sup>28</sup>
- Query: What is a “tax strategy”? For example, government representatives have observed that a tax strategy may include routine statements made in tax disclosure, or made to principals (*e.g.*, a partnership will be treated as a partnership for tax purposes).
- A taxpayer “participates” in a confidential transaction if the taxpayer’s tax return reflects a tax benefit from the transaction and the taxpayer’s disclosure of the tax treatment or tax

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The IRS revised the final regulations in August 2007, but the principal change from the 2004 regulations appears to be the addition of a statement that the government will closely scrutinize all of the facts and circumstances to determine whether consideration received in connection with a confidential transaction constitutes fees. Treas. Reg. § 1.6011-4(b)(3).

<sup>27</sup> T.D. 9108, 2004-1 C.B. 429.

<sup>28</sup> Treas. Reg. § 1.6011-4(b)(3). The “tax treatment” of a transaction is the purported or claimed Federal income tax treatment of the transaction, and the “tax structure” of a transaction is any fact that may be relevant to understanding the tax treatment of the transaction. Treas. Reg. § 1.6011-4(c)(8), (9).

The regulations do not define the terms “tax strategies” or “tax advisor.”

structure of the transaction is limited in the manner described.<sup>29</sup>

- Because the term “advisor” is not defined in the regulations and has the potential to be interpreted quite broadly, many law firms and financial intermediaries continue to include tax confidentiality waivers in their documents to ensure non-confidentiality.
- Query: What is an “advisor”? Presumably an advisor includes any attorney, accountant, investment banker, or other individual that is paid a fee for advice regarding a “tax strategy.” Can it include a principal who discusses a tax strategy that affects deal pricing with other parties?
- Query: Will some or all fees received by an advisor that also participates in the transaction as a principal be considered received in that person’s capacity as principal?<sup>30</sup> Will a specific allocation of fees be respected? When will a person with two roles be treated as imposing

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<sup>29</sup> Treas. Reg. § 1.6011-4(c)(3)(i)(B). If a partnership’s, S corporation’s, or trust’s disclosure is limited and a partner’s, shareholder’s, or beneficiary’s disclosure is not, “participation” occurs only at the entity level. Treas. Reg. § 1.6011-4(c)(3)(i)(B). If both the entity and its partner’s, shareholder’s, or beneficiary’s disclosure are limited, “participation” occurs at both levels. Treas. Reg. § 1.6011-4(c)(3)(ii), *example 2*.

<sup>30</sup> The regulations provide that:

. . . all fees for a tax strategy or for services for advice (whether or not tax advice) or for the implementation of a transaction are taken into account . . . . A fee does not include amounts paid to a person, including an advisor, in that person’s capacity as a party to the transaction. For example, a fee does not include reasonable charges for the use of capital or the sale or use of property. Treas. Reg. § 1.6011-4(b)(3)(iv).

Corresponding revisions were made to the material advisor fee requirements of the tax shelter listing regulations.

confidentiality as an advisor rather than as a principal?

- A proprietary or exclusive transaction will not be treated as confidential if the advisor confirms to the taxpayer that there is no limitation on disclosure of the tax treatment or tax structure of the transaction.<sup>31</sup>
  - Query: What does it mean to “impose” confidentiality by limiting disclosure? Government representatives have agreed that if an advisor confirms to the taxpayer that there is “no limitation on disclosure of the tax treatment or tax structure of the transaction, other than limitations imposed by the SEC, other regulatory bodies, or under the law,” that confirmation should satisfy the regulations since the advisor has only referenced (but has not personally imposed) third party limitations on such disclosure.
  - Query: What result obtains if an advisor imposes confidentiality on an opposing principal party, but not on its own client acting as a principal?
  - Query: If an advisor permits the disclosure of the tax treatment and tax structure of a transaction, but imposes confidentiality on all other facts, including, for example, the advisor’s investment strategy, will the transaction be considered confidential for purposes of the regulations?
  - Query: Does a limitation on opinion reliance (*e.g.*, only the addressee is permitted to rely) constitute confidentiality?
  - Query: Will confidentiality imposed by an advisor for only a limited period of time,

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<sup>31</sup> Treas. Reg. § 1.6011-4(b)(3)(ii).

*i.e.*, during initial negotiations, now cause a transaction to be considered confidential?

- Ordinary course transactions such as debt and equity offerings, cash purchases and sales of stock and assets, and executive compensation arrangements should not be considered confidential transactions reportable by the participants, because they do not involve tax advice provided for a fee by an advisor imposing confidentiality. This result should obtain even if the tax consequences of such a transaction are set forth in disclosure, as long as no fee is paid for advice regarding a tax strategy. However, more complicated transactions, including certain M&A deals, joint ventures, and investment fund offerings, may include advisory fees (including fees embedded in returns paid to principals) and if so, those transactions should also include confidentiality waivers.
- Persons treated as related parties under section 267(b) or section 707(b) are treated as the same person for the purposes of confidential transaction rules.<sup>32</sup>

#### **D. Loss Transactions**

- A loss transaction is defined as any transaction that results in a loss under section 165 of at least:<sup>33</sup>
  - \$10 million in a single year or \$20 million in any combination of years for corporations and partnerships (all of whose partners are corporations).
  - \$2 million in a single year or \$4 million in any combination of years for all other taxpayers.

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<sup>32</sup> Treas. Reg. § 1.6011-4(b)(3)(v).

<sup>33</sup> Treas. Reg. § 1.6011-4(b)(5)(i)(A)-(E).

- \$50,000 in any single year for individuals or trusts that recognize a section 988 foreign currency loss.
- A taxpayer “participates” in a loss transaction if the taxpayer’s tax return reflects a section 165 loss equal to or greater than the applicable threshold.<sup>34</sup> In determining whether a transaction results in a loss that equals or exceeds a threshold, only losses claimed in the first taxable year the transaction occurs and the five succeeding taxable years are combined.<sup>35</sup>
- A safe harbor excepts from this category of reportable transactions, transactions involving assets in which the taxpayer has “qualifying basis.”<sup>36</sup>
- A taxpayer has “qualifying basis” in an asset only if the basis of the asset is equal to, and is determined solely by reference to, the amount

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<sup>34</sup> Treas. Reg. § 1.6011-4(c)(3)(i)(D). If the taxpayer is a partner in a partnership, shareholder in an S corporation, or beneficiary of a trust and the section 165 loss flows through the entity to the taxpayer (disregarding netting at the entity level), the taxpayer has “participated” in a loss transaction if the taxpayer’s tax return reflects a section 165 loss that exceeds the applicable threshold amount. Treas. Reg. § 1.6011-4(c)(3)(i)(D).

<sup>35</sup> Treas. Reg. § 1.6011-4(b)(5)(ii). In determining whether a transaction results in a loss that equals or exceeds a threshold, loss amounts are adjusted for any salvage value, insurance or other compensation received, but are not adjusted to reflect offsetting gains, or other income or limitations. The full amount of a loss is taken into account for the year in which the loss is sustained, regardless of whether all or part of the loss creates a net operating loss or a net capital loss that is carried back or carried over to another year. Similarly, a loss does not include any portion of a loss attributable to a capital loss carryback or carryover from another year that is treated as a deemed capital loss. However, a loss does include an amount deductible pursuant to a provision that treats a transaction as a sale or other disposition, or otherwise results in a deduction under section 165. Treas. Reg. § 1.6011-4(b)(5)(iii).

<sup>36</sup> Rev. Proc. 2004-66, 2004-2 C.B. 966.

(including any option premium) paid in cash by the taxpayer to acquire or improve the asset.<sup>37</sup> Revenue Procedure 2004-66 identifies several additional circumstances in which a taxpayer will be considered to have qualifying basis in an asset.<sup>38</sup>

- However, the qualifying basis safe harbor is not available if the asset is an interest in a “pass-through entity” other than a regular interest in a REMIC (*i.e.*, partnerships, PFIC equity interests, and REMIC residual interests do not qualify for the safe harbor).<sup>39</sup>
- Revenue Procedure 2004-66 exempts certain other losses.<sup>40</sup>

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<sup>37</sup> Rev. Proc. 2004-66, 2004-2 C.B. 966.

<sup>38</sup> A taxpayer also has qualifying basis if the basis of the asset is (i) determined under section 358 by reason of it being received in an exchange to which section 354, 355, or 361 applies, and the taxpayer had qualifying basis in the property exchanged, (ii) determined under section 1014, (iii) determined under section 1015, and the donor had qualifying basis, (iv) determined under section 1031(d), the taxpayer had qualifying basis in the property exchanged and any debt instrument issued or assumed by the taxpayer in exchange is treated as a payment in cash, (v) adjusted under section 961 or section 1.1502-32, and the taxpayer had qualifying basis in the asset immediately prior to the adjustment, or (vi) adjusted under section 1272(d)(2) or section 1278(b)(4), and the taxpayer had qualifying basis in the asset immediately prior to the adjustment. In addition, an amount included as compensation income under section 83 will be treated as an amount paid in cash by the taxpayer for an asset if the amount is included in the taxpayer’s basis in the asset. Rev. Proc. 2004-66, 2004-2 C.B. 966.

<sup>39</sup> The safe harbor is also not available if (i) the loss from the sale or exchange of the asset is an ordinary foreign currency loss, (ii) the asset has been separated from any portion of the income it generates, or (iii) the asset is or has in the past been part of a straddle, other than a mixed straddle under temporary Treasury regulation section 1.1092(b)-4T. Rev. Proc. 2004-66, 2004-2 C.B. 966.

<sup>40</sup> See Rev. Proc. 2004-66, 2004-2 C.B. 966. Revenue Procedure 2004-66 modifies and supersedes Revenue Procedure 2003-24, 2003-1 C.B. 599. Revenue Procedure 2004-66 exempts from the

## E. Contractual Protection Transactions

- Contractual protection transactions include any transaction for which:
  - The taxpayer has the right to a full or partial refund of fees paid to a tax advisor if some or all of the intended tax consequences from the transaction are not sustained,<sup>41</sup> or
  - The tax advisor's fees are contingent on the taxpayer's realization of the tax benefits from the transaction.<sup>42</sup>
- A taxpayer "participates" in a contractual protection transaction if the taxpayer's tax return reflects a tax benefit from the transaction and the taxpayer has the right to a refund of fees paid to a tax advisor or the taxpayer's obligation to pay fees to a tax advisor is

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category of "loss transactions," for example, a loss from fire, storm, shipwreck, or other casualty, or from theft.

<sup>41</sup> Treas. Reg. § 1.6011-4(b)(4)(i). This provision also applies if the party entitled to a refund is related to the taxpayer within the meaning of section 267(b) or section 707(b). All facts and circumstances are considered in determining whether a fee is refundable or contingent, including the right to reimbursement of amounts the parties have not designated as fees and any agreement to provide services without reasonable compensation. Treas. Reg. § 1.6011-4(b)(4)(i).

<sup>42</sup> Treas. Reg. § 1.6011-4(b)(4). The regulations provide that refundable or contingent fees will not be taken into account in determining whether the transaction has contractual protection if a tax advisor makes a statement as to the potential tax consequences of a transaction only after the taxpayer has entered into and reported the transaction on a filed tax return, and the person making the statement has not previously received fees from the taxpayer relating to the transaction. Treas. Reg. § 1.6011-4(b)(4)(iii)(B). This exception permits an attorney to receive contingent fees with respect to a tax controversy without causing the underlying transaction to be a reportable transaction.

contingent on the taxpayer's realization of tax benefits from the transaction.<sup>43</sup>

- Transactions in which a refundable or contingent fee is related to certain specified tax credits will not be considered contractual protection transactions unless they qualify as reportable transactions under another category of reportable transactions.<sup>44</sup>
- A party's right to terminate a transaction upon the happening of an event affecting the taxation of one or more parties is not a contractual protection transaction, *e.g.*, ISDA termination provisions.<sup>45</sup>

#### **F. Transactions of Interest**

- Regulations proposed in November 2006 and finalized in August 2007, added "transactions of interest" as an additional category of reportable transactions.<sup>46</sup>
- The regulations define a transaction of interest as a transaction that is the same as, or substantially

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<sup>43</sup> Treas. Reg. § 1.6011-4(c)(3)(i)(C). If a partnership, S corporation, or trust has the right to a full or partial refund of fees or has a contingent fee arrangement, and a partner, shareholder, or beneficiary does not individually have the right to the refund of fees or a contingent fee arrangement, "participation" occurs only at the entity level. Treas. Reg. § 1.6011-4(c)(3)(i)(C).

<sup>44</sup> Rev. Proc. 2007-20, 2007-7 I.R.B. 517. More specifically, a transaction in which a fee is refundable or contingent shall not be considered a contractual protection transaction if the transaction is related to the: (i) work opportunity credit under section 51, (ii) welfare-to-work credit under section 51A, (iii) Indian employment credit under section 45A, (iv) low-income housing credit under section 42(a), (v) new markets tax credit under section 45D, (vi) empowerment zone employment credit under section 1396(a), (vii) renewal community employment credit under section 1400H, or (viii) employee retention credit under section 1400R.

<sup>45</sup> Treas. Reg. § 1.6011-4(b)(4)(iii).

<sup>46</sup> Prop. Treas. Reg. § 1.6011-4(b)(6), 71 Fed. Reg. 64488, 64491 (Nov. 2, 2006); Treas. Reg. § 1.6011-4(b)(6).

similar to, one of the types of transactions that the IRS identifies by notice, regulation, or other form of published guidance as a transaction of interest.<sup>47</sup>

- The preambles to the proposed and final regulation provide that a transaction of interest is a transaction that the IRS and Treasury Department believe has a potential for tax avoidance or evasion, but for which they lack enough information to determine whether the transaction should be identified specifically as a tax avoidance transaction (*i.e.*, a listed transaction).<sup>48</sup> Accordingly, the regulations permit the IRS to gather information regarding transactions of interest without treating the transactions as listed transactions (described in Section II.B., above); the IRS may then use that information to determine whether a transaction of interest should become a listed transaction.
- Transactions of interest are identified in published guidance,<sup>49</sup> and a taxpayer will be considered to have “participated” in a transaction of interest if the taxpayer is one of the types or classes of persons identified in the transaction in that published guidance.<sup>50</sup>
- When the IRS and Treasury Department have gathered enough information to determine that a transaction of interest is a tax avoidance type of transaction, they may take actions, including re-classifying the transaction of interest as a listed transaction, or creating a new category of reportable transactions. Conversely, if it is determined that the transaction of interest is not a tax avoidance type of transaction, the transaction may be removed from

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<sup>47</sup> Reg. § 1.6011-4(b)(6).

<sup>48</sup> Prop. Treas. Reg. § 1.6011-4, preamble, 71 Fed. Reg. 64488 (Nov. 2, 2006); T.D. 9350, 72 Fed. Reg. 43146.

<sup>49</sup> Treas. Reg. § 1.6011-4(b)(6).

<sup>50</sup> Treas. Reg. § 1.6011-4(c)(3)(E).

the transaction of interest category in published guidance.<sup>51</sup>

- Listed transactions do not have to be transactions of interest before the transactions are identified as listed transactions.<sup>52</sup>
- The transactions of interest category of reportable transactions apply to transactions entered into on or after November 2, 2006.<sup>53</sup>
- The IRS has identified four transactions of interest thus far.<sup>54</sup>
  - The “Contribution of Successor Member Interest” transaction of interest involves a section 170 charitable contribution deduction for a section 170(c) transfer of certain real property interests that is significantly higher than the amount the taxpayer paid for the transferred rights.<sup>55</sup>
  - The “Toggling Grantor Trust” transaction of interest involves a purported termination and

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<sup>51</sup> Prop. Treas. Reg. § 1.6011-4, preamble, 71 Fed. Reg. 64488 (Nov. 2, 2006). Commentators recommended that the period of time during which a transaction may be considered a transaction of interest be limited to two years, unless the IRS and Treasury Department affirmatively act to extend the transaction’s status as a transaction of interest. However, the IRS and Treasury felt that a two year time limitation would hinder their ability to determine whether a certain transaction is a tax avoidance type of transaction, and did not adopt the suggestion in the final regulations. T.D. 9350, 72 Fed. Reg. 43146.

<sup>52</sup> Prop. Treas. Reg. § 1.6011-4, preamble, 71 Fed. Reg. 64488 (Nov. 2, 2006).

<sup>53</sup> Treas. Reg. § 1.6011-4(h)(1).

<sup>54</sup> See Notice 2009-55, 2009-31 I.R.B. 170 (listing the transactions of interest identified by the IRS and directing taxpayers to the “Abusive Tax Shelters and Transactions” tab at <http://www.irs.gov/businesses/corporations> for updates to the list).

<sup>55</sup> Notice 2007-72, 2007-36 I.R.B. 544.

subsequent re-creation of a trust's grantor trust status to allow the grantor to either (i) claim a tax loss in excess of the actual economic loss sustained by the taxpayer, or (ii) inappropriately avoid the recognition of gain.<sup>56</sup>

- The “Potential for Avoidance of Tax Through Sale of Charitable Remainder Trust Interests” transaction of interest involves the contribution of appreciated assets to a charitable remainder trust and their reinvestment by the trust, followed by the disposition of all interests in the charitable remainder trust, which results in the grantor or other noncharitable recipient receiving value from the trust while claiming to recognize little or no taxable gain.<sup>57</sup>
- The “Subpart F Income Partnership Blocker” transaction of interest involves a U.S. taxpayer that owns a CFC that holds stock of a lower-tier CFC through a domestic partnership and takes the position that neither subpart F income of the lower-tier CFC nor any section 956(a) amount related to holdings of U.S. property by the lower-tier CFC results in income inclusions under section 951(a) for the U.S. taxpayer.<sup>58</sup>

### **G. Leasing Transactions**

- Under prior regulations, certain commercial leases of tangible personal property described in Notice 2001-18<sup>59</sup> were excluded from all reportable transaction categories except the listed transaction category.<sup>60</sup> Final regulations issued in August 2007

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<sup>56</sup> Notice 2007-73, 2007-36 I.R.B. 545.

<sup>57</sup> Notice 2008-99, 2008-47 I.R.B. 1194.

<sup>58</sup> Notice 2009-7, 2009-3 I.R.B. 312.

<sup>59</sup> Notice 2001-18, 2001-1 C.B. 731.

<sup>60</sup> At the time, the IRS and Treasury determined that such exemptive relief was consistent with the objectives of the disclosure requirements in section 6111. Notice 2001-18, 2001-1 C.B. 731.

eliminate this special exclusion for leasing transactions and subject leasing transactions to the same disclosure rules as other transactions.<sup>61</sup>

## H. Patented Transactions

- Regulations proposed in September 2007 would add patented transactions to the list of reportable transactions. The IRS and Treasury Department have expressed concern that a patent for tax advice or tax strategies that have the potential for tax avoidance might be interpreted by taxpayers as approval by the IRS or Treasury Department of the transaction.<sup>62</sup> If issued in final form, the proposed regulations would apply to transactions entered into after September 25, 2007.<sup>63</sup>
- The proposed regulations define a patented transaction as (i) any transaction for which a taxpayer pays any fee to a patent holder for the legal right to use a tax planning method that is the subject of the patent, and (ii) any transaction for which a patent holder or its agent has the right to payment for another person's use of a

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<sup>61</sup> Treas. Reg. § 1.6011-4. *See also* Prop. Treas. Reg. § 1.6011-4, preamble, 71 Fed. Reg. 64488, 64489 (Nov. 2, 2006). The government believes that subsequent modifications to the reportable transaction categories excepted most customary commercial leasing transactions from the reportable transaction rules and therefore a specific exclusion is no longer necessary. Further, the IRS and Treasury Department intend to obsolete Notice 2001-18, 2001-1 C.B. 731, although this has not yet been accomplished.

<sup>62</sup> Prop. Treas. Reg. § 1.6011-4, preamble, 72 Fed. Reg. 71 Fed. Reg. 64488 (Nov. 2, 2006).

