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MEMORANDUM

Re: Review of Tax Shelter Provisions in the American Jobs Creation Act of 2004

From: Susan J. Hotine
Joseph A. Sergi

Date: October 21, 2004

Recently, Congress passed the American Jobs Creation Act of 2004, HR 4520 (“JOBS Act”), a \$138 billion dollar tax package that repeals the foreign sales corporation/extraterritorial income exclusion (“FSC/ETI”). It is expected that the President will sign the JOBS Act into law. The JOBS Act will add several tax shelter provisions to the Code. Of particular importance are the increased penalties related to reportable transactions. The JOBS Act increases the penalty for failure to disclose a reportable transaction, including imposition of the penalty when there is no underpayment of tax. It imposes a strict-liability penalty for failure to disclose listed transactions and gives the IRS Commissioner non-reviewable discretion regarding whether to rescind penalties related to reportable transactions. Additionally, the JOBS Act increases the accuracy-related penalty on reportable transactions that are not disclosed and severely limits taxpayers’ ability to rely on a reasonable cause defense. Also, it