<sup>63</sup> Prop. Treas. Reg. § 1.6011-4(h)(2). The proposed regulations also describe when a person becomes a material advisor with respect to a patented transaction. According to the preamble, because of the nature of patented transactions and how they are marketed, the threshold fee amounts required to be received in order for a person to be treated as a material advisor are significantly reduced. Prop. Treas. Reg. § 1.6011-4, preamble, 72 Fed. Reg. 54615 (Sept. 26, 2007).

tax planning method that is the subject of the patent.<sup>64</sup>

- The taxpayer must know or have reason to know that the tax planning method is the subject of a patent.<sup>65</sup>
- Under the proposed regulations, a taxpayer would be considered to participate in a patented transaction if:
  - The taxpayer’s tax return reflects a benefit from the patented transaction, or
  - The taxpayer is the patent holder (or agent) whose tax return reflects either (i) a tax benefit in relation to obtaining a patent for a tax planning method (*e.g.*, any deduction for

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<sup>64</sup> Prop. Treas. Reg. § 1.6011-4(b)(7).

A “Patent” means a patent, either applied for or granted, under the provisions of title 35 of the United States Code, and a “patent holder” is defined by reference to Treasury regulation section 1.1235-2. Prop. Treas. Reg. § 1.6011-4(b)(7)(ii)(C). The “patent holder’s agent” is any person who (i) has patent holder’s permission to offer for sale, market, or sell a tax planning method subject to a patent, or (ii) receives (directly or indirectly) on patent holder’s behalf a fee in any amount for a tax planning method subject to a patent. Prop. Treas. Reg. § 1.6011-4(b)(7)(ii)(D). A “tax planning method” is any plan, strategy, technique, or structure designed to affect Federal income, estate, gift, generation skipping transfer, employment, or excise taxes. Prop. Treas. Reg. § 1.6011-4(b)(7)(ii)(F). The term does not include a patent issued solely for tax preparation software or other tools used to perform or model mathematical calculations or to provide mechanical assistance in the preparation of tax or information returns.

A “fee” includes any consideration that the taxpayer knows or has reason to know will be paid indirectly to the patent holder or patent holder’s agent (*e.g.*, a referral fee, fee sharing agreement, or license), but does not include settlement or damages payments in a suit for damages for infringement of the patent. Prop. Treas. Reg. § 1.6011-4(b)(7)(ii)(A).

<sup>65</sup> Prop. Treas. Reg. § 1.6011-4(b)(7).

payments to the United States Patent and Trademark Office), or (ii) income from a payment received from another person for the use of the patented tax planning method.<sup>66</sup>

## I. Former Reportable Transactions

- *Book-Tax Difference Transactions.* A transaction giving rise to a significant book-tax difference was defined as any transaction involving an SEC reporting company or a company with \$250 million or more in gross assets that gave rise to a book-tax difference under U.S. GAAP of more than \$10 million in any year, other than certain exempted transactions.<sup>67</sup>
- In January 2006, the IRS issued Notice 2006-6, which eliminated the book-tax difference category of reportable transactions. The removal of this category of reportable transactions applies to transactions that would otherwise have to be disclosed by taxpayers or disclosed or listed by material advisors on or after January 6, 2006.<sup>68</sup> The IRS issued final regulations in August 2007,<sup>69</sup> consistent with the Notice.
- *Brief Holding Period Transactions.* A tax credit transaction involving a brief holding period was defined as any transaction in which the taxpayer claimed tax credits exceeding \$250,000 and held the

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<sup>66</sup> Prop. Treas. Reg. § 1.6011-4(c)(3)(i)(F).

<sup>67</sup> Treas. Reg. § 1.6011-4(b)(6)(i), (ii)(A) (prior to August 2007).

<sup>68</sup> Notice 2006-6, 2006-1 C.B. 385.

<sup>69</sup> Treas. Reg. § 1.6011-4. The IRS and Treasury Department determined that characterization as a reportable transaction is no longer necessary since Schedule M-3 includes disclosure of book-tax differences for corporations.

underlying asset for 45 days or less (disregarding days for which the taxpayer was hedged).<sup>70</sup>

- Regulations issued in August 2007 removed the brief asset holding period transactions from the list of reportable transactions.<sup>71</sup>

## **J. Effect of Rules on Shareholders of Foreign Corporations**

- If a “controlled foreign corporation” (a “CFC”) enters into a transaction that would be a reportable transaction if the CFC were a domestic corporation, any United States person that owns 10% or more of the voting stock in the CFC is treated as participating in a reportable transaction.<sup>72</sup>

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<sup>70</sup> Treas. Reg. § 1.6011-4(b)(7) (prior to August 2007). The principles of section 246(c)(3) and (c)(4) applied for purposes of determining an asset’s holding period. Rev. Proc. 2004-68, 2004-2 C.B. 969.

Revenue Procedure 2004-68 had exempted the following transactions from brief asset holding period reportable transaction characterization: (i) in the case of transactions involving solely foreign tax credits, sales of inventory made in the ordinary course of the taxpayer’s trade or business, (ii) transactions involving a brief asset holding period under the principles of section 246(c)(4) solely by reason of (A) a hedge that reduces only the risk of interest rate or currency fluctuations, or (B) a guarantee issued by a related person, (iii) transactions involving a debt instrument that has a term of 45 days or less if the taxpayer’s holding period in the debt instrument equals the debt instrument’s entire term, and (iv) transactions that are not disallowed under section 901(l) resulting in a foreign tax credit for withholding taxes imposed in respect of non-dividend income or gain with respect to any property (including transactions eligible for the securities dealer exception under section 901(l)(2)). Rev. Proc. 2004-68, 2004-2 C.B. 969.

<sup>71</sup> Treas. Reg. § 1.6011-4. The IRS and Treasury Department determined that changes to section 901 rendered the brief asset holding period reportable transaction category unnecessary. *See* T.D. 9350, 72 Fed. Reg. 43146.

<sup>72</sup> Treas. Reg. § 1.6011-4(c)(3)(i)(G). A CFC is any foreign corporation in which U.S. persons holding 10% or more of the voting stock together own more than 50% of the vote or value of its stock. *See* I.R.C. § 957.

- If a “passive foreign investment company” (a “PFIC”) enters into a transaction that would be a reportable transaction if the PFIC were a domestic corporation, any United States person that owns 10% or more of the stock (by vote or value) of a PFIC with respect to which it has made a “qualified electing fund” election is treated as participating in a reportable transaction.<sup>73</sup>

### **K. Effect of Rules on Tax-Exempt Entities**

- Certain tax-exempt entities that (i) become a party to a “prohibited tax shelter transaction” or (ii) that are parties to a subsequently listed transaction may be subject to an excise tax and disclosure obligations for the taxable year in which the entity becomes a party to the transaction and any subsequent taxable year.<sup>74</sup> Any manager that knowingly approves of a prohibited tax shelter transaction is also subject to tax.<sup>75</sup>
- A “prohibited tax shelter transaction” is any listed transaction, any reportable confidential transaction or any reportable transaction with contractual protection.<sup>76</sup>

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<sup>73</sup> Treas. Reg. § 1.6011-4(c)(3)(i)(G). A PFIC is a foreign corporation 75% or more of the income of which is passive or 50% or more of the assets of which generate passive income. *See* I.R.C. § 1297.

<sup>74</sup> I.R.C. § 4965(a).

<sup>75</sup> I.R.C. § 4965(a)(2). The regulations divide the tax-exempt entities referred to in section 4965(c) into “non-plan” entities and “plan” entities. Treas. Reg. § 53.4965-2(a). Non-plan tax-exempt entities include all section 501(c) and 501(d) entities, entities described in section 170(c) (other than the United States), and Indian tribal governments; plan tax-exempt entities include all other types of tax-exempt entities (*e.g.*, IRAs, certain benefit plans; qualified tuition plans).

Plan and non-plan entities are subject to the same excise tax, but the distinction is important in defining managers who are potentially subject to an excise tax (discussed below).

<sup>76</sup> I.R.C. § 4965(e)(1)(A), (C). The terms “listed transaction,” “confidential transaction” and “transaction with contractual

- Final regulations issued on July 6, 2010, set forth a two prong test for when a tax-exempt entity will be considered a “party” to a transaction.<sup>77</sup>
  - Under the final regulations, a tax-exempt entity is a party to a transaction if it (i) facilitates the transaction by reason of its tax-exempt, tax indifferent, or tax-favored status, or (ii) is identified in published guidance, by type, class or role, as a party to a prohibited tax shelter transaction.<sup>78</sup>
- The amount of the excise tax imposed on a tax-exempt entity that is a party to a prohibited tax shelter transaction is equal to 35% of the greater of (i) 100% of the entity’s net income for the taxable year which is attributable to the transaction, and (ii) 75% of the entity’s proceeds for the taxable year which are attributable to the transaction,<sup>79</sup> unless the

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protection” are defined by cross-reference to the reportable transaction rules in section 6707A. I.R.C. § 4965(e)(1)(B), (C).

<sup>77</sup> Treas. Reg. § 53.4965-4(a). T.D. 9492.

<sup>78</sup> Treas. Reg. § 53.4965-4(a)(1) and (2).

The regulations permit the IRS to identify in future guidance tax-exempt entities that will not be treated as a party to a prohibited transaction. Treas. Reg. § 53.4965-4(b).

Proposed regulations issued in July 2007 would have expanded the definition of a “party” to a prohibited tax shelter transaction to include a tax-exempt entity that enters into a listed transaction that reduces or eliminates the entity’s Federal employment, excise or unrelated business income taxes. Prop. Treas. Reg. § 53.4965-4. However, the final regulations did not contain this part of the definition and thus a tax exempt entity entering into a transaction to reduce its own tax liability will not be considered to be a party to a prohibited tax shelter transactions, unless the IRS identifies a specific transaction or circumstance in published guidance. T.D. 9492.

<sup>79</sup> I.R.C. § 4965(b)(1)(A). Treasury regulations provide that the net income attributable to a tax-exempt’s prohibited tax shelter transaction is the gross income derived by the tax-exempt from the transaction, reduced by allowable deductions and certain taxes attributable to the transaction. Treas. Reg. § 53.4965-8(b)(1). The

tax-exempt entity knew or had reason to know that the transaction was a prohibited tax shelter transaction at the time it entered the transaction, in which case the excise tax is the greater of (i) 100% of the entity's net income for the taxable year attributable to the prohibited transaction, or (ii) 75% of the proceeds for the taxable year attributable to the transaction.<sup>80</sup>

- A tax-exempt entity will be treated as knowing or having reason to know that it was entering into a prohibited tax shelter transaction if at

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proceeds attributable to a transaction entered into by a tax-exempt entity that facilitates the transaction by reason of its tax-exempt, tax indifferent or tax-favored status is equal to the gross amount of the consideration received for facilitating the transaction without taking into account any costs or expenses attributable to the transaction. Treas. Reg. § 53.4965-8(b)(2). The IRS may designate additional amounts as "proceeds" in published guidance related to a particular transaction. Treas. Reg. § 53.4965-8(b)(2).

<sup>80</sup> I.R.C. § 4965(b)(1)(B). A tax-exempt entity that became a party to a transaction before the IRS identified the transaction as a listed transaction is similarly subject to an excise tax in an amount equal to 35% of the greater of (i) 100% of the entity's net income attributable to the transaction, and (ii) 75% of the entity's proceeds attributable to the transaction. I.R.C. § 4965(b)(1)(A)(i)(II), (ii)(II). In the case of such a subsequently listed transaction, the entity's income and proceeds are allocated between the period before the transaction became listed and the period beginning on the date the transaction became listed, and the income or proceeds taken into consideration for purposes of the excise tax is the amount that is properly allocated to the periods (i) beginning on the later of the date the transaction is listed or the first day of the taxable year. I.R.C. § 4965(b)(1)(A)(i)(II), (ii)(II); Treas. Reg. § 53.4965-7(a)(1)(ii). The regulations treat the periods (i) beginning on the first day of the listing year and ending on the day immediately preceding the date of the listing, and (ii) beginning on the date of the listing and ending on the last day of the listing year, as short taxable years solely for purposes of allocating net income and proceeds under section 4965. Treas. Reg. § 53.4965-8(e).

The regulations generally allocate net income and proceeds attributable to a prohibited tax shelter transaction consistently with the tax-exempt entity's established method of accounting. Treas. Reg. § 53.4965-8(c)(1).

least one of its managers knew or had reason to know that the transaction was a prohibited tax shelter transaction at the time the manager approved or caused the entity to become a party to the transaction.<sup>81</sup>

- An excise tax will also be imposed on any manager of a tax-exempt entity who knew or who had reason to know that a transaction was a prohibited tax shelter transaction and approved or caused the entity to become a party to the transaction.<sup>82</sup>
  - The manager excise tax is \$20,000 for each approval or act causing the entity to participate in a prohibited tax shelter transaction.<sup>83</sup>
  - In general, regulations adopt a facts and circumstances test and reasonable person standard to determine whether an entity's manager knows or has reason to know that the transaction is a prohibited tax shelter transaction.<sup>84</sup>

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<sup>81</sup> Treas. Reg. § 53.4965-6(a). A non-plan entity would be treated as knowing or having reason to know that it was entering into a tax shelter transaction if a manager with the authority or responsibility of an officer, director, or trustee knows or has reason to know that the transaction is a prohibited tax shelter transaction, whether or not the manager causes the entity to be a party to the transaction. Treas. Reg. § 53.4965-6(a) (citing the definition of an entity manager in Treas. Reg. § 53.4965-5(a)(1)(i)).

<sup>82</sup> I.R.C. § 4965(a)(2).

<sup>83</sup> I.R.C. § 4965(b)(2).

<sup>84</sup> Treas. Reg. § 53.4965-6(b)(1). The entity manager must have knowledge of sufficient facts that would lead a reasonable person to conclude that the transaction is a prohibited tax shelter transaction. More specifically, the regulations provide that an entity manager would be treated as knowing or having reason to know that the transaction is a prohibited tax shelter transaction if sufficient facts are reasonably available to the manager that would lead a reasonable person in the manager's circumstances to conclude that the transaction was a prohibited tax shelter transaction.

- A manager may demonstrate that he did not have reason to know that a transaction was a prohibited tax shelter transaction if he reasonably, and in good faith, relied on a written opinion of a professional tax advisor that (i) is based upon all pertinent facts and circumstances and the law as it relates to these facts and circumstances, (ii) does not rely on unreasonable assumptions or representations and (iii) reaches a level of at least “more likely than not” that the transaction is not a prohibited tax shelter transaction.<sup>85</sup>

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Among other factors, the regulations consider (i) the presence of tax shelter indicia (*e.g.*, the transaction is of significant size relative to the receipts of the entity, the transaction is extraordinary considering the entity’s prior investment history, or the promised economic return is exceptional considering the amount invested or the absence of risk), (ii) whether the manager received a section 6011(g) disclosure statement indicating that the transaction might be a tax shelter transaction before entering into the transaction (or if the manager receives a statement that a partnership, hedge fund or other conduit may engage in a prohibited tax shelter transaction in the future), and (iii) whether the manager made appropriate inquiries into the transaction (*e.g.*, after receiving a disclosure statement). Treas. Reg. § 53.4965-6(b)(1).

<sup>85</sup> Treas. Reg. § 53.4965-6(c)(2). The reliance on an opinion will not be reasonable and in good faith if the manager “knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law,” and an opinion may not be relied upon if the manager fails to disclose a fact that he knows or reasonably should know is relevant to determining whether a transaction is a prohibited tax shelter transaction. Treas. Reg. § 53.4965-6(c)(2).

A manager is not required to procure the advice of a professional tax advisor, and failure to seek professional advice does not in and of itself give rise to an inference that the manager had reason to know the transaction is a prohibited tax shelter transaction. Treas. Reg. § 53.4965-6(c)(1).

A manager’s reliance on a written opinion of a professional tax advisor is unreasonable if the advisor is, or is related to a person who is, a material advisor with respect to the transaction. Treas. Reg. § 53.4965-6(c)(3).

- A manager will not be treated as knowing or having reason to know that a transaction (other than a confidential or contractual protection transaction) is a prohibited tax shelter transaction if the entity enters into the transaction before it is identified as a listed transaction by the IRS.<sup>86</sup>
- A manager is treated as causing a tax-exempt entity to enter into a prohibited tax shelter transaction if the manager (i) has the authority to commit the entity to the transaction (including as part of a larger committee), and (ii) exercises that authority.<sup>87</sup>
- A tax-exempt entity that is a party to a prohibited tax shelter transaction is required to disclose to the IRS on Form 8886-T (i) its participation in the prohibited transaction, and (ii) the identity of any other parties known by the tax-exempt entity to be a party to the transaction.<sup>88</sup>
- In addition, non-plan exempt entities that are a party to a prohibited tax-shelter transaction, and managers of such entities, must file an IRS Form 4720 on or before the due date (not including extensions) for

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<sup>86</sup> Treas. Reg. § 53.4965-6(d).

<sup>87</sup> Treas. Reg. § 53.4965-5(c)(1). A member of a collective body that commits the entity to a prohibited tax shelter transaction would be treated as exercising the authority to commit the entity to the transaction only if such member votes in favor of committing the entity to the transaction. Treas. Reg. § 53.4965-5(c)(2).

<sup>88</sup> I.R.C. § 6033(a)(2); Treas. Reg. § 1-6033-5(a). In general, IRS Form 8886-T must be filed before May 16th of the calendar year following the close of the calendar year during which (i) the tax-exempt entity enters into the prohibited tax shelter transaction, or (ii) the transaction is identified as a listed transaction, if it is so identified after the tax-exempt entity enters the transaction. Treas. Reg. § 1-6033-5(d). Penalties under section 6652(c)(3) apply for failure to properly file IRS Form 8886-T with respect to transactions entered into after May 17, 2006. Treas. Reg. § 1-6033-5(e), (f).

the entity's annual information return under section 6033(a)(1).<sup>89</sup>

- A taxable party<sup>90</sup> that knowingly participates with a tax-exempt entity in a prohibited tax shelter transaction must provide a written statement to the tax-exempt entity disclosing that the transaction is a prohibited transaction.<sup>91</sup>

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<sup>89</sup> Treas. Reg. § 53.6071-1(g). Managers of non-plan exempt entities, and non-plan exempt entities that do not file annual information returns, must file IRS Form 4720 before the 16th day of the fifth month following the close of the manager's or the entity's taxable year (respectively) during which the entity entered into the transaction.

With respect to plan exempt entities, the entity manager must file an IRS Form 5330 before the 16th day of the fifth month following the close of the manager's taxable year during which the entity entered into the prohibited tax shelter transaction. Treas. Reg. § 54.6011-1(c), (c).

<sup>90</sup> A "taxable party" is defined as a person identified as a taxable party by the Secretary in published guidance, or who has entered into any confidential transaction, contractual protection transaction or listed transaction, or a listed transaction or transaction of interest involving an estate tax, gift tax, employment tax, or excise tax. Treas. Reg. § 301.6011(g)-1(c).

<sup>91</sup> I.R.C. § 6011(g); Treas. Reg. § 301.6011(g)-1(a).

A tax-exempt entity is a party to a prohibited tax shelter transaction for purposes of section 6011(g) if the entity facilitates a prohibited tax shelter transaction by reason of its tax-exempt, tax indifferent or tax-favored status, or is identified in published guidance (by type, class or role). Treas. Reg. § 301.6011(g)-1(b) (cross referencing Treas. Reg. § 53.4965-4).

A disclosure statement must be provided to every tax-exempt entity that is a party to the transaction. Treas. Reg. § 301.6011(g)-1(e).

Multiple taxable parties required to disclose a prohibited tax shelter transaction to a tax-exempt entity may designate a single taxable party to make the disclosure statement; however, the non-designated taxable parties would not be relieved of their filing obligation if the designated party fails to file the disclosure statement. Treas. Reg. § 301.6011(g)-1(h).

- The written statement must be provided to the tax-exempt entity by the later of 60 days after (i) the person becomes a taxable party, or (ii) the taxable party knows or has reason to know that a tax-exempt entity is a party to the transaction.<sup>92</sup>
- The written statement must identify the type of prohibited tax shelter transaction and state that the tax-exempt entity's involvement in the transaction may subject the entity and/or its manager to excise taxes and disclosure obligations.<sup>93</sup>
- A taxable party is required to provide written statement only if it knows or has reason to know (based on the facts and circumstances) that a tax-exempt entity is a party to a prohibited tax shelter transaction.<sup>94</sup>
- Penalties under section 6707A apply to any taxable entity that fails to provide a required written disclosure statement to a tax-exempt

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<sup>92</sup> Treas. Reg. § 301.6011(g)-1(d). A taxable party is not required to make the disclosure if it does not know and does not have a reason to know that a tax-exempt entity is a party to the transaction on or before the first date on which the person is required to disclose the listed transaction or transaction of interest. Treas. Reg. § 301.6011(g)-1(d)(2).

<sup>93</sup> Treas. Reg. § 301.6011(g)-1(f).

The written statement must be provided to any manager (or the primary contact on the transaction if the manager is unknown) in the case of a non-plan exempt entity, and to a manager who caused the tax-exempt entity to enter the transaction in the case of a plan exempt entity. Treas. Reg. § 301.6011(g)-1(g).

<sup>94</sup> Treas. Reg. § 301.6011(g)-1(a). This determination may be based on the extent of the efforts made to determine whether a tax-exempt entity is facilitating the transaction and the extent of the efforts made to determine the identity of the tax-exempt entity. Treas. Reg. § 301.6011(g)-1(a)(2).

entity.<sup>95</sup> The amount of the penalty is 75% of the decrease in tax shown on the return as a result of the transaction.<sup>96</sup> The maximum penalty is \$10,000 in the case of a natural person or \$50,000 in any other case (unless the transaction is a listed transaction, in which case the penalty is \$100,000 in the case of a natural person or \$200,000 in any other case).<sup>97</sup> The minimum penalty is \$5,000 in the case of a natural person or \$10,000 in any other case.<sup>98</sup>

- The excise tax imposed on tax-exempt entities entering into prohibited tax shelter transactions and their entity managers is effective for taxable years ending after May 17, 2006, with respect to transactions entered into before, on or after May 17, 2006.<sup>99</sup> The disclosure requirements apply to any disclosure the due date for which is after May 17, 2006.<sup>100</sup> The regulations relating to tax-exempt entities entering into prohibited tax shelter transactions apply for taxable years ending after July 6, 2007.<sup>101</sup>

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<sup>95</sup> Notice 2006-65, 2006-2 C.B. 102, Q&A 18; *see* Prop. Treas. Reg. § 301.6011(g)-1(i).

<sup>96</sup> I.R.C. § 6707A(b)(1).

<sup>97</sup> I.R.C. § 6707A(b)(2).

<sup>98</sup> I.R.C. § 6707A(b)(3).

<sup>99</sup> Treas. Reg. § 53.4965-9(a). However, the excise tax shall not apply with respect to income or proceeds that are properly allocated to any period ending on or before August 15, 2006. Treas. Reg. § 53.4965-9(a).

The regulations provide that the 100% excise tax on knowing transactions would apply only to (i) a tax-exempt entity that knowingly entered into a prohibited tax shelter transaction after May 17, 2006, and (ii) a manager who caused a tax-exempt entity to enter into a prohibited tax shelter transaction after May 17, 2006. Treas. Reg. § 53.4965-9(c).

<sup>100</sup> Treas. Reg. § 301.6011(g)-1(j).

<sup>101</sup> Treas. Reg. § 53.4965-9(b).

### III. TAX SHELTER LISTING REQUIREMENTS FOR MATERIAL ADVISORS

#### A. General Requirements

- Each “material advisor” with respect to a reportable transaction is subject to list maintenance requirements. A material advisor includes any person or entity that:
  - Knows or reasonably expects that a transaction is or will become a reportable transaction, makes any oral or written statement regarding a tax aspect of a transaction that causes it to be a reportable transaction to either a taxpayer or another material advisor required to disclose the transaction (a “tax statement”),<sup>102</sup> and in return for making the

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<sup>102</sup> A statement relates to a tax aspect of a transaction that causes it to be a confidential transaction if the statement concerns a tax benefit related to the transaction and either the taxpayer’s disclosure of the tax treatment or the tax structure of the transaction is limited to protect the confidentiality of the advisor’s tax strategies by or for the benefit of the person making the statement, or the person making the statement knows the taxpayer’s disclosure of the tax structure or tax aspects of the transaction is limited to protect the confidentiality of the advisor’s tax strategies. Treas. Reg. § 301.6111-3(b)(2)(ii)(B).

A statement relates to a tax aspect of a transaction that causes it to be a contractual protection transaction if the statement concerns a tax benefit related to the transaction and either (i) the taxpayer has the right to a full or partial refund of fees paid to the person making the statement or the fees are contingent on the taxpayer’s realization of tax benefits from the transaction, or (ii) the person making the statement knows or has reason to know that the taxpayer has the right to a full or partial refund of fees paid to another if all or part of the intended tax consequences from the transaction are not sustained or that fees paid by the taxpayer to another are contingent on the taxpayer’s realization of tax benefits from the transaction. Treas. Reg. § 301.6111-3(b)(2)(ii)(C).

A statement relates to a tax aspect of a transaction that causes it to be a loss transaction if the statement concerns an item that gives rise to a threshold loss to qualify as a loss transaction under Treasury regulation section 1.6011-4(b)(5). Treas. Reg. § 301.6111-3(b)(2)(ii)(D).

statement (*i.e.*, providing the material aid, assistance or advice), directly or indirectly, in excess of \$50,000 in the case of a reportable transaction, substantially all of the tax benefits of which are provided to individuals looking through any partnerships, S-corporations, or trusts (\$10,000 for a listed transaction; \$250 for a proposed patented transaction), and in excess of \$250,000 in all other cases (\$25,000 for a listed transaction; \$500 for a proposed patented transaction).<sup>103</sup>

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A statement relates to a tax aspect of a transaction that causes it to be a patent transaction if the statement is made or provided by the patent holder or the patent holder's agent and concerns the tax planning method that is the subject of the patent. Prop. Treas. Reg. § 301.6111-3(b)(2)(ii)(E).

With respect to a pre-January 6, 2006 significant book-tax difference transaction, a person will be considered a material advisor only if the person both made the tax statement and also made a statement relating to the financial accounting treatment of the item giving rise to the book-tax difference. Notice 2004-80, 2004-50 I.R.B. 963; *see also* Notice 2006-6, 2006-1 C.B. 385 (eliminating book-tax difference transactions from categories of reportable transactions).

<sup>103</sup> The term "material advisor" is defined under Treasury regulation section 301.6111-3(b) for purposes of Treasury regulation section 301.6112-1. Treas. Reg. § 301.6112-1(c)(1).

The IRS and Treasury may reduce the income threshold in published guidance for transactions of interest. Treas. Reg. § 301.6111-3(b)(3)(i)(B).

For purposes of determining the amount of gross income a person derives, directly or indirectly, for making a tax statement (*i.e.* providing material aid, assistance or advice, all fees for a tax strategy or for services for advice (whether or not it is tax advice) or for the implementation of a reportable transaction are taken into account. Fees include consideration in any form paid, whether in cash or in kind, or services to analyze the transaction (regardless of whether related to the tax consequences of the transaction), for services to implement the transaction, and for services to prepare tax returns to the extent return preparation fees are not unreasonable in light of all of the facts and circumstances. A fee does not include amounts paid to a person (including an advisor) in that person's capacity as a party to the transaction. The threshold amount must be met independently for each reportable transaction. Treas. Reg. § 301.6111-3(b)(3)(ii).

- The “substantially all” requirement is generally met if at least 70 percent of the tax benefits are provided to natural persons (looking through any partnerships, S corporations, or trusts), unless the facts and circumstances indicate otherwise.<sup>104</sup>
- A person or entity is considered to be a material advisor with respect to a reportable transaction if the person or entity makes a tax statement to another material advisor to a reportable transaction and derives income in excess of the threshold amount.<sup>105</sup> In such a case, the person or entity making the tax statement may be required to maintain a list of taxpayers who are not clients of that person or entity.
- A person is not considered a material advisor with respect to a transaction if the tax advisor provides a tax statement regarding the transaction only after the first tax return reflecting the tax benefit of the transaction is filed with the IRS.<sup>106</sup> This exception does not apply if it is expected that the taxpayer will file a supplemental or amended return reflecting additional tax benefits from the transaction.<sup>107</sup>
- A statement that includes only information contained in publicly available documents filed with the SEC by the close of a transaction is not considered a tax statement for this purpose.<sup>108</sup>

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<sup>104</sup> Treas. Reg. § 301.6111-3(b)(3)(i)(D).

<sup>105</sup> Treas. Reg. § 301.6111-3(b)(2)(i).

<sup>106</sup> Treas. Reg. § 301.6111-3(b)(2)(iii)(B).

<sup>107</sup> Treas. Reg. § 301.6111-3(b)(2)(iii)(B).

<sup>108</sup> Treas. Reg. § 301.6111-3(b)(2)(iii)(C).

## B. List Maintenance Requirements

- Material advisors must maintain a list for 7 years for possible inspection by the IRS of those persons to whom the advisor made tax statements, together with certain other information, as described below.<sup>109</sup>
- Multiple material advisors that are required to maintain lists may designate by written agreement to have a single material advisor maintain the list.<sup>110</sup> However, the designation of one material advisor to maintain a list does not relieve the other material advisors from their obligation to furnish the list to the IRS if the designated list keeper fails to do so.<sup>111</sup>
- In light of the potential for continuing liability, non-designated material advisors should consider obtaining a copy of the listing materials described below, perhaps on electronic media.

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<sup>109</sup> Treas. Reg. § 301.6112-1(d). A material advisor is not required to identify a person on the list if the person entered into a listed transaction or a transaction of interest more than 6 years before the transaction was identified in published guidance as a listed transaction or a transaction of interest. Treas. Reg. § 301.6112-1(b)(2).

<sup>110</sup> Treas. Reg. § 301.6112-1(f).

<sup>111</sup> Treas. Reg. § 301.6112-1(f).

Proposed regulations clarify that the existence of a designation agreement does not affect the ability of the IRS to request the list from any material advisor party to the designation agreement, or the obligation of the material advisor receiving the IRS request to furnish the list to the IRS. Prop. Treas. Reg. § 301.6112-1(f).

- The following items must be included on material advisors' lists:<sup>112</sup>
  - An itemized statement containing the following information:
    - Identifying information about each taxpayer to whom the advisor made tax statements (*e.g.*, name, address, TIN) and identifying information about the reportable transaction (*e.g.*, name, reportable transaction number).
    - The date on which each taxpayer entered into each reportable transaction (if known).
    - Amount of money invested in the transaction by each taxpayer (if known).
    - A summary or schedule of intended or expected tax treatment to be derived from the transaction by each taxpayer.
    - Names of other material advisors to the transaction (if known).
  - A detailed description of each transaction, including the tax structure and its expected tax treatment.
  - Documents, including a copy of the designation agreement to which the material advisor is a party (if any), and copies of any additional written materials, including tax analyses or opinions, that are material to an understanding of the purported tax treatment or tax structure of the transaction that have been shown or provided to any actual or potential investor in the transaction.<sup>113</sup>

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<sup>112</sup> Treas. Reg. § 301.6112-1(b)(3)(1).

<sup>113</sup> A material advisor is not required to retain earlier drafts of a document, provided the later (or final) draft contains all the information in the earlier drafts that is material to the understanding of the purported tax treatment or the tax structure of the transaction.

- If a potential material advisor requests a private letter ruling as to whether a transaction is a reportable transaction, the potential obligation to maintain a list with respect to that transaction is not suspended during the period in which the ruling request is pending.<sup>114</sup>
- Each material advisor responsible for maintaining list information must, upon written request, furnish the list to the IRS within 20 business days from the day on which the request was provided.<sup>115</sup>
- A material advisor who has a reasonable belief that information required to be furnished to the IRS is privileged remains obligated to maintain list information.<sup>116</sup>

#### IV. TAX SHELTER DISCLOSURE REQUIREMENTS FOR MATERIAL ADVISORS

- In 2004, the American Jobs Creation Act of 2004 (the “JOBS Act”) replaced the tax shelter registration regime that existed under prior law with a requirement that “material advisors” file information returns with the IRS for reportable transactions.<sup>117</sup>

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<sup>114</sup> Treas. Reg. § 301.6111-3(h), (i). This rule applies with respect to ruling requests received on or after November 1, 2006.

<sup>115</sup> Treas. Reg. § 301.6112-1(e)(1); I.R.C. § 6708. The regulations provide that the list must be furnished to the IRS within the period prescribed by section 6708. Section 6708 currently provides that the list must be made available within 20 business days after the day on which the request was provided. However, according to the preamble to the regulations, an alternative schedule for furnishing the list will be addressed in published guidance under section 6708. See T.D. 9352, 72 Fed. Reg. 43154.

Proposed regulations would give a material advisor 30 calendar days from the date the list maintenance requirement first arises with respect to a reportable transaction to prepare the list. If a list is requested by the IRS during the 30 day time period, the request for the list will be treated as having been made on the day after the 30 day time period ends. Prop. Treas. Reg. § 301.6112-1(b)(1).

<sup>116</sup> Treas. Reg. § 301.6112-1(e)(2).

<sup>117</sup> Act Sec. 815 of the JOBS Act, amending I.R.C. § 6111.

- In response to the JOBS Act provisions, the IRS and Treasury Department issued Notice 2004-80, providing interim guidance on the material advisor disclosure requirements.<sup>118</sup> After receiving questions and comments on the application of the material advisor rules, in November 2006, the IRS and Treasury Department proposed regulations relating to the material advisor disclosure requirements.<sup>119</sup> Final regulations were issued in August 2007.<sup>120</sup>
- A “material advisor” for purposes of this requirement has the same definition as for purposes of the material advisor listing requirements.<sup>121</sup>
- A person becomes a material advisor when all of the following events have occurred:
  - the material advisor makes a tax statement,<sup>122</sup>
  - the material advisor directly or indirectly receives the minimum fees, and

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<sup>118</sup> Notice 2004-80, 2004-50 I.R.B. 963.

<sup>119</sup> Prop. Treas. Reg. § 301.6111-3, 71 Fed. Reg. 64496 (Nov. 2, 2006).

<sup>120</sup> Treas. Reg. § 301.6111-3.

<sup>121</sup> See Section III.A. of this article for the definition of a “material advisor.” Section 6111(c) permits the IRS to prescribe regulations that (i) require only one material advisor to file an information return in situations where two or more material advisors would otherwise be required to file information returns with respect to a particular reportable transaction, (ii) exempt certain persons or transactions from the reporting requirements, and (iii) provide other rules for carrying out the purposes of the reporting requirements, including rules for aggregating fees in appropriate circumstances.

However, parties to the designation agreement may still be liable for penalties under section 6707 if the designated material advisor fails to disclose the reportable transaction. Treas. Reg. § 301.6111-3(f).

<sup>122</sup> See Section III.A. of this article for the definition of a “tax statement.” The definition of a tax statement includes another person’s statement that relates to a tax aspect of a transaction that causes the transaction to be a reportable transaction. Treas. Reg. § 301.6111-3(b)(2)(ii)(A).

- the transaction is entered into by the taxpayer.<sup>123</sup>
- If a transaction that was not a reportable transaction when entered into by the taxpayer is later identified as a listed transaction or a transaction of interest, a person who otherwise would have constituted a material advisor when the transaction was entered into will subsequently be considered to have become a material advisor with respect to the transaction on the date the transaction is identified in published guidance as a listed transaction or transaction of interest.<sup>124</sup>
- Thus, to ensure compliance with the disclosure and list maintenance requirements, practitioners will need to monitor the status of closed transactions and determine whether closed transactions are later identified as listed transactions or transactions of interest.
- A “reportable transaction” for purposes of this requirement has the same definition as for purposes of the participant disclosure requirements.<sup>125</sup>

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<sup>123</sup> Treas. Reg. § 301.6111-3(b)(4). Material advisors, including those who cease providing services prior to the time the transaction is entered into, must make reasonable and good faith efforts to determine whether the taxpayer enters into the transaction. Treas. Reg. § 301.6111-3(b)(4)(ii).

A person is also considered to be a material advisor and has disclosure obligations if the person makes a tax statement with respect to a transaction and it is expected that the taxpayer will file a supplemental or amended return reflecting additional tax benefits from the transaction. Treas. Reg. § 301.6111-3(b)(2)(iii)(B).

<sup>124</sup> Treas. Reg. § 301.6111-3(b)(4)(iii).

<sup>125</sup> Treas. Reg. § 301.6111-3(c)(1). For purposes of section 6111(a), a “reportable transaction” is defined in Treasury regulation section 1.6011-4(b) as (i) listed transactions, (ii) confidential transactions, (iii) loss transactions, (iv) contractual protection transactions, and (v) transactions of interest.

- Each material advisor must timely file IRS Form 8918 – “*Material Advisor Disclosure Statement*” with the IRS with respect to any reportable transaction for which the material advisor provided material aid, assistance or advice on or after August 3, 2007.<sup>126</sup> The return must include:
  - information identifying and describing the transaction in sufficient detail for the IRS to be able to understand the tax structure of the transaction and the identity of any material advisors whom the advisor knows or has reason to know acted as a material advisor with respect to the transaction,
  - information describing the expected tax treatment and all potential tax benefits expected to result from the transaction,
  - a description of any tax result protection with respect to the transaction,<sup>127</sup> and

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<sup>126</sup> Treasury regulation section 301.6111-3 applies to transactions with respect to which a material advisor makes a tax statement on or after August 3, 2007 (November 2, 2006 for transactions of interest entered into on or after November 2, 2006). The rules that apply with respect to transactions entered into before August 3, 2007 are contained in Notice 2004-80, 2004-50 I.R.B. 963; Notice 2005-17, 2005-1 C.B. 606; and Notice 2005-22, 2005-1 C.B. 756. Treas. Reg. § 301.6111-3(i).

A person provides material aid with respect to a reportable transaction by making or providing a statement to or for the benefit of (i) a taxpayer who is required to disclose the transaction, (ii) a taxpayer who the potential material advisor knows is, or reasonably expects to be, required to report the transaction, (iii) a material advisor who is required to disclose the transaction, or (iv) a material advisor who the potential material advisor knows is, or reasonably expects to be, required to report the transaction. Treas. Reg. § 301.6111-3(b)(2).

<sup>127</sup> Treas. Reg. § 301.6111-3(d). The term “tax result protection” includes insurance company and other third party products commonly described as tax result insurance. Treas. Reg. 301.6111-3(c)(12).

- The provision of tax result protection for a reportable transaction may subject a person to the section 6111 material advisor disclosure rules, because tax statements include third party tax result protection that insures the tax benefits of a reportable transaction.<sup>128</sup>
  - such other information as the IRS may prescribe.<sup>129</sup>
- A potential material advisor may make a protective disclosure if the advisor is uncertain as to whether the transaction is a reportable transaction.<sup>130</sup>
- Potential material advisors may request a ruling on whether a transaction is a reportable transaction, however the deadline for providing disclosure will not be tolled during the pendency of the ruling request.<sup>131</sup>
- The information return must be filed on IRS Form 8918 by the last day of the first month after the end of the calendar quarter during which the advisor becomes a material advisor.<sup>132</sup>
  - Once a material advisor has filed an IRS Form 8918 with respect to a particular transaction, there is no requirement to file an additional Form 8918 for subsequent taxpayers that enter into the transaction

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<sup>128</sup> Treas. Reg. § 301.6111-3(b)(2)(ii). However, a transaction will not constitute a reportable transaction solely because it has tax result protection.

<sup>129</sup> I.R.C. § 6111(c). The IRS may seek from the material advisor the same type of information that the IRS may request from a taxpayer with respect to a reportable transaction. Treas. Reg. § 301.6111-3(d).

<sup>130</sup> The protective disclosure must include all information required under Treasury regulation section 301.6111-3 and Treasury regulation section 301.6112-1 in order to be effective. Treas. Reg. § 301.6111-3(g).

<sup>131</sup> Treas. Reg. § 301.6111-3(h).

<sup>132</sup> Treas. Reg. § 301.6111-3(d), (e).

or further transactions that are the same or substantially similar as the transaction for which an IRS Form 8918 has been filed.<sup>133</sup>

- The IRS will issue to a material advisor a “reportable transaction number” with respect to the disclosed reportable transaction. The material advisor is required to provide the reportable transaction number to all taxpayers for whom the material advisor acted in that capacity.<sup>134</sup> The taxpayers and material advisors who are provided with the reportable transaction number are required to include the number on all required disclosures with respect to the reportable transaction.<sup>135</sup>

## V. DISCLOSURE REQUIREMENTS FOR UNCERTAIN TAX POSITIONS

### A. Overview

- In a series of Announcements, the first of which was issued on January 26, 2010, the IRS stated its intention to develop a schedule that would require certain business taxpayers to provide information regarding their “uncertain tax positions,” including a concise description and the magnitude of each (but not the taxpayer’s risk assessments or tax reserve amounts) on their annual tax returns.<sup>136</sup>

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<sup>133</sup> Treas. Reg. § 301.6111-3(d)(1). An incomplete Form 8918 containing a statement that information will be provided upon request is not considered a complete disclosure form under proposed regulations.

<sup>134</sup> Treas. Reg. § 301.6111-3(d)(2). In addition, the material adviser should provide the reportable transaction number to other material advisers for whom the material adviser acted in that capacity.

<sup>135</sup> Treas. Reg. § 1.6011-4(d).

<sup>136</sup> Announcement 2010-9, 2010-7 I.R.B. 408. Announcement 2010-17, 2010-13 I.R.B. 515, Announcement 2010-30 I.R.B. 2010-19; Announcement 2010-75, 2010-41 I.R.B. 428. While the IRS proposes to require corporations to report their uncertain tax positions, the IRS otherwise intends to retain its existing policy of restraint regarding the requests for tax accrual workpapers during the

- The IRS’s motivation for developing the new schedule and reporting requirements was to “improve transparency regarding material tax issues [in order to] achieve three objectives of certainty, consistency, and efficiency for [the IRS] and taxpayers.”<sup>137</sup>
- In the Announcements, the IRS requested comments on its uncertain tax position proposal and on a draft schedule and instructions.<sup>138</sup>
- The IRS received a significant number of comments on the UTP proposal and draft schedule and instructions.<sup>139</sup> After considering these comments, the IRS released a

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course of an examination. Announcement 2010-9, 2010-7 I.R.B. 408. *See also* Announcement 2010-76, 2010-41 I.R.B. 432 (“The Internal Revenue Service is expanding its policy of restraint in connection with its decision to require certain corporations to file Schedule UTP, Uncertain Tax Position Statement, and will forgo seeking particular documents that relate to uncertain tax positions and the work papers that document the completion of Schedule UTP.”)

<sup>137</sup> *See* Prepared Remarks of IRS Commissioner Doug Shulman to New York State Bar Association Taxation Section Annual Meeting in New York City (Jan. 26, 2010), *available at* <http://www.irs.gov/newsroom/article/0,,id=218705,00.html>.

<sup>138</sup> *See* Announcement 2010-9, 2010-7 I.R.B. 408, Announcement 2010-17, 2010-13 I.R.B. 515, Announcement 2010-30 I.R.B. 2010-19.

<sup>139</sup> Announcement 2010-75, 2010-41 I.R.B. 428. According to the Announcement, many of the comments received by the IRS expressed concern over (i) whether and how the IRS would implement the reporting requirement, (ii) how the IRS would use the reported information, (iii) the interaction of the reporting requirement with the IRS’s existing policy of restraint, (iv) the additional burden the reporting requirement would have on affected corporations, (v) the impact the reporting requirement would have on the relationship between the filing corporation and the IRS or its advisors or independent auditors, and (vi) the IRS’s authority to require reporting of uncertain tax positions. Announcement 2010-75, 2010-41 I.R.B. 428.

final Schedule UTP, Uncertain Tax Position Statement, on September 24, 2010.<sup>140</sup>

## B. Scope of Schedule UTP

- Public and privately held corporations that (i) issue audited financial statements<sup>141</sup> (or are included in the audited financial statements of a related party), (ii) file an IRS Form 1120, 1120-F, 1120-L or 1120-PC, and (iii) have recorded a reserve in its audited financial statements (or did not record a reserve because it expects to litigate the position)<sup>142</sup> for U.S. federal income tax with respect to a tax position taken on its U.S. federal income tax return, are required to complete

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<sup>140</sup> See Announcement 2010-75, 2010-41 I.R.B. 428.

<sup>141</sup> Announcement 2010-30 confirmed that an “audited financial statement” includes a financial statement on which an independent third party expresses an opinion under U.S. generally accepted accounting principles (“U.S. GAAP”), International Financial Reporting Standards, or another country-specific accounting standard, including a modified version of any of the above. Announcement 2010-30, 2010-19 I.R.B. 668.

The initial recording of a reserve will trigger reporting of an uncertain tax position, but subsequent increases or decreases with respect to a tax position taken in a tax return will not require additional disclosure. Announcement 2010-30, 2010-19 I.R.B. 668.

Some commentators are concerned that the proposed disclosure requirements will impact communications between taxpayers and their auditors and tax advisors. Because Schedule UTP requires disclosure for items for which there are reserves under FIN 48 and other accounting standards, auditors may face pressure to limit FIN 48 reserve items and tax advisors may be pressured into providing stronger tax opinions in order to avoid such reserves. See *NYSBA Comments On Proposal To Require Reporting Of Large Corporations’ Uncertain Tax Positions*, 2010 TNT 60-27 (Mar. 30, 2010) (“NYSBA UTP Comments”).

<sup>142</sup> The IRS has clarified that this includes a situation in which the taxpayer determines that if the IRS had full knowledge of the tax position, there is less than a 50% chance that a settlement could be reached and thus the taxpayer expects to litigate the position, but the taxpayer believes that more likely than not it will be successful in litigation. Announcement 2010-30, 2010-19 I.R.B. 668; 2010 Instructions for Schedule UTP.

Schedule UTP for the 2010 tax year and thereafter if they satisfy an asset threshold.<sup>143</sup>

- The IRS has implemented a five-year phase-in of the Schedule UTP for corporations with total assets of less than \$100 million. Under the phase-in schedule, corporations that have total assets equal to or exceeding \$100 million must file Schedule UTP starting with 2010 tax years, those with total assets equal to or exceeding \$50 million must file Schedule UTP starting with 2012 tax years and those with total assets equal to or exceeding \$10 million must file Schedule UTP starting with 2014 tax years.<sup>144</sup>
- The Schedule UTP must contain a concise description<sup>145</sup> of each uncertain tax position and must rank all of the reported tax positions based in the U.S. federal income tax reserve (including interest and

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<sup>143</sup> Announcement 2010-75, 2010-41 I.R.B. 428. Corporations are not required to report tax positions that are either immaterial under applicable financial accounting standards or are sufficiently certain so that no reserve is required by those standards. *See* Announcement 2010-75, 2010-41 I.R.B. 428.

<sup>144</sup> *See* Announcement 2010-75, 2010-41 I.R.B. 428. According to the Announcement, the IRS will consider whether to extend all or a portion of Schedule UTP reporting to other taxpayers for 2011 or later tax years, such as pass-through entities and tax-exempt entities. A corporation is not required to report on Schedule UTP a tax position taken in a tax year beginning before January 1, 2010, even if a reserve is recorded in audited financial statements issued in 2010 or later. *See* Announcement 2010-75, 2010-41 I.R.B. 428.

<sup>145</sup> A concise description of an uncertain tax position includes a description of the relevant facts affecting the tax treatment of the position and information that reasonably can be expected to apprise the IRS of the identity of the tax position and nature of the issue. *See* Announcement 2010-75, 2010-41 I.R.B. 428. An explanation of the rationale and nature of the uncertainty, which was required by the proposed draft Schedule UTP, is not required by the final Schedule UTP. *See* Announcement 2010-75, 2010-41 I.R.B. 428. Moreover, the concise description need not include information related to the corporation's assessment of the hazards of, or the support for or against, a tax position. *See* Announcement 2010-75, 2010-41 I.R.B. 428. 2010 Instructions for Schedule UTP.

penalties) recorded by the corporation for the position and must identify any tax position for which the reserve exceeds ten percent of the aggregate amount of the reserves for all of the tax positions reported on the schedule.<sup>146</sup>

- The IRS will treat the complete and accurate disclosure of a tax position on the appropriate year's Schedule UTP as if the corporation filed an IRS Form 8275 or IRS Form 8275-R regarding the tax position and will not require separate filings of these forms to avoid certain accuracy-related penalties with respect to the uncertain tax position.<sup>147</sup>

### C. Additional Burdens Imposed on Taxpayers<sup>148</sup>

The IRS has stated that Schedule UTP imposes no additional burden because taxpayers must already establish tax reserves for uncertain tax positions in determining their financial statement income under U.S. reporting accounting standards such as FIN 48. However, commentators have noted that Schedule UTP requires certain information that is not already prepared under FIN 48 (or a similar accounting standard), may require legal advice and may be time consuming for taxpayers to prepare.<sup>149</sup>

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<sup>146</sup> Announcement 2010-75, 2010-41 I.R.B. 428. Corporations may rely on the reserve computations performed for audited financial statement purposes and are not required to disclose the actual amount of the tax reserves.

<sup>147</sup> Announcement 2010-75, 2010-41 I.R.B. 428; 2010 Instructions for Schedule UTP.

<sup>148</sup> Practitioners have expressed their concern that the disclosure requirements will be very time-consuming and costly for taxpayers and may be more burdensome than the IRS intended. *See NYSBA Comments On Proposal To Require Reporting Of Large Corporations' Uncertain Tax Positions*, 2010 TNT 60-27 (Mar. 30, 2010); *Firm Advises Against Proposal To Require Reporting Of Large Corporations' Uncertain Tax Positions*, 2010 TNT 37-20 (Feb. 25, 2010).

<sup>149</sup> NYSBA UTP Comments at 24 (Mar. 29, 2010) (warning that "careful consideration, however, should be given to disclosure of information that deviates from the breadth or level of specificity required under the taxpayer's applicable accounting standard.").

- More specifically, (i) under Schedule UTP corporations must report each uncertain tax position independently, whereas under FIN 48 an aggregate approach is permitted; (ii) under Schedule UTP, corporations must provide a concise statement for each uncertain position, whereas no written explanation is required to accompany UTPs under FIN 48; (iii) recording reserves under FIN 48 requires recognition (whether the tax position meets the more likely than not standard) and measurement (including consideration that the corporation may settle with the IRS), whereas Schedule UTP requires corporations to report uncertain positions even if they do not record a reserve because they have an expectation of favorable litigation of the tax position.<sup>150</sup>

Commentators also note the potential for inconsistent treatment of taxpayers because (i) Schedule UTP only affects taxpayers that maintain reserves for uncertain tax positions for purposes of audited financial statements; (ii) International Financial Reporting Standards and FIN 48, for example, have very different approaches to uncertain tax positions and; (iii) the process for determining reserves is based on judgments of taxpayers and their

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This issue also creates special issues for U.S. subsidiaries of foreign parent companies that may be subject to IFRS rather than FIN 48 standards and so would report reserves under different circumstances than under FIN 48. Moreover, Schedule UTP requires disclosure of only federal income tax positions whereas FIN 48 may require reserves to be recorded for foreign UTPs. The different requirements of UTP and FIN 48 complicate matters because foreign UTPs may affect line items on U.S. tax returns. *See* ABA 2010 Comments at 14.

<sup>150</sup> *See* NYSBA UTP Comments; *PwC Comments on IRS Announcement 2010-9 on Uncertain Tax Positions, Exhibit I: Operational Comments on the UTP Proposal* (June 2, 2010); Alison Bennett, *Accounting: Uncertain Tax Position Reporting Plan Seen Changing Landscape of Disclosure*, DAILY TAX REPORT (Feb. 2, 2010); Debra J. Bennett, *Announcement 2010-9: Disclosure of Uncertain Tax Positions*, TAXES - THE TAX MAGAZINE 7, 10 (Aug. 2010).

advisors and is affected by taxpayer risk appetite and the nature and size of their businesses.<sup>151</sup>

#### **D. Privilege Concerns**

- The initial proposed Schedule UTP required corporations to identify uncertain tax positions along with their views and assessments, rationale and nature of the uncertainty. Many commentators raised concerns regarding these requirements on the basis that disclosure of this information is inconsistent with the attorney-client privilege, the work product doctrine, and tax practitioner privilege.<sup>152</sup> In response to these concerns, the final Schedule UTP removes these disclosure requirements. In addition, the IRS issued Announcement 2010-76, expanding its policy of restraint and announcing that it will forgo seeking particular documents that relate to uncertain tax positions and workpapers that document completion of Schedule UTP.<sup>153</sup>
- The policy of restraint stated in Announcement 2010-76 provides that:
  - Other than requiring the disclosure of the information on the schedule, the requirement to file Schedule UTP does not affect the IRS's policy of restraint.
  - If a document is otherwise privileged under the attorney-client privilege, the tax advice privilege in section 7525, or the work product doctrine, and the document was provided to an independent auditor as part of an audit of the taxpayer's financial statements, the IRS will not assert during an examination that privilege has been waived by such

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<sup>151</sup> Some taxpayers set up reserves only for large, questionable transactions that the IRS would have an interest in auditing and other taxpayers will set up reserves for each small issue that is likely to be negotiated on audit, even if the issue is routine and settlement likely.

<sup>152</sup> See Announcement 2010-75, 2010-41 I.R.B. 428.

<sup>153</sup> Announcement 2010-76, 2010-41 I.R.B. 432.

disclosure, unless (i) the taxpayer has engaged in any activity or taken any action, other than those described, that would waive the attorney-client privilege, the tax advice privilege in section 7525, or the work product doctrine, or (ii) a request for tax accrual work papers is made under IRM 4.10.20.3 because unusual circumstances exist or the taxpayer has claimed the benefits of one or more listed transactions; and

3. Taxpayer's may redact the following information from any copies of tax reconciliation work papers relating to the preparation of Schedule UTP that it is asked to produce during an examination:
  - (i) working drafts, revisions, or comments concerning the concise description of tax positions reported on Schedule UTP; (ii) the reserve amount related to a tax position reported on Schedule UTP; and (iii) computations determining the ranking of tax positions to be reported on Schedule UTP or the designation of a tax position as a Major Tax Position.<sup>154</sup>

## **VI. PENALTIES**

### **A. Participant Penalties for Failing to Disclose a Reportable Transaction**

- Section 6706A imposes a penalty on any taxpayer that fails to file a disclosure statement (IRS Form 8886) with respect to a reportable transaction with its tax return and with the OSTA as required under Section 6011. The amount of the penalty is the greater of (i) \$5,000 in the case of an individual or \$10,000 for all other taxpayers or (ii) 75% of the decrease in tax shown on the tax return as a result of the reportable transaction (or which would have been shown if the transaction had been respected), not to exceed \$10,000 in the case of an individual (\$100,000 with respect to a listed transaction and

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<sup>154</sup> Announcement 2010-76, 2010-41 I.R.B. 432.

\$50,000 for all other taxpayers (\$200,000 with respect to a listed transaction).<sup>155</sup>

- A reportable transaction disclosure statement is due upon the filing of an original or amended return reflecting the taxpayer's participation in a reportable transaction and therefore a penalty will not be imposed until a taxpayer fails to include the required statement with its return or provide the statement to the OSTA.<sup>156</sup>
- The penalty applies regardless of whether the taxpayer's position is sustained on the merits<sup>157</sup> and may be imposed in addition to any accuracy related penalties.<sup>158</sup>
- The IRS may impose a penalty with respect to each failure to (i) attach a reportable transaction disclosure statement to an original or amended

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<sup>155</sup> Section 6707A(a) and (b). Prior to the enactment of the JOBS Act in 2004, no specific penalty was imposed on a participant for failure to disclose a reportable transaction in accordance with section 6011. The JOBS Act significantly modified the tax shelter penalty landscape and instituted a penalty under Section 6707A for failing to disclose a reportable transaction. The amount of the penalty imposed by the JOBS Act was \$10,000 in the case of individuals (\$100,000 with respect to a listed transaction) and \$50,000 for all other taxpayers (\$200,000 with respect to a listed transaction) with respect to disclosure statements required to be attached to an original or amended return filed after October 22, 2004 (with a copy sent to the Office of Tax Shelter Analysis), regardless of whether the original return was due before October 22, 2004. In 2010, Section 6707A was amended to revise the penalty amount to make the penalty proportionate to the tax reduction shown on the tax return as a result of the transaction and minimum and maximum limitations were placed on the penalty amount. P.L. 111-240, Sec. 2041(a). The amended penalty provision applies to penalties assessed after December 31, 2006. P.L. 111-240, Sec. 2041(b).

<sup>156</sup> Treas. Reg. § 301.6707A-1(c)(1).

<sup>157</sup> H.R. Rep. No. 108-548, pt 1.

<sup>158</sup> I.R.C. § 6707A(f).

return, or (ii) provide a copy of a disclosure statement to the OSTA, if required.<sup>159</sup>

- However, a taxpayer that fails to attach the disclosure statement to an original or amended return and fails to provide a copy of a required disclosure statement to the OSTA will only be subject to a single penalty.<sup>160</sup>
- The IRS Commissioner may rescind the penalty with respect to a reportable transaction that is not a listed transaction only if rescinding the penalty would promote compliance with the tax laws and effective tax administration.<sup>161</sup>
- The IRS has provided guidance to taxpayers who desire to request a penalty rescission, including (i) the procedure for requesting rescission, (ii) the information the person must provide in the request, and (iii) the factors that weigh in favor of and against granting rescission.<sup>162</sup>
- Treasury regulations, largely adopting prior IRS guidance,<sup>163</sup> provide that in determining whether to rescind the penalty, the IRS Commissioner will take into account whether (i) the taxpayer filed a complete and proper disclosure statement

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<sup>159</sup> Treas. Reg. § 301.6707A-1(c)(1).

<sup>160</sup> Treas. Reg. § 301.6707A-1(c)(1).

<sup>161</sup> I.R.C. § 6707A(d); Treas. Reg. § 301.6707A-1(d)(1). The authority to rescind the penalty is exercisable only by the IRS Commissioner. H.R. Rep. No. 108-548, pt. 1. The IRS must (i) document any decision to rescind a penalty, including a description of the facts and reasons for the rescission and the amount rescinded, and (ii) submit an annual report to Congress summarizing the application of the disclosure penalties and describing each penalty rescinded and the reasons therefor. I.R.C. § 6707A(d) and P.L. 108-357, Sec. 811(d). A taxpayer may not judicially appeal the IRS's refusal to rescind a penalty. I.R.C. § 6707A(d)(2).

<sup>162</sup> Rev. Proc. 2007-21, 2007-9 I.R.B. 613.

<sup>163</sup> Rev. Proc. 2007-21 at 4.04, 2007-91 I.R.B. 613.

upon becoming aware of the violation,<sup>164</sup> (ii) the violation is due to an unintentional mistake of fact, (iii) the taxpayer has a history of complying with the tax laws, (iv) the violation arose from events beyond the taxpayer's control, (v) the taxpayer cooperates with the IRS by providing timely information requested with respect to the application for rescission, (vi) imposing the penalty would be against equity and good conscience (including whether the taxpayer demonstrates that there was reasonable cause for the failure and that it acted in good faith).<sup>165</sup> This is not a comprehensive list and no single factor will be dispositive as to whether the IRS will rescind the penalty.<sup>166</sup> The Commissioner may not consider collectability of, or doubt as to liability for, the penalties in determining whether to grant rescission (although the Commissioner may consider doubt as to liability as a factor in determining whether the taxpayer had reasonable cause and good faith).<sup>167</sup>

- The IRS may not rescind the penalty with respect to a listed transaction.<sup>168</sup>
- Public entities required to pay a penalty for failing to disclose a listed transaction, or subject to an understatement or gross valuation misstatement penalty attributable to a non-disclosed reportable transaction, must disclose the penalty in a report to

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<sup>164</sup> This factor weighs “heavily” in favor of rescission if the taxpayer files the disclosure before being contacted by the IRS and other circumstances suggest that the person did not delay disclosure until after the IRS had taken steps to identify the taxpayer's participation in the transaction. Treas. Reg. § 301.6707A-1(d)(3)(i); *see also* Rev. Proc. 2007-21 at 4.04(A), 2007-91 I.R.B. 613.

<sup>165</sup> Treas. Reg. § 301.6707A-1(d)(3).

<sup>166</sup> Treas. Reg. § 301.6707A-1(d)(3).

<sup>167</sup> Treas. Reg. § 301.6707A-1(d)(5).

<sup>168</sup> I.R.C. § 6707A(d).

the SEC, regardless of whether the penalty is material to the report.<sup>169</sup> A failure to disclose the penalty in a report to the SEC is also subject to penalty.<sup>170</sup>

- The penalty for failing to disclose certain penalties in an SEC report as required will be rescinded only if the IRS rescinds in full the underlying Section 6707A penalty, and otherwise may not be rescinded.<sup>171</sup>
- The statute of limitations with respect to a listed transaction that a participant does not properly disclose to the IRS does not close until one year after the first date on which the IRS is furnished the required information either by the taxpayer or a material advisor in satisfaction of its list maintenance requirements.<sup>172</sup> The extended statute of limitations is effective for taxable years with respect to which the period for assessing a deficiency did not expire before October 22, 2004.<sup>173</sup>
- If a taxpayer files a return for a year in which the taxpayer participated in an undisclosed listed transaction and the IRS has not previously

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<sup>169</sup> I.R.C. § 6707A(e); Treas. Reg. § 301.6707A-1(e); Rev. Proc. 2007-25, 2007-12 I.R.B. 761; Rev. Proc. 2005-51, 2005-2 C.B. 296. A disclosure on Form 10-K must include (i) the amount of any penalty, (ii) whether the penalty has been paid in full, (iii) the Code section and subparagraph under which the penalty was determined, and (iv) a description of the penalty. Rev. Proc. 2005-51, 2005-2 C.B. 296.

<sup>170</sup> Treas. Reg. § 301.6707A-1(e)(1)(iv).

<sup>171</sup> Treas. Reg. § 301.6707A-1(e)(3).

<sup>172</sup> I.R.C. § 6501(c)(10).

<sup>173</sup> I.R.C. § 6501(c)(10). The exception to the statute of limitations under section 6501(c)(10) does not supplant or shorten any other applicable statute of limitations on assessment, including a statute of limitations that has been extended by agreement, or a limitations period relating to a false or fraudulent return. Rev. Proc. 2005-26, 2005-1 C.B. 965.

received the required listing information from the material advisor, the statute of limitations on assessment with respect to that transaction will not expire earlier than one year after the later of (i) the date on which the taxpayer discloses the transaction, or (ii) the date on which the IRS receives a list from the material advisor.<sup>174</sup>

### **B. Material Advisor Penalties for Failing to Maintain an Investor List**

- Any material advisor who is required to maintain an investor list that fails to make the list available upon written request by the IRS within 20 business days after the request will be subject to a \$10,000 per day penalty.<sup>175</sup>
- The IRS may waive the penalty if the failure to make the list available is due to reasonable cause.<sup>176</sup> However, the failure to maintain a list does not constitute reasonable cause.<sup>177</sup>

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<sup>174</sup> Rev. Proc. 2005-26, 2005-1 C.B. 965. A taxpayer discloses a transaction by submitting a Form 8886, with a cover letter as described in Revenue Procedure 2005-26, to the appropriate Internal Revenue Service Center and a copy to the OTSA for each year in which the taxpayer participated in an undisclosed listed transaction. A taxpayer will not be deemed to have disclosed a transaction until both the Internal Revenue Service Center and OTSA have received the appropriate disclosure documents. A taxpayer under examination by the IRS or under Appeals consideration must also disclose in this manner any undisclosed listed transactions for any taxable year under consideration.

<sup>175</sup> I.R.C. § 6708(a). Prior to 2004, the penalty for failing to maintain an investor list as required by section 6112 was \$50 for each name that was required to have been on the list, subject to a maximum penalty of \$100,000 per year. The increased penalties may be imposed with respect to any request for a material advisor's list made after October 22, 2004, even if the transaction took place before that date.

<sup>176</sup> I.R.C. § 6708(a).

<sup>177</sup> H.R. Rep. No. 108-548.

### C. Material Advisor Penalties for Failing to Disclose a Reportable Transaction

- A material advisor who fails to file an information return on IRS Form 8918, or who files a false or incomplete information return in compliance with the material advisor disclosure statement regime, is subject to a penalty of:
  - \$50,000 with respect to a reportable transaction that is not a listed transaction, or
  - with respect to a listed transaction, the greater of (i) \$200,000 or (ii) 50% of the advisor's gross income attributable to aid, assistance, or advice provided with respect to the transaction before the date the information return that includes the transaction is filed (75% in the case of intentional disregard).<sup>178</sup>
- Under proposed regulations, an information return will not be considered false or incomplete if the false or omitted information is immaterial or if the advisor's failure to provide true and accurate information is due to mistake or accident after the exercise of reasonable care.<sup>179</sup>
- The IRS Commissioner may rescind the penalty with respect to a reportable transaction that is not a listed transaction only if rescinding the penalty would promote compliance with the tax laws and effective tax administration.<sup>180</sup>

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<sup>178</sup> I.R.C. § 6707(a), (b).

<sup>179</sup> Prop. Treas. Reg. § 301.6707-1(b)(4), (5).

<sup>180</sup> I.R.C. § 6707(c) (cross-referencing I.R.C. § 6707A(d)). The IRS must (i) document any decision to rescind a penalty including a description of the facts and reasons for the rescission and the amount rescinded and (ii) submit an annual report to Congress summarizing the application of the disclosure penalties and describing each penalty rescinded and the reasons therefor. A taxpayer may not judicially appeal the IRS's refusal to rescind a penalty. I.R.C. § 6707A(d)(2), (3).

- Under IRS guidance and proposed regulations that are substantially similar to the rules regarding rescission of participant disclosure penalties, in determining whether to rescind the penalty, the IRS will take into account whether (i) the material advisor filed a complete and proper disclosure statement upon becoming aware of the violation,<sup>181</sup> (ii) the violation is due to an unintentional mistake of fact, (iii) the advisor has a history of complying with the tax laws, (iv) the violation arose from events beyond the advisor's control, (v) the advisor cooperates with the IRS by providing timely information requested with respect to the application for rescission, and (vi) imposing the penalty would be against equity and good conscience.<sup>182</sup> This is not a comprehensive list and no single factor will be dispositive as to whether the IRS will rescind the penalty.<sup>183</sup>
- The IRS may not rescind a penalty with respect to a listed transaction.<sup>184</sup>
- The penalty applies to returns due after October 22, 2004.<sup>185</sup>

#### **D. Tax Shelter Promoter Penalties**

- The IRS may impose a penalty on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a

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<sup>181</sup> This factor weighs “strongly” in favor of rescission if the advisor files the disclosure statement before being contacted by the IRS and before any taxpayer files a disclosure statement identifying the advisor with respect to the reportable transaction. Rev. Proc. 2007-21 at 4.04(A), 2007-91 I.R.B. 613; Prop. Treas. Reg. § 301.6707-1(e)(3).

<sup>182</sup> Rev. Proc. 2007-21 at 4.04, 2007-91 I.R.B. 613; Prop. Treas. Reg. § 301.6707-1(e)(3).

<sup>183</sup> Prop. Treas. Reg. § 301.6707-1(e)(3).

<sup>184</sup> I.R.C. § 6707(c) (cross-referencing I.R.C. § 6707A(d)).

<sup>185</sup> Act Sec. 816(c) of the JOBS Act.

partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes:<sup>186</sup>

- a statement concerning the allowance of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement, which the person knows or has reason to know is false or fraudulent as to any material matter (a “false tax benefit statement”).<sup>187</sup>
- The penalty for false tax benefit statements with respect to activities occurring after October 22, 2004 concerning any material matter is equal to 50% of the gross income derived by the person from the activity for which the penalty is imposed.<sup>188</sup>

#### **E. Actions to Enjoin Certain Conduct**

- The IRS is authorized to (A) bring civil actions to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability,<sup>189</sup> or (B) seek injunctions (i) against a material advisor for failing to file an information return with respect to a reportable transaction, (ii) against a material advisor for failing to maintain, or to timely furnish upon written request by the IRS, a list of investors with respect to each reportable transaction, or (iii) with respect to violations of Circular 230.<sup>190</sup>

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<sup>186</sup> I.R.C. § 6700(a).

<sup>187</sup> I.R.C. § 6700(a).

<sup>188</sup> I.R.C. § 6700(a). Under prior law, the penalty with respect to any of these activities was equal to the lesser of \$1,000 or 100% of the gross income derived from the activity.

<sup>189</sup> I.R.C. § 7408.

<sup>190</sup> I.R.C. § 7408(c).

## **F. Tax Shelter Exception to Taxpayer Communication Confidentiality Privileges**

- In general, a taxpayer is entitled to treat certain communications with its tax advisor as privileged.<sup>191</sup> This privilege, however, does not apply to (i) any written communication between a corporate taxpayer (or representative of a corporate taxpayer) and its Federally authorized tax practitioner in connection with the promotion of the direct or indirect participation of the corporation in a tax shelter,<sup>192</sup> or (ii) any written communication with respect to a tax shelter that takes place on or after October 22, 2004 between all taxpayers (including non-corporate taxpayers) and the taxpayer's Federally authorized tax practitioner.<sup>193</sup>

## **G. Accuracy-Related Penalty for Reportable Transactions**

- Section 6662 generally imposes an accuracy-related penalty of 20% of the understatement of tax resulting from an incorrect tax return position (i) due to negligence, disregard of the rules or regulations, or certain substantial misstatements or overstatements of value, basis, estate or gift tax, or liabilities, or (ii) that gives rise to a "substantial understatement" of tax (generally the greater of 10% of the tax required to be shown on the taxpayer's return or \$5,000 (\$10,000 in the case of a corporation)).<sup>194</sup>

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<sup>191</sup> I.R.C. § 7525.

<sup>192</sup> I.R.C. § 7525.

<sup>193</sup> I.R.C. § 7525.

<sup>194</sup> I.R.C. § 6662(a). Under section 6662(d), an amount of an understatement can be reduced if there was substantial authority for the position taken by a taxpayer or if the facts affecting an item's tax treatment are adequately disclosed and there was a reasonable basis for the position taken. This reduction is not applicable in the case of tax shelters. The IRS has provided guidance for determining when disclosure is adequate to reduce an amount of an understatement under section 6662(d). Rev. Proc. 2010-15, 2010-7 I.R.B. 404

- Section 6662A imposes an accuracy-related penalty on understatements with respect to reportable transactions defined in Treasury regulation section 1.6011-4.<sup>195</sup>
- In general, a 30% penalty is imposed on any understatement attributable to a reportable transaction that a taxpayer failed to adequately disclose in accordance with the participant reportable transaction disclosure requirements.<sup>196</sup> There are no exceptions to this penalty.<sup>197</sup>
- Alternatively, a lesser 20% accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed reportable transaction.
  - A taxpayer may avoid the 20% penalty by demonstrating that (i) there was reasonable cause for the understatement, and (ii) the taxpayer acted in good faith.<sup>198</sup> Reasonable cause and good faith require a taxpayer to:

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(updating Rev. Proc. 2008-14, 2008-7 I.R.B. 435 to reflect changes made to section 6694(a) by the Tax Extenders and Alternative Minimum Tax Relief Act). According to the revenue procedure, for disclosure to reduce an understatement, (i) money amounts entered on a return must be verifiable, (ii) the taxpayer must clearly describe any items on a return that do not already have a preprinted description identifying the items, and (iii) positions taken on the return must have a reasonable basis. Further, the disclosure will not reduce the understatement amount if (i) the item disclosed is attributable to a tax shelter, (ii) the item is not substantiated, or (iii) the taxpayer failed to keep adequate books and records with respect to the item or position. Finally, disclosure is not adequate to reduce an understatement amount if the understatement arises from a transaction between related parties.

<sup>195</sup> Reportable transactions currently include (i) listed transactions, (ii) confidential transactions, (iii) loss transactions, (iv) contractual protection transactions and (v) transactions of interest. Treas. Reg. § 1.6011-4(b).

<sup>196</sup> I.R.C. § 6662A(c).

<sup>197</sup> Notice 2005-12, 2005-1 C.B. 494.

<sup>198</sup> I.R.C. § 6664(d).

- have adequately disclosed the relevant facts affecting the tax treatment of the transaction in accordance with the regulations under section 6011,<sup>199</sup>
  - demonstrate that there was substantial authority for the claimed tax treatment of the transaction, and
  - demonstrate that it reasonably believed that the claimed tax treatment was more likely than not the proper treatment.<sup>200</sup>
- A taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief:
    - is based on the facts and law that exist at the time the tax return including the item was filed, and
    - relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (i) a return will not be audited, (ii) the treatment will not be

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<sup>199</sup> Weisbach at 1289.

<sup>200</sup> I.R.C. § 6664(d)(2). The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. More specifically, the amount of the understatement is determined as the sum of (i) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return), and (ii) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. I.R.C. § 6662A(b)(1). Except as provided in regulations, a taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted regarding an examination of the return or such other date as specified by the IRS. I.R.C. § 6662A(e)(3).

raised on audit, or (iii) the treatment will be resolved through settlement if raised.<sup>201</sup>

- A taxpayer may (but is not required to) rely on an opinion of a tax advisor to establish reasonable belief with respect to the tax treatment of an item. However, a taxpayer may not rely on an opinion that:
  - is provided by a “disqualified tax advisor,”
  - is based on unreasonable factual or legal assumptions (including assumptions as to future events),
  - unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person,
  - does not identify and consider all relevant facts, or
  - fails to meet any other requirement prescribed by the IRS.<sup>202</sup>
- A disqualified tax advisor is any advisor who:
  - is a material advisor and who participates in the organization,<sup>203</sup>

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<sup>201</sup> I.R.C. § 6664(d)(3)(A).

<sup>202</sup> Notice 2005-12, 2005-1 C.B. 494.

<sup>203</sup> Participating in the “organization” of a transaction includes (i) devising, creating, investigating or initiating the transaction or tax strategy, (ii) devising the business or financial plans for the transaction or tax strategy, (iii) carrying out those plans through negotiations or transactions with others, or (iv) performing acts relating to the development of the transaction. Performing acts relating to the development or establishment of a transaction may

management,<sup>204</sup> promotion<sup>205</sup> or sale of the transaction or is related to any person who so participates,<sup>206</sup>

- is compensated directly or indirectly by a material advisor with respect to the transaction under a referral fee or fee sharing arrangement (a

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include, for example, preparing documents (i) establishing a structure used in connection with the transaction (such as a partnership agreement or articles of incorporation), (ii) describing the transaction (such as an offering memorandum, tax opinion, prospectus or other document describing the transaction), or (iii) registering the transaction with any Federal, state or local government body. Notice 2005-12, 2005-1 C.B. 494.

<sup>204</sup> Participating in the “management” of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction, including managing assets, directing business activity, or acting as general partner, trustee, director or officer of an entity involved in a transaction. Notice 2005-12, 2005-1 C.B. 494.

<sup>205</sup> Participating in the “promotion or sale” of a transaction means involvement in the marketing or solicitation of the transaction or tax strategy, including (i) soliciting, directly or through an agent, taxpayers to enter into a transaction or tax strategy using direct contact, mail, telephone or other means, (ii) placing an advertisement, or (iii) instructing or advising others with respect to marketing the transaction or tax strategy. Notice 2005-12, 2005-1 C.B. 494. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

<sup>206</sup> A tax advisor whose only involvement in a transaction consists of rendering a tax opinion regarding the tax consequences of the transaction will not be treated as participating in the organization, management, promotion or sale of a transaction. The tax advisor may suggest modifications to the transaction, but may not suggest material modifications to the transaction that assist the taxpayer in obtaining the anticipated tax benefits. Notice 2005-12, 2005-1 C.B. 494. The performance of support services or ministerial functions, including typing, photocopying or printing will not be considered participating in the organization, management, promotion or sale of a transaction. Notice 2005-12, 2005-1 C.B. 494.

“disqualified compensation arrangement”),<sup>207</sup>

- has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, including agreements providing that (i) a taxpayer has the right to a full or partial refund of fees if all or part of the tax consequences from the transaction are not sustained or (ii) the amount of the fee is contingent on the taxpayer’s realization of tax benefits from the transaction, or
  - as determined under regulations, has a disqualifying financial interest with respect to the transaction.
- The portion of an understatement upon which a penalty is imposed under section 6662A (*i.e.*, the portion of an understatement attributable to a reportable transaction) is not subject to the accuracy-related penalty under section 6662. However, any such understatement is included for purposes of determining whether any understatement (as defined in section 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1). The section 6662A accuracy-related penalty on understatements attributable to

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<sup>207</sup> In addition, an arrangement will be treated as a disqualified compensation arrangement if there is an agreement or understanding (oral or written) with a material advisor of a reportable transaction pursuant to which the tax advisor is expected to render a favorable opinion regarding the tax treatment of the transaction to any person referred by the material advisor. A tax advisor will not be treated as having a disqualified compensation arrangement if a material advisor merely recommends the tax advisor, who does not have an agreement or understanding with the material advisor, to render a favorable opinion regarding the tax treatment of a transaction. Notice 2005-12, 2005-1 C.B. 494.

reportable transactions does not apply to any portion of an understatement (i) to which a fraud penalty is applied under section 6663 or (ii) for which the rate of penalty is calculated under section 6662(h) in the case of gross valuation misstatements or under section 6662(i) in the case of non-disclosed economic substance transactions.<sup>208</sup>

## H. Tax Return Preparer Penalties for Understatement Of Taxpayer's Liability

- Section 6694(a), as amended by the Emergency Economic Stabilization Act of 2008, generally provides that a “tax return preparer” that prepares any return or claim of refund with respect to which any part of an understatement of liability is due to an “unreasonable position” and knew (or reasonably should have known) of the position is subject to a penalty.<sup>209</sup> No penalty under Section 6694(a) is

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<sup>208</sup> I.R.C. § 6662A(e). We note that the amount of the penalty is 40% for gross valuation misstatements and non-disclosed economic substance transactions. I.R.C. § 6662(h), (i).

<sup>209</sup> The section 6694 tax return preparer penalty provision has a long and winding history. As originally enacted in 1976, section 6694 subjected an income tax return preparer to a penalty if the preparer engaged in (1) a negligent or intentional disregard of the tax law, rules, or regulations in an attempt to understate a taxpayer's tax liability or (2) a willful attempt to understate a taxpayer's tax liability, either of which led to an understatement of tax liability. Tax Reform Act of 1976, Pub. L. No. 94-455 (1976). The section was added to the Code to deter the growing number of income tax return preparers from engaging in improper conduct. *See* General Explanation of the Tax Reform Act of 1976, Pub. L. No. 94-455 (1976).

The tax return preparer penalty rules under section 6694(a) were amended in 1989 to impose a higher standard for preparer penalties. Under the revised standard, income tax return preparers would not be subject to penalties unless (1) the preparer knew or reasonably should have known of a position on the return that did not have a realistic possibility of being sustained on the merits if it were examined by the IRS, (2) any part of an understatement of liability was due to the position, and (3) the position was not adequately

imposed if there is a reasonable cause for the understatement and the tax return preparer acted in good faith.<sup>210</sup>

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disclosed or was frivolous. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239 (1989). For background on the decision to reform the section 6694 penalty provisions in 1989, as well as a detailed analysis of the exemptions allowed under this Act, *see* Harvey L. Coustan and Sheldon I. Banoff, *Dodging the Bullet: Avoiding the Accuracy-Related and Preparer Penalties Through Reasonable Cause and Good Faith, or Disclosure*, 69 TAXES 351 (June 1991).

Under the Small Business and Work Opportunity Act of 2007 (the “2007 Act”), section 6694(a) was again amended to subject all tax return preparers (not just income tax return preparers) to a penalty for an understatement of liability if the tax return preparer knew or should have known of a position that the preparer did not reasonably believe was more likely than not to be sustained on its merits, unless the position was adequately disclosed and there was a reasonable basis for the opinion. Small Business and Work Opportunity Act of 2007, Pub. L. No. 110-28 (2007). Notice 2007-54, 2007-27 I.R.B. 12. These 2007 Act changes made it easier for tax return preparers to get caught in the section 6694(a) penalty provision.

Finally, on October 3, 2008, the Emergency Economic Stabilization Act of 2008 (“EESA”) once again revised the penalty provisions applicable to tax return preparers to lower the standard from the relatively high more likely than not to be sustained on its merits requirement, to a substantial authority requirement. However, the EESA also introduced a new, separate standard for positions that are tax shelters (as defined in section 6662(d)(2)(C)(ii)) or reportable transactions to which section 6662A applies, which retained the more likely than not standard of certainty. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343 (2008).

<sup>210</sup> I.R.C. § 6694(a)(3). Factors that will be considered in determining whether an understatement was due to reasonable cause and good faith include the complexity of the error causing the understatement, the frequency of errors, the materiality of the error, the preparer’s normal office practice, reliance on advice of others and reliance on generally accepted administrative or industry practice. Treas. Reg. § 1.6694-2(e).

- Under current law, a position will only be considered an “unreasonable position” if:
  - (1) the position is a tax shelter (as defined in section 6662(d)(2)(C)(ii)) or a reportable transaction to which section 6662A applies, and the preparer does not reasonably believe that the position would more likely than not be sustained on the merits, or<sup>211</sup>

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<sup>211</sup> I.R.C. § 6694(a). Treas. Reg. § 1.6694-2(a)(1). The new standard for positions that are not tax shelters or reportable transactions applies to all returns prepared after May 25, 2007; the standard for tax shelter and reportable transaction positions applies to returns prepared for taxable years ended after October 3, 2008. Notice 2009-5, 2009-3 I.R.B. 309.

The penalty applies to an understatement of liability, which exists if there is an understatement of the net amount payable with respect to any tax imposed by the Code or an overstatement of the net amount creditable or refundable with respect to any tax imposed by the Code. Treas. Reg. § 1.6694-1(c). If a penalty is assessed against a tax return preparer, and a final administrative determination or a final judicial decision later establishes that there was no understatement of liability relating to the position on the return or claim for refund, the assessment will be abated and any penalty paid will be refunded as if the payment were an overpayment of tax, without consideration of any period of limitations. Treas. Reg. § 1.6694-1(d).

The revisions to section 6694 included in the EESA have generally been welcomed by tax practitioners because they reduce the standard for avoiding the penalties for non-tax shelter and reportable transactions. However, retention of the more likely than not standard for tax shelters and reportable transactions has caused some practitioners to express concern that the retention of the more likely than not standard for tax shelters and reportable transactions will lead to conflict between taxpayers and tax preparers, because tax preparers may be motivated to take conservative positions in preparing tax returns, in order to avoid potential penalties. See Richard M. Lipton and Robert S. Walton, *Tax Return Preparer Penalty Final Regulations*, 110 J. TAX’N 229 (April 2009).

For a thorough overview of the Section 6694 penalties, see Charles P. Rettig, *Practitioner Penalties: Potential Pitfalls in the Tax Trenches*, 2009 TNT 69-12 (April 13, 2009). For a detailed discussion of the history of, and changes to, section 6694, see Richard M. Lipton and Robert S. Walton, *Tax Return Preparer Penalty Final Regulations*, 110 J. TAX’N 229 (April 2009). See also

(2) in all other cases, the position is neither

(a) supported by substantial authority, nor

(b) adequately disclosed (or disclosed without any reasonable basis for the disclosed position).

- The substantial authority standard is an objective standard that is less stringent than the more likely than not standard (which is only met if there is a greater than 50% likelihood of the position being upheld), but more stringent than the reasonable basis standard (as described below).<sup>212</sup> Substantial authority generally exists if the weight of the authorities supporting the treatment are substantial in relation to the weight of authorities supporting contrary treatment. The weight accorded to any authority must be considered in light of its relevance, persuasiveness, and the type of document providing the authority. Only certain types of authorities may be considered authority for purposes of determining whether there is substantial authority for the tax treatment of an item.<sup>213</sup>

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*Preparer Penalty Changed Again, This Time Mostly for the Better*, 110 J. TAX'N 62 (Sheldon I. Banoff and Richard M. Lipton eds., Jan. 2009).

<sup>212</sup> Treas. Reg. § 1.6662-4(d)(2). Substantial authority, for purposes of section 6694(a), has the same definition as in Treasury regulation section 1.6662-4(d)(2). Notice 2009-5, 2009-3 I.R.B. 309.

<sup>213</sup> Treas. Reg. § 1.6662-4(d)(3). Appropriate authorities include the following: the Code; regulations; revenue rulings and revenue procedures; tax treaties and their official explanations; court cases; congressional intent; the Blue Book; private letter rulings and technical advice memoranda; actions on decision and general counsel memoranda; IRS information or press releases; and administrative pronouncements published in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-4(d)(3)(iii).

Substantial authority also exists for a position that is supported by the conclusion of a ruling or determination letter issued to the taxpayer, by the conclusion of a technical advice memorandum in

- A reasonable basis for a position exists if the return position is reasonably based on one or more appropriate authorities, taking into consideration the relevance and persuasiveness of the authorities and any subsequent developments.<sup>214</sup>
- Reasonable basis is a standard of tax reporting that is significantly higher than not frivolous or not patently improper and it is not satisfied by a return position that is merely arguable or that is merely a colorable claim.<sup>215</sup> For purposes of determining whether a tax return preparer has a reasonable basis for the position, the preparer may rely in good faith upon information furnished by the taxpayer, as well as information and advice furnished by another advisor, another tax return preparer, or other party.<sup>216</sup>

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which the taxpayer is named, or by an affirmative statement in the revenue agent's report with respect to a prior taxable year of the taxpayer (each, a "written determination"), unless the written determination contained a misstatement or omission of material fact about which the tax return preparer knew or should have known. Notice 2009-5, 2009-3 I.R.B. 309; Treas. Reg. § 1.6662-4(d)(3)(iv)(A).

Substantial authority for a position is tested as of the date the return or claim for refund is deemed prepared. Notice 2009-5, 2009-3 I.R.B. 309.

<sup>214</sup> Treas. Reg. § 1.6694-2(d)(2). The authorities that are appropriate for determining whether there is a reasonable basis for a position are the same as the appropriate authorities for determining whether substantial authority exists (as discussed above). Treas. Reg. § 1.6662-4(d)(3)(iii).

<sup>215</sup> Treas. Reg. § 1.6662-3(b)(3).

<sup>216</sup> Treas. Reg. § 1.6694-2(d)(2). In order to meet the good faith standard, a tax return preparer is not required to audit, examine or review books and records, business operations, documents, or other evidence to independently verify information provided by the taxpayer, advisor, other tax return preparer, or other party who the tax return preparer has reason to believe is competent to render the advice or information. The tax return preparer may also rely in good

- Treasury regulations set forth the requirements necessary to satisfy the adequate disclosure exception to the understatement penalty.<sup>217</sup> In general, nonsigning and signing income tax return preparers are subject to different disclosure obligations.
  - A signing tax return preparer is the preparer who has the primary responsibility for the overall substantive accuracy of the preparation of the return or claim for refund.<sup>218</sup>
  - A nonsigning tax return preparer is any preparer who is not a signing preparer but who prepares all or a substantial portion of a return or claim for refund

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faith without verification upon a tax return that has been previously prepared and filed with the IRS (although the preparer must confirm that the position being relied upon has not been adjusted by examination or otherwise). However, the tax return preparer may not ignore the implications of information provided to the preparer or actually known by the preparer, and the preparer must make reasonable inquiries if any information provided appears to be incorrect or incomplete. The advice or information may be written or oral. The tax return preparer is not considered to have relied in good faith if the advice or information is unreasonable on its face, the preparer knew or should have known that the other party providing the advice or information was not aware of all relevant facts, or the preparer knew or should have known at the time the return or claim for refund was prepared that the advice or information was no longer reliable due to developments in the law since the time the advice was given. Treas. Reg. §§ 1.6694-1(e) and 1.6694-2(e)(5).

<sup>217</sup> Treas. Reg. § 1.6694-2(d)(3).

Revenue Procedure 2010-15 also provides guidance with respect to what constitutes adequate disclosure on a taxpayer's return for purposes of avoiding the section 6694(a) penalty. *See* Rev. Proc. 2010-15, 2010-7 I.R.B. 404 (updating Rev. Proc. 2008-14, 2008-7 I.R.B. 435).

<sup>218</sup> Treas. Reg. § 301.7701-15(b)(1).

with respect to events that have occurred when the advice is rendered.<sup>219</sup>

- In the case of a signing tax return preparer, disclosure is generally considered adequate if (1) the position is disclosed on a properly completed Form 8275 or Form 8275-R attached to the return or to a qualified amended return (or in accordance with a specified annual revenue procedure), (2) the

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<sup>219</sup> Treas. Reg. § 301.7701-15(b)(2)(i). The regulations provide a safe harbor, which provides that in determining whether a preparer qualifies as a nonsigning tax return preparer, time spent on advice given after the events have occurred will not be taken into account if it represents less than 5% of the aggregate time incurred by the individual with respect to the position giving rise to the understatement. However, an anti-abuse rule provides that notwithstanding the 5% safe harbor, time spent on advice given before the events occurred will be taken into account if all facts and circumstances demonstrate that (i) the positions giving rise to the understatement are primarily attributable to the advice, (ii) the advice was substantially given before events occurred primarily to avoid treating the advisor as a tax return preparer, and (iii) the advice was confirmed after events had occurred for purposes of preparing a tax return. Treas. Reg. § 301.7701-15(b)(2)(i). The IRS has indicated that there “is no movement to expand” the 5% safe harbor. See Jeremiah Coder, *Don’t Expect Preparer Penalty Safe Harbor to Be Expanded, Treasury Official Says*, 2009 TNT 9-5 (Jan. 15, 2009).

Previously, under Treas. Reg. § 1.6694-1(b)(2), a “nonsigning” preparer was defined as any preparer who was not a signing preparer, *e.g.*, one who provides advice to a taxpayer. A “signing” preparer was any preparer who signed a return or refund claim as a preparer. If more than one preparer was involved in the preparation of a tax return, the preparer with the primary responsibility for the overall substantive accuracy of the return was required to sign it. Treas. Reg. § 1.6695-1(b).

One IRS official has described the application of section 6694 to nonsigning preparers as a “huge policy issue.” See *Final Section 6694 Preparer Penalty Guidance Coming Later in the Year, Says IRS Official*, 2008 TNT 21-4 (Jan. 30, 2008). Another IRS official has stated that removing nonsigning preparers from the ambit of section 6694 might inequitably put too much pressure on signing preparers. See *News Analysis: New Preparer Penalties Sweep Away Circular 230*, 2008 TNT 24-8 (Jan. 31, 2008).

tax return preparer provides the taxpayer with a prepared tax return that discloses the position on a properly completed Form 8275 or Form 8275-R attached to the return or to a qualified amended return (or in accordance with a specified annual revenue procedure), or (3) for returns or claims for refund that are subject to certain penalties pursuant to section 6662, the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer under section 6662 and contemporaneously documents the advice in the tax return preparer's files.<sup>220</sup>

- In the case of a nonsigning tax return preparer, disclosure is generally considered adequate if the position is disclosed on a properly completed Form 8275 or Form 8275-R attached to the return or to a qualified amended return (or in accordance with a specified annual revenue procedure).<sup>221</sup>
- In addition, if the tax return preparer provides advice to the taxpayer (as compared to another tax return preparer), adequate disclosure also requires the tax

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<sup>220</sup> Treas. Reg. § 1.6694-2(d)(3)(i). The tax return preparer must inform the taxpayer of any penalties imposed under section 6662 that apply to an underpayment of tax that is attributable to one or more of the following: negligence or disregard of rules or regulations; any substantial understatement of income tax; any substantial valuation misstatement under chapter 1; any substantial overstatement of pension liabilities; or any substantial estate or gift tax valuation understatement.

In order to satisfy this disclosure requirement, each return position for which there is a reasonable basis but for which there is not substantial authority must be addressed by the tax return preparer and the advice must be particular to the taxpayer and tailored to the taxpayer's facts and circumstances. Treas. Reg. § 1.6694-2(d)(3)(iii).

<sup>221</sup> Treas. Reg. § 1.6694-2(d)(3)(ii).

return preparer to advise the taxpayer of any relevant opportunity to avoid any section 6662 penalties that could apply to the position and of any applicable standards for disclosure to the extent applicable, and contemporaneously document the advice in the tax return preparer's files.<sup>222</sup>

- Alternatively, if the tax return preparer provides advice to another tax return preparer (as opposed to the taxpayer), adequate disclosure requires the tax return preparer to advise the other tax return preparer that disclosure may be required under section 6694(a) and contemporaneously document the advice in the tax return preparer's files.<sup>223</sup>
- In determining whether the standard has been met for a tax shelter or reportable transaction position, a tax return preparer's belief that tax treatment of an item meets the more likely than not standard is reasonable if the preparer analyzes the pertinent facts and authorities and, in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50% likelihood that the tax treatment of the position will be upheld on the merits if challenged by the IRS.<sup>224</sup> In addition, neither

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<sup>222</sup> Treas. Reg. § 1.6694-2(d)(3)(ii)(A). Penalties may be imposed under section 6662 due to an underpayment of tax that is attributable to one or more of the following: negligence or disregard of rules or regulations; any substantial understatement of tax; any substantial valuation misstatement under chapter 1; any substantial overstatement of pension liabilities; any substantial estate or gift tax valuation understatement; or any undisclosed foreign financial asset understatement. I.R.C. § 6662.

<sup>223</sup> Treas. Reg. § 1.6694-2(d)(3)(ii)(B).

<sup>224</sup> Treas. Reg. § 1.6694-2(b)(1).

The preparer must analyze the pertinent facts and authorities in a manner described in Treasury regulation section 1.6662-4(d)(3)(ii).

the audit lottery nor probability that an issue will be settled may not be taken into account for purposes of determining whether a position meets the standard.<sup>225</sup>

- The tax return preparer may rely in good faith without verification upon information furnished by the taxpayer and/or other third party, consistent with Treasury regulation sections 1.6694-1(e) and 1.6694-2(e)(5)<sup>226</sup> to determine whether the preparer has a reasonable belief that a position is more likely than not to be sustained on the merits.<sup>227</sup>
- Accordingly, the tax return preparer is not required to independently verify information furnished by the taxpayer or another party. However, the preparer may not ignore the implications of information furnished or actually known to the preparer, and must make reasonable inquiries if the information furnished by another tax return preparer or a third party appears to be incorrect or incomplete.<sup>228</sup>

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Accordingly, the weight given to a particular authority depends on the type of document, the age of the document, and the relevance and persuasiveness of the document providing the authority.

Reasonable basis standard is interpreted in accordance with Treasury regulation section 1.6662-3(b)(3), as described above. Notice 2008-13, 2008-3 I.R.B. 282.

<sup>225</sup> Treas. Reg. 1.6694-2(b)(1).

<sup>226</sup> The good faith standards of Treasury regulation sections 1.6694-1(e) and 1.6694-2(e)(5) are discussed in footnote 192, *supra*.

<sup>227</sup> Treas. Reg. § 1.6694-2(b)(1).

<sup>228</sup> Treas. Reg. § 1.6694-1(e)(1). In addition, a tax return preparer must make appropriate inquiries to determine the existence of facts and circumstances required by the Code or regulations as a condition for claiming a deduction or credit. Treas. Reg. § 1.6694-1(e)(2). See Treas. Reg. § 1.6694-1(e)(3), *examples* 1, 2, and 3.

- In addition, the tax return preparer who prepares an amended return or claim for refund is not required to verify the positions on the original return.<sup>229</sup>
- Query whether requiring a tax return preparer to analyze all pertinent authorities is an exceedingly burdensome requirement, especially if the taxpayer is not willing to pay for exhaustive research.
- A “tax return preparer”<sup>230</sup> potentially subject to penalties under section 6694 generally includes any person who, for compensation, prepares or employs others to prepare all or a “substantial portion” of any tax return or refund claim,<sup>231</sup> regardless of such

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<sup>229</sup> Treas. Reg. § 1.6694-1(e)(2).

<sup>230</sup> “Tax return preparer” is defined in Treas. Reg. § 301.7701-15.

<sup>231</sup> Generally, a return or claim for refund for these purposes includes returns and claims for refunds that are specifically identified in published guidance in the Internal Revenue Bulletin. Treas. Reg. § 301.7701-15(b)(4). Simultaneously with the issuance of the final regulations, the IRS issued Revenue Procedure 2009-11, which identifies categories of returns to which the penalty under section 6694 could apply. *See* Rev. Proc. 2009-11, 2009-3 I.R.B. 313 (identifying relevant categories of tax returns and claims for refund for purposes of the section 6694 and 6695 penalties).

Whether a schedule, entry or other part of a return or refund claim represents a “substantial portion” is determined based upon whether the person rendering the tax advice knows or reasonably should know that the tax attributable to such portion of the return or claim for refund is a substantial portion of the tax required to be shown on the return or claim for refund. Treas. Reg. § 301.7701-15(b)(3)(i). The regulations indicate that, among other things, both the the size and complexity of the item relative to the taxpayer’s gross income and the size of the understatement attributable to the item compared to the taxpayer’s reported tax liability will be considered in determining whether a schedule, entry or other portion of a return is substantial. Treas. Reg. 301.7701-15(b)(3). A *de minimis* rule for nonsigning return preparers generally provides that a schedule, entry or other portion of a return is insubstantial if it involves amounts of gross income, deductions or amounts on the basis of which credits are determined that are less than (i) \$10,000 or (ii) \$400,000 and also

person's educational qualifications, professional status, nationality, residence or place of business.<sup>232</sup>

- A person that renders tax advice on a position (such as a tax advisor on specific issues of law) is not a tax return preparer, unless the advice (i) covers events which have occurred at the time advice is rendered, and (ii) is directly relevant to the determination of the existence, characterization, or amount of any entry on a return or refund claim.<sup>233</sup> This exception is generally intended to except certain lawyers that provide tax advice.<sup>234</sup>
- An individual is a tax return preparer subject to section 6694 if the individual is primarily responsible for the position on the return or claim for refund giving rise to an understatement, whether or not such individual was the signing preparer.

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less than 20% of gross income (or adjusted gross income, for individuals), based on an aggregate of all of the work performed. Treas. Reg. § 301.7701-15(b)(3)(ii)(A), (B), (C).

The final regulations raised the threshold for an item to be treated as a substantial portion of a return or claim for a refund. Previously, whether a portion was substantial depended on the relative size of the deficiency attributable to the portion in question. A “substantial portion” was a schedule, entry, or other portion of a tax return or refund claim that, if adjusted or disallowed, could result in a deficiency determination (or refund claim disallowance) that the preparer knew or reasonably should have known was a significant portion of the tax liability reported on the return (or, in the case of a refund claim, a significant portion of the tax originally reported). Notice 2008-13, 2008-3 I.R.B. 282.

<sup>232</sup> I.R.C. § 7701(a)(36); Treas. Reg. § 301.7701-15(d), (e).

<sup>233</sup> See Treas. Reg. § 301.7701-15(b)(2), (3).

Commentators have suggested that section 6694 should not apply to someone who never drafts, reviews, or discusses the actual return. See NYSBA, *Report on the Definition of “Tax Return Preparer” and Other Issues Under Code Sections 6694, 6695 and 7701(a)(36)* (Dec. 20, 2007).

<sup>234</sup> See Treas. Reg. § 301.7701-15(b)(2)(ii), *examples 1, 2, and 3.*

- Only one individual within a firm can be held primarily responsible for each refund or claim position on a return.<sup>235</sup> However, where multiple firms were engaged to work on a return or claim position, more than one tax return preparer may be held primarily responsible for the position.<sup>236</sup>
- Subject to certain exceptions, the signing tax return preparer generally will be considered the person primarily responsible for all return or claim positions giving rise to an understatement.<sup>237</sup>
- Both an individual and the firm that employs or is associated with the individual may be subject to penalty under section 6694 with respect to a position giving rise to an understatement.<sup>238</sup>
  - A firm that employs or is associated with a tax return preparer subject to a penalty under section 6694(a) is also subject to penalty if, and only if, (i) any member of the principal

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<sup>235</sup> Treas. Reg. § 1.6694-1(b)(1). This rule, which was included in the final regulations, modified the existing rule, which provided that only the signing preparer was treated as the tax return preparer.

<sup>236</sup> Treas. Reg. § 1.6694-1(b)(1).

<sup>237</sup> Treas. Reg. § 1.6694-1(b)(2). If there is no signing tax return preparer for the return or claim for refund within the firm, or if it is concluded that the signing tax return preparer is not primarily responsible for the position, the nonsigning tax return preparer within the firm with overall supervisory responsibility for the position giving rise to the understatement generally will be considered the tax return preparer who is primarily responsible for the position unless, based upon credible information from any source, it is concluded that another nonsigning tax return preparer within that firm is primarily responsible for the position giving rise to the understatement. Treas. Reg. § 1.6694-1(b)(3). If either the signing tax return preparer or a nonsigning tax return preparer is primarily responsible for a position giving rise to an understatement, the penalty may be assessed against either one of the individuals, but not both. Treas. Reg. § 1.6694-1(b)(4).

<sup>238</sup> Treas. Reg. § 1.6694-1(b)(5).

management (or principal officers) of the firm or a branch office participated in or knew of the prohibited conduct; (ii) the firm failed to provide reasonable and appropriate procedures for review of the position for which the penalty is imposed; or (iii) the firm disregarded its reasonable and appropriate review procedures through willfulness, recklessness, or gross indifference (including ignoring facts that would lead a person of reasonable prudence and competence to investigate or ascertain) in the formulation of the advice, or the preparation of the return or claim for refund that included the position for which the penalty is imposed.<sup>239</sup>

- The penalty for violating section 6694 is the greater of 50 percent of the “income derived (or to be derived)” by the tax return preparer with respect to the return or refund claim, or \$1,000.<sup>240</sup>
  - Income derived (or to be derived) by the tax return preparer includes all compensation received or expected to be received with respect to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position taken on the return or claim.<sup>241</sup>

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<sup>239</sup> Treas. Reg. § 1.6694-2(a)(2).

<sup>240</sup> A similar penalty is imposed on any tax return preparer who prepares any return or claim for refund with respect to which any part of an understatement of liability is due to a willful attempt to understate the liability for tax on the return or claim, or a reckless or intentional disregard of rules or regulations. I.R.C. § 6694(b). The penalty is the greater of \$5,000 or 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim. I.R.C. § 6694(b)(1).

<sup>241</sup> Treas. Reg. § 1.6694-1(f).

- If a tax return preparer is not compensated directly by the taxpayer, but instead by a firm that employs or is associated with the tax return preparer, then income derived (or to be derived) includes all compensation the tax return preparer receives from the firm that can be reasonably allocated to the engagement.<sup>242</sup>
- If a firm that employs or is associated with an individual tax return preparer is subject to a penalty, then the income derived (or to be derived) means all compensation the firm receives or expects to receive with respect to the engagement.<sup>243</sup>
- If the tax return preparer or the tax return preparer's firm has multiple engagements related to the same return or claim for refund, only those engagements relating to the positions giving rise to the understatement are considered for purposes of determining the income derived.<sup>244</sup>
- Only compensation for tax advice that is given with respect to events that have occurred at the time of the advice is rendered and that relates to the position giving rise to the understatement are taken into account for purposes of calculating the penalties.<sup>245</sup>
- Income received in the form of a lump sum is allocated between tax advice giving rise to

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<sup>242</sup> Treas. Reg. § 1.6694-1(f).

<sup>243</sup> Treas. Reg. § 1.6694-1(f).

<sup>244</sup> Treas. Reg. § 1.6694-1(f)(2).

<sup>245</sup> Treas. Reg. § 1.6694-1(f)(2)(ii).

a penalty and advice that does not give rise to a penalty.<sup>246</sup>

- If less than the total amount of compensation received by a tax return preparer or its firm with respect to an engagement is attributable to the position giving rise to the understatement on a return or claim for a refund, then the amount of the penalty will be calculated based upon the portion of the compensation attributable to the position giving rise to the understatement.<sup>247</sup>
- If both an individual within a firm and a firm that employs or is associated with the individual are subject to a penalty, the amount of penalties assessed against the individual and the firm cannot exceed 50% of the income derived (or to be derived) by the firm from the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the positions taken on the return or claim for refund that gave rise to the understatement. Moreover, the portion of the total amount of the penalty assessed against the individual tax return preparer cannot exceed 50% of the individual's compensation with respect to the engagement.<sup>248</sup>

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<sup>246</sup> Treas. Reg. § 1.6694-1(f)(2)(ii). Refunds to the taxpayer of all or part of the amount paid to the tax return preparer or its firm will not reduce the amount of any assessed penalty. Treas. Reg. § 1.6694-1(f)(2)(iii).

<sup>247</sup> Treas. Reg. § 1.6694-1(f)(2)(iv).

<sup>248</sup> Treas. Reg. § 1.6694-1(f)(3).

## I. Taxpayer Penalties for Failure to Disclose Uncertain Tax Positions

- Announcement 2010-9 indicates that the IRS is considering its options for imposing penalties or sanctions on taxpayers that fail to sufficiently disclose their uncertain tax positions on the proposed schedule.<sup>249</sup> Specific instructions regarding penalties for Schedule UTP reporting failures are not included in the final instructions to Schedule UTP.<sup>250</sup> Announcement 2010-75, provides that the IRS intends to review compliance on how the Schedule UTP is completed and to take appropriate enforcement action, such as opening an examination or otherwise contacting the taxpayer, in situations where there is either a failure to complete the Schedule UTP or to report whether the corporation is required to complete the Schedule UTP.<sup>251</sup>
- Query: Would a failure to include a schedule disclosing a taxpayer's uncertain tax positions subject a taxpayer to current penalties, including penalties for underpayments and understatements of

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<sup>249</sup> Announcement 2010-9, 2010-7 I.R.B. 408. The Announcement states that the IRS is considering seeking legislation that would impose a penalty for failure to file the schedule or make adequate disclosure. The IRS reserved on penalties in Announcement 2010-30. Announcement 2010-30, 2010-19 I.R.B. 668.

Internal Revenue Service Chief Counsel William Wilkins said that even if no additional penalties are added, taxpayers would still face consequences for failure to properly disclose their uncertain tax positions, and that he believes “preparers will be nervous.” See *Uncertain Tax Positions Proposal Intended to Fine-Tune Audit Process*, DAILY TAX REPORT G-6. (Mar. 3, 2010).

Commentators have suggested that penalties should not be asserted if taxpayers make good faith claims of privilege and that because uncertainty about a tax position can change over time, the uncertainty of the issue should be determined at the time of filing.

<sup>250</sup> Announcement 2010-75, 2010-41 I.R.B. 428.

<sup>251</sup> Announcement 2010-75, 2010-41 I.R.B. 428.

tax,<sup>252</sup> or penalties for failure to file a required tax return or complete a required tax return sufficiently?<sup>253</sup>

#### **J. Strict Liability Penalties for Understatements of Transactions that Lack Economic Substance**

- Section 7701(o) codifies the economic substance doctrine to provide that in order for a transaction to have economic substance, apart from federal income tax effects, the transaction must: (i) change in a meaningful way, the taxpayer's economic position and (ii) have a significant nontax business purpose.<sup>254</sup> A taxpayer may rely on the profit

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<sup>252</sup> See I.R.C. § 6662.

<sup>253</sup> See I.R.C. § 6651.

Some practitioners believe it is unclear whether a failure to include the proposed schedule with a tax return would subject a taxpayer to the current regime of penalties. For example, the New York State Bar Association suggests that penalties for failure to file a required tax return may not apply in this situation; courts have previously held that providing enough information to “comply substantially with the Service’s need to audit a taxpayer’s liability” may shield a taxpayer from penalties for failure to file a return, and the IRS arguably does not need to know the taxpayer’s uncertain tax positions in order to assess a taxpayer’s tax liability. See *NYSBA Comments On Proposal To Require Reporting Of Large Corporations’ Uncertain Tax Positions*, 2010 TNT 60-27 (Mar. 30, 2010). Similarly, accuracy-related penalties may not apply because they are measured by understatements of income tax liability, and disclosure of uncertain tax positions does not involve understatements. See *NYSBA Comments On Proposal To Require Reporting Of Large Corporations’ Uncertain Tax Positions*, 2010 TNT 60-27 (Mar. 30, 2010).

<sup>254</sup> For a detailed discussion of the issues raised by the codification of the economic substance doctrine, see NYSBA Tax Section, *Report on Codification of the Economic Substance Doctrine* (Jan. 5, 2011) (“NYSBA ESD Report”). For an example of when the IRS is likely to invoke the economic substance doctrine against tax shelter transactions see Chief Counsel Notice 2012-008 (Apr. 3, 2012).

potential of the transaction to satisfy the economic substance test.<sup>255</sup>

- Section 6662(b)(6) imposes a strict liability accuracy-related penalty of 20% on any portion of an underpayment attributable to any disallowance of claimed benefits by reason of a transaction lacking economic substance under section 7701(o) or failing to meet the requirements of any similar law.
- This penalty is increased to 40% if the transaction is a “nondisclosed economic substance transaction”.<sup>256</sup> A “nondisclosed economic substance transaction” is any portion of a transaction lacking economic substance with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return or an attachment.<sup>257</sup>

## VII. FINAL CIRCULAR 230 REGULATIONS

### A. Overview

Congress granted the Treasury Department the authority to “regulate the practice of representatives of persons before the Department of the Treasury.” The Treasury Department originally issued regulations governing the practice of attorneys (and others) practicing before the IRS in Treasury Department Circular No. 230 (“Circular 230”) over 90 years ago.<sup>258</sup> In the early 2000’s, the IRS

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<sup>255</sup> A transaction’s potential for profit may be taken into account in determining whether the transaction has economic substance if the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected. I.R.C. § 7701(o)(2)(A). Fees and other costs of the transaction are included in calculating the pre-tax profit. I.R.C. § 7701(o)(2)(B). The statute directs the IRS to issue regulations on how to treat foreign taxes for purposes of the profit potential test.

<sup>256</sup> I.R.C. § 6662(i).

<sup>257</sup> I.R.C. § 6662(i)(2).

<sup>258</sup> The first version of Circular 230 was made effective in 1921, and addressed attorneys and other persons who represented claimants before the Treasury Department and its offices. *See* Circular 230, 1921 C.B. 4-1600A (Feb. 15, 1921).

proposed several revisions to the Circular 230 regulations to address the problem of tax shelters, and on December 20, 2004, the IRS appeared to culminate these efforts with its publication of final Circular 230 regulations, introducing requirements for providing written tax advice and presenting aspirational “best practices” for tax practitioners. These regulations contained detailed requirements that practitioners had to follow when providing written tax advice that constituted a “covered opinion”. However, in many instances, a practitioner could “opt out” of the covered opinion requirements by including a “Circular 230 disclaimer” in the written advice. Accordingly, many practitioners routinely included a Circular 230 disclaimer in all written advice – tax related or not – to remove the writing from the covered opinion rules.

- Naturally, these regulations were met with a firestorm of criticism<sup>259</sup> and on September 17, 2012, the IRS again proposed to revise the Circular 230 regulations applicable to written advice.<sup>260</sup>
- In the preamble to the proposed regulations, the government conceded that the Circular 230 covered opinion requirements produced unintended consequences and offered five main reasons for their proposed repeal:
  - Compliance was difficult and costly;
  - The rules were overboard and unduly interfere with client relationships;
  - The rules did not necessarily produce higher quality tax advice;

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<sup>259</sup> The 2004 regulations were revised in May 2005 to address certain practitioner comments highlighting where the language of the 2004 regulations could result in consequences inconsistent with its intent. *See, e.g., NYSBA Tax Section, Report on Circular 230 Regulations* (Mar. 3, 2005).

<sup>260</sup> The IRS issued final Circular 230 regulations in 2007 modifying the rules regarding contingent fees and conflicting interests and significantly revising the rules governing disciplinary proceedings under Circular 230. T.D. 9359, 2007-2 C.B. 931.

- The rules provided minimum taxpayer protection; and
- The rules incentivized oral tax advice.<sup>261</sup>
- To address these issues, the proposed regulations significantly relaxed and simplified the Circular 230 rules applicable to written tax advice by replacing the covered opinion rules with a single “streamlined” standard applicable to all written advice.<sup>262</sup> Practitioners strongly supported these proposed regulations.<sup>263</sup>
- On June 9, 2014, the IRS finalized the Circular 230 regulations applicable to written advice and, consistent with the proposed regulations, eliminated the covered opinion rules in favor of a single standard for all written tax advice, obviating the need to include boilerplate Circular 230 disclaimers on all emails and other written advice.<sup>264</sup>
- The following section summarizes the current final Circular 230 regulations.

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<sup>261</sup> Preamble to Regulations Governing Practice Before the Internal Revenue Service, 77 Fed. Reg. 57,055 (Sept. 17, 2012), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-09-17/html/2012-22836.htm>.

<sup>262</sup> Prop. Cir. 230 §§ 10.35, 10.37. Preamble to Regulations Governing Practice Before the Internal Revenue Service, 77 Fed. Reg. 57,055 (Sept. 17, 2012), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-09-17/html/2012-22836.htm>.

<sup>263</sup> See, e.g., NYSBA Tax Section, *Report on Proposed Amendments to Circular 230 Relating to Standards with Respect to Written Tax Advice* (Dec. 26, 2012).

<sup>264</sup> T.D. 9668

## B. Scope of Circular 230

- A threshold question is whether Circular 230’s regulation of written tax advice exceeds its authority. As mentioned above, pursuant to its authority to “regulate the practice of representatives of persons before the Department of the Treasury,”<sup>265</sup> Treasury issued regulations governing the practice of attorneys, CPAs, actuaries, enrolled agents and other persons practicing before the IRS in Treasury Department.<sup>266</sup>
- “Practice” before the IRS includes all matters connected with a presentation to the IRS relating to a taxpayer’s rights, privileges, or liabilities under laws or regulations administered by the IRS.<sup>267</sup>
- An attorney may practice before the IRS by filing with the IRS a written declaration (*e.g.*, IRS Form 2848) that he or she is currently qualified as an attorney and is authorized to represent the party or parties on whose behalf he or she acts.<sup>268</sup> This person is a “practitioner” for purposes of the Circular 230 regulations.<sup>269</sup>
- Final regulations issued in 2007 provide that attorneys and accountants (not under suspension or disbarment from practice before the IRS) who render written advice governed by Circular

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<sup>265</sup> 31 U.S.C. § 330(a)(1).

<sup>266</sup> Circular 230, 31 C.F.R. pt. 10 (hereinafter, “Cir. 230” or “Circular 230”).

<sup>267</sup> Cir. 230 § 10.2(a)(4). This includes, but is not limited to, preparing and filing documents, communicating with the IRS, rendering written advice with regard to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion, and representing clients at conferences, hearings and meetings.

<sup>268</sup> Cir. 230 § 10.3(a).

<sup>269</sup> Cir. 230 §§ 10.2(a)(5) and 10.3(a). The attorney may not currently be under suspension or disbarment from practice before the IRS.

230 section 10.35 or 10.37 are practicing before the IRS even if the practitioners do not file a written declaration with the IRS.<sup>270</sup>

- On May 31, 2011, the IRS released final regulations providing that any individual who receives compensation to prepare all or substantially all of a tax return or refund claim is engaged in “practice” before the IRS and, among other things, requiring paid tax-return preparers to register with the IRS, pay an annual fee, pass a competency exam, and satisfy an annual continuing education requirement.<sup>271</sup> In response to these regulations, three independent tax-return preparers sued the IRS in the U.S. District Court for the District of Columbia, claiming that the regulations exceeded the IRS’s authority to “regulate the practice of representatives before the Department of Treasury” under Circular 230.<sup>272</sup> The District Court ruled against the IRS and held that the IRS’s statutory authority under Circular 230 does not include the regulation of paid tax-return preparers and permanently enjoined the tax-return preparer regulations.<sup>273</sup> On February 11, 2014, the United States District Court of Appeals for the D.C. Circuit affirmed the District Court’s decision.<sup>274</sup> Some practitioners

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<sup>270</sup> Cir. 230 § 10.3(a), (b). The preamble to the Circular 230 regulations provides: “The Treasury Department and IRS conclude that the rendering of written advice is practice before the IRS subject to Circular 230 when it is provided by a practitioner.” T.D. 9359, 2007-2 C.B. 931.

<sup>271</sup> T.D. 9527. The regulations also provided updated rules with respect to the standards for tax returns and are intended to be consistent with the tax return preparer penalty regulations under section 6694(a). T.D. 9527.

<sup>272</sup> *Loving v. IRS*, 917 F.Supp. 2d 67 (D.C. Dist. Col.) (Jan. 18, 2013); *affd Loving v. IRS*, 742 F.3<sup>rd</sup> 1013 (C.A. Dist. Col (Feb. 11, 2014).

<sup>273</sup> *Loving v. IRS*, 917 F.Supp. 2d 67 (D.C. Dist. Col.) (Jan. 18, 2013); *affd Loving v. IRS*, 742 F.3<sup>rd</sup> 1013 (C.A. Dist. Col (Feb. 11, 2014).

<sup>274</sup> *Loving v. IRS*, 742 F.3<sup>rd</sup> 1013 (C.A. Dist. Col (Feb. 11, 2014).

believe this decision casts doubt upon the IRS's authority to regulate tax lawyers who provide written tax advice.<sup>275</sup>

- Failure to comply with the final Circular 230 regulations (other than with respect to best practices) is subject to censure, suspension or disbarment from practice before the IRS or monetary penalty.<sup>276</sup>

### C. Monetary Penalties for Non-Compliance

- Circular 230 permits the IRS to impose monetary penalties on a tax practitioner that engages in "proscribed conduct" and any employer, firm, or other entity on whose behalf the tax practitioner was acting that knew, or reasonably should have known,

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<sup>275</sup> See Erin McManus, *D.C. Circuit Says Tax Preparer Rules Invalid, Outside of IRS's Statutory Authority*, DAILY TAX REPORT (February 11, 2014) ("Loving makes clear that advice for a return is not practice before the IRS. There remains a question about whether the IRS has the authority to broadly regulate nearly all written tax advice from a practitioner to a taxpayer where nothing reflecting the substance of that advice is submitted to the IRS beyond the taxpayer's own tax return." quoting Jeffrey Paravano, former Treasury official and managing partner at Baker Hostetler LLP).

<sup>276</sup> A practitioner may also be subject to sanctions for incompetence and disreputable conduct, including conviction of any criminal offense under the Federal tax laws or involving dishonesty, misappropriation of funds received from a client for the purpose of payment of taxes due the United States, and other actions. Cir. 230 §§ 10.50(a), 10.51(a). The regulations list a total of eighteen examples of incompetence and disreputable conduct for which a practitioner may be sanctioned, but provide no general definition of incompetence and disreputable conduct.

The Guide to Sanctions, released by the IRS's Office of Professional Responsibility, provides direction for determining which corrective sanction (censure, suspension, or disbarment) is appropriate for particular Circular 230 violations. See Internal Revenue Service, *IRS Releases Guide To Practitioner Sanctions*, 2009 TNT 83-13 (May 1, 2009); available at [http://www.irs.gov/pub/irs-utl/newly\\_revised\\_final\\_tax-non\\_compliance\\_sanction\\_guidelines\\_3.pdf](http://www.irs.gov/pub/irs-utl/newly_revised_final_tax-non_compliance_sanction_guidelines_3.pdf).

of the practitioner's proscribed conduct.<sup>277</sup> The amount of any monetary penalty is limited to the gross income derived (or to be derived) from the conduct giving rise to the penalty and could be imposed in addition to, or in lieu of, any suspension, disbarment, or censure of the practitioner.<sup>278</sup>

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<sup>277</sup> Cir. 230 § 10.50(c).

A practitioner acts on behalf of an employer (or any other entity) if (i) the practitioner and the employer have an agency relationship, the purpose of which is to provide services in connection with practice before the IRS under Circular 230 section 10.2(d), and (ii) the prohibited conduct arises in connection with the agency relationship. Notice 2007-39, 2007-20 I.R.B. 1243.

An employer knows or reasonably should know of the prohibited conduct if (i) a principal manager or officer of the employer or a branch office (x) knows of the prohibited conduct or (y) has information from which a person with similar experience and background would reasonably know of the prohibited conduct, or (ii) the employer through willfulness, recklessness, or gross indifference fails to take reasonable steps to ensure compliance with Circular 230, and an individual, in connection with the agency relationship with the employer, engages in (A) prohibited conduct under Circular 230 section 10.52 that harms a client, the public, or tax administration, or (B) a pattern or practice of failing to comply with Circular 230. Notice 2007-39, 2007-20 I.R.B. 1243. Failure to take reasonable steps to ensure compliance with Circular 230 through willfulness, recklessness, or gross indifference includes ignoring facts that would lead a person of reasonable prudence and competence to investigate or ascertain.

Other factors that may be relevant in determining whether a monetary penalty should appropriately be imposed on an employer include (i) the gravity of the misconduct, (ii) any history of noncompliance by the employer, (iii) preventative measures in effect prior to the misconduct's occurrence, and (iv) any corrective measures taken by the employer after it discovers the misconduct. Notice 2007-39, 2007-20 I.R.B. 1243.

<sup>278</sup> Cir. 230 § 10.50(c)(2), (3).

Notice 2007-39 provides that if the act of prohibited conduct giving rise to a penalty is an integral part of a larger engagement, the amount of the penalty is limited by the income derived from the larger engagement. Notice 2007-39, 2007-20 I.R.B. 1243.

- Proscribed conduct subject to monetary penalty includes (i) incompetence or disrepute, (ii) failure to comply with certain Circular 230 regulations, and (iii) willfully and knowingly misleading or threatening a client or a prospective client with intent to defraud.<sup>279</sup>
- Notice 2007-39 and the final Circular 230 regulations, which were issued after the Notice was published, have each provided guidance with respect to monetary penalties.<sup>280</sup> As commentators have noted, this guidance appears to be inconsistent in some respects.<sup>281</sup>
- Notice 2007-39 and Circular 230 section 10.50 both cover the same subject matter,<sup>282</sup> and while

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Notice 2007-39 describes the facts and circumstances that will determine the amount of the penalty. These include the practitioner's level of culpability; whether there was a violation of duty owed to a client or prospective client; and the actual or potential injury caused by the violation. Mitigating factors may include prompt action to correct the noncompliance; promptly ceasing to engage in the prohibited conduct; rectifying the harm caused by the prohibited conduct; and taking preventive measures to avoid repetition of the prohibited conduct in the future. Penalties determined by reference to income derived both before and after October 22, 2004 are pro-rated to exclude amounts attributable to conduct occurring on or before October 22, 2004. Notice 2007-39, 2007-20 I.R.B. 1243.

<sup>279</sup> Cir. 230 § 10.50(a).

<sup>280</sup> Notice 2007-39, 2007-20 I.R.B. 1243; Cir. 230 § 10.50(c).

<sup>281</sup> *See* Letter from Stanley L. Blend, Chair, American Bar Association Section of Taxation, to Linda Stiff, Acting Commissioner, Internal Revenue Service (Oct. 5, 2007) (the phrase used by the Notice, "in connection with such prohibited conduct," may be construed more broadly than the phrase used by the statute and Circular 230 section 10.50, "derived from the conduct"). Without expressing a view as to the correctness of this statement, we observe that the scope of a Notice would logically be limited by both statutory and regulatory language.

<sup>282</sup> *See* Letter from Stanley L. Blend, Chair, American Bar Association Section of Taxation, to Linda Stiff, Acting Commissioner, Internal Revenue Service (Oct. 5, 2007) (arguing that the Notice should be

the preamble to Circular 230 section 10.50 mentions the Notice, it does not address whether the Notice has continuing effect.<sup>283</sup>

#### D. Recommended Best Practices for Tax Advisors

- The final Circular 230 regulations provide that “tax advisors”<sup>284</sup> should adhere to certain best practices set forth below, and that the tax advisors with oversight responsibility for a firm’s tax practice should take reasonable steps to ensure that the firm’s procedures for members and other employees are consistent with the following best practices:<sup>285</sup>
  - Communicate clearly with clients regarding the terms of an engagement (*e.g.*, determine the purpose for and use of the advice and have a clear understanding regarding the form and scope of the advice).<sup>286</sup>
  - Establish the relevant facts and evaluate the reasonableness of assumptions or representations.<sup>287</sup>
  - Relate the applicable law (including potentially applicable judicial doctrines) to the relevant

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incorporated into the Circular 230 regulations). In addition, commentators asked for clarity as to when the monetary penalty might be appropriate, for example, when or how the mitigating factors are to be taken into account.

<sup>283</sup> T.D. 9359, 2007-2 C.B. 931.

<sup>284</sup> The final Circular 230 regulations do not define the term “tax advisor.”

<sup>285</sup> Cir. 230 § 10.33(b). Best practices apply to all tax advice whether it be oral or written. *See* Cir. 230 § 10.33(a) (“Tax advisors should provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices in *providing advice* and in preparing or assisting in the preparation of a submission to the Internal Revenue Service.”) (emphasis added).

<sup>286</sup> Cir. 230 § 10.33(a)(1).

<sup>287</sup> Cir. 230 § 10.33(a)(2).

facts and arrive at a conclusion supported by the law and the facts.<sup>288</sup>

- Advise clients regarding the importance of the conclusions reached (*e.g.*, whether a taxpayer can avoid substantial understatement penalties if it relies on the advice).<sup>289</sup>
- Act fairly and with integrity in practice before the IRS.<sup>290</sup>
- The preamble to the final regulations clarifies that these best practices are aspirational. Failure to comply with the best practices will not subject a practitioner to discipline under the regulations.

#### **E. Requirements for Written Advice**

- Section 10.37 sets forth universal guidelines that a practitioner must follow when providing written advice (including email) concerning a federal tax matter.<sup>291</sup> These guidelines require the practitioner to:
  - base the advice on reasonable factual and legal assumptions (including assumptions as to future events);
  - reasonably consider all relevant facts and circumstances that the practitioner knows or reasonably should know;

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<sup>288</sup> Cir. 230 § 10.33(a)(2).

<sup>289</sup> Cir. 230 § 10.33(a)(3).

<sup>290</sup> Cir. 230 § 10.33(a)(4).

<sup>291</sup> A federal tax matter is any matter concerning the application or interpretation of (i) a revenue provision as defined in section 6110(i)(1)(B) of the Code, (ii) any provision of law impacting a person's obligations under the internal revenue laws and regulations, including but not limited to the person's liability to pay tax or obligation to file returns, or (iii) any other law or regulation administered by the IRS. Cir. 230 § 10.37(d).

- use reasonable efforts to identify and ascertain the facts relevant to written advice on each federal tax matter;
  - not rely upon the taxpayer’s or any other person’s representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) if reliance on them would be unreasonable;
  - relate the law and authorities to facts; and
  - not, in evaluating a federal tax matter, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit.<sup>292</sup>
- Government submissions on matters of general policy (e.g., NYSBA reports) and continuing education presentations offered for the sole purpose of enhancing attendants’ professional knowledge (by contrast to presentations marketing or promoting transactions) are not considered “written advice” subject to these rules.<sup>293</sup>
  - In providing written advice, a practitioner may rely on the reasonable advice of another person so long as the reliance is in good faith considering all the facts and circumstances.<sup>294</sup> If the practitioner knows or reasonably should know that (i) the opinion of the other person should not be relied on, (ii) the other person is not competent or lacks the necessary qualifications to provide the advice, or (iii) the other person has a conflict of interest in violation of the Circular 230 rules, then reliance on the other person’s advice is not reasonable.<sup>295</sup>

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<sup>292</sup> Cir. 230 § 10.37(a).

<sup>293</sup> Cir. 230 § 10.37(a).

<sup>294</sup> Cir. 230 § 10.37(b).

<sup>295</sup> Cir. 230 § 10.37(b). According to the preamble to the regulations, a practitioner relying on the advice of another person may have a duty to inquire into such person’s skills and experience if the practitioner is

- A “reasonable practitioner” standard will be applied by the IRS in evaluating compliance with the Circular 230 requirements for written advice.<sup>296</sup> All facts and circumstances will be considered, including, the scope of the engagement and type and specificity of the advice requested by the taxpayer.<sup>297</sup> In situations where a practitioner knows or has reason to know his or her opinion will be used or referred to by a person outside his or her firm in promoting, marketing, or recommending to one or more taxpayers a partnership or other entity, investment plan or arrangement a significant purpose of which is the avoidance or evasion of any federal tax the IRS will give emphasis to the additional risk caused in applying the reasonable practitioner standard by the practitioner’s lack of knowledge of the taxpayer’s particular circumstances.<sup>298</sup>

#### **F. General Standard of Competence.**

- The Circular 230 regulations require a practitioner to satisfy a general standard of competence in order to engage in practice before the IRS.<sup>299</sup> Competence requires having the “appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged”.<sup>300</sup> The regulations provide that a practitioner may become competent for a matter by consulting with relevant area experts, by studying the relevant law, or through other methods.<sup>301</sup>

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not acquainted with the person’s qualifications to provide the advice to be relied upon. T.D. 9668.

<sup>296</sup> Cir. 230 § 10.37(c).

<sup>297</sup> Cir. 230 § 10.37(c).

<sup>298</sup> Cir. 230 § 10.37(c).

<sup>299</sup> Cir. 230 § 10.35(a).

<sup>300</sup> Cir. 230 § 10.35(a).

<sup>301</sup> Cir. 230 § 10.35(a).

## G. Circular 230 Regulations Relating to Contingent Fees and Conflicting Interests

### 1. Contingent Fees

- Practitioners are prohibited from charging contingent fees for services rendered in connection with any matter before the IRS, except with respect to:<sup>302</sup>
  - An IRS examination of, or challenge to, (i) an original tax return, or (ii) an amended return or claim for refund filed before or no later than 120 days after the taxpayer receives a written notice of the examination or a challenge to the original tax return;
  - A claim for credit or refund filed solely with respect to statutory interest or penalties assessed by the IRS;
  - A whistleblower claim under section 7623; and
  - A judicial proceeding arising under the Internal Revenue Code.

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<sup>302</sup> Cir. 230 § 10.27(b), *as clarified by* Notice 2008-43, 2008-15 I.R.B. 748.

A “contingent fee” means any fee wholly or partially based on whether or not a position taken on a tax return or other filing avoids a challenge by the IRS or is sustained in litigation (including any fee that is based on a percentage of the refund reported on a return, that is based on a percentage of taxes saved, or that otherwise depends on a specific result attained, and any fee arrangement in which the practitioner reimburses the client in the event a position is challenged or is not sustained).

Proposed modifications to Circular 230 section 10.27(b), proposed in July 2009, are consistent with the interim guidance set forth in Notice 2008-43. *See* REG-113289-08, 74 Fed. Reg. 37183 (Jul. 28, 2009).

## 2. Conflicting Interests

- Practitioners are prohibited from representing a client before the IRS if (i) the representation will be directly adverse to another client, or (ii) there is a significant risk that the representation will be materially limited by the practitioner's (x) personal interest, or (y) responsibilities to another client, a former client, or a third person.<sup>303</sup>
- A practitioner may represent a client despite a conflict of interest, provided (i) the practitioner reasonably believes that the practitioner is able to provide competent and diligent representation to each affected client, (ii) the representation is not prohibited by law, and (iii) each affected client waives the conflict of interest by giving informed consent in writing within 30 days of being informed of the conflict by the practitioner.<sup>304</sup>

### **H. Circular 230 Standards With Respect to Tax Returns and Documents**

- The Circular 230 regulations contain rules governing the standards applicable to tax returns and documents, affidavits and other papers.<sup>305</sup>

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<sup>303</sup> Cir. 230 § 10.29(a).

<sup>304</sup> Cir. 230 § 10.29(b). The practitioner must retain copies of the written consents for 36 months. Cir. 230 § 10.29(c).

The preamble to Circular 230 section 10.29 states that a practitioner would not be subject to a sanction or a monetary penalty because of the client's failure to provide written consent to the practitioner if the practitioner has documented its good faith effort to obtain the written consent, and the practitioner promptly withdraws from the conflicted representation within a reasonable period. *See* T.D. 9359, 2007-2 C.B. 931.

<sup>305</sup> *See* Cir. 230 § 10.34. The IRS and Treasury Department generally intend for the professional standards in Circular 230 § 10.34(a) to be consistent with the civil penalty standards in section 6649. *See* T.D. 9527. However, a tax practitioner liable for a penalty under section 6694 will not automatically be subject to discipline under Circular

- These regulations subject a practitioner to sanctions if the practitioner willfully, recklessly, or through gross incompetence<sup>306</sup> (i) signs a tax return or refund claim that he knows, or reasonably should know contains a position, or (ii) advises a client to take a position on a tax return or refund claim, or prepares a portion of a tax return or refund claim, containing a position, that:
  - lacks a reasonable basis,
  - is an unreasonable position described in section 6694(a)(2), the regulations thereunder, and other published guidance,<sup>307</sup> or
  - is a willful attempt by the practitioner to understate the tax liability or a reckless or intentional disregard of rules or regulations by the practitioner described in section 6694(a)(2), the regulations thereunder, and other published guidance.<sup>308</sup>
- In addition, a practitioner is subject to sanctions if the practitioner advises a client to (i) take a frivolous position on a document, affidavit, or other paper submitted to the IRS, or (ii) submit a

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230 § 10.34(a). Rather, an independent determination of violation of Circular 230 § 10.34(a) will be made before disciplinary proceedings are initiated or sanctions imposed. *See* T.D. 9527.

<sup>306</sup> The regulations provide that a practitioner's pattern of conduct will be taken into account in determining whether a practitioner acted willfully, recklessly, or through gross incompetence. Cir. 230 § 10.34(a)(2).

<sup>307</sup> Section 6694(a)(2) provides that an unreasonable position is a position that lacks substantial authority, unless the position is not a tax shelter or reportable transaction and there is a reasonable basis for the position and the position is adequately disclosed. Notice 2009-5, 2009-3 I.R.B. 309 applies to determine whether a tax return preparer took an unreasonable position described in section 6694(a)(2). *See* T.D. 9527.

<sup>308</sup> Cir. 230 § 10.34(a)(1). Sanctions are applicable for returns or refund claims filed, or advice provided on or after August 2, 2011. Cir. 230 § 10.34(e).

document, affidavit, or other paper to the IRS in order to delay or impede the administration of federal tax law or if the paper is frivolous or contains or omits information in an intentional disregard of a rule or regulation (unless the practitioner also advises the client to submit papers evidencing a good faith challenge to the rule or regulation).<sup>309</sup>

- A practitioner is also required to advise his clients of any penalties that are reasonably likely to apply to the client (and any opportunity to avoid the penalties through disclosure) with respect to (i) a position taken on a tax return if the practitioner advised the client regarding the position or if the practitioner prepared or signed the return and (ii) any document, affidavit or other paper submitted to the IRS.<sup>310</sup>
- The regulations permit a practitioner that advises a client to take a position on a tax document submitted to the IRS, or prepares or signs a tax return as a preparer, to rely in good faith without verification upon information furnished by the client, but the practitioner may not ignore the implications of information furnished to, or actually known by, the practitioner, and is required to reasonably question the information provided by the client if it appears to be incomplete, incorrect, or inconsistent with an important fact or another factual assumption.<sup>311</sup>

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<sup>309</sup> Cir. 230 § 10.34(b). Sanctions are applicable to tax returns, documents, affidavits, and other papers filed on or after September 26, 2007. Cir. 230 § 10.34(e).

<sup>310</sup> Cir. 230 § 10.34(c). This requirement applies with respect to tax returns, documents, affidavits, and other papers filed on or after September 26, 2007. Cir. 230 § 10.34(e).

<sup>311</sup> Cir. 230 § 10.34(d). This requirement applies with respect to tax returns, documents, affidavits, and other papers filed on or after September 26, 2007. Cir. 230 § 10.34(e).

## I. Compliance Procedures

- The final Circular 230 regulations require a practitioner with principal authority and oversight responsibility for a firm's Federal tax practice to take reasonable steps to ensure adequate firm procedures for all members, associates, and employees (*e.g.*, counsel) to comply with the Circular 230 rules governing authority to practice, duties and restrictions relating to practice before the IRS, and sanctions for violating the regulations.<sup>312</sup> Such practitioners will be disciplined for failure, due to willfulness, recklessness, or gross incompetence, to:
  - take reasonable steps to ensure the firm has adequate procedures to comply with the Circular 230 requirements and that such procedures are properly followed, in each case, in the event a member, associate or employee of the firm engages in a pattern or practice of failing to comply with the requirements of Circular 230,<sup>313</sup> or
  - take prompt action to correct noncompliance of a member, associate or firm employee whom the practitioner knows or has reason to know has engaged in a practice that does not comply with the Circular 230 requirements.<sup>314</sup>
  - In addition to the head(s) of a tax department, the regulations are silent as to whether the head of a firm's opinion committee and/or a firm's managing partner could also constitute practitioners with oversight responsibility for the firm's tax practice (or not).

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<sup>312</sup> Cir. 230 § 10.36(a). In 2001, the IRS and the Treasury Department expanded these compliance procedures to help ensure compliance and encourage firms to self-regulate. *See* T.D. 9527.

<sup>313</sup> Cir. 230 § 10.36(a)(1).

<sup>314</sup> Cir. 230 § 10.36(a)(2).

- The final regulations unfortunately impose liability on practitioners for actions of other practitioners under their supervision without providing any guidance as to what procedures will be considered sufficient.

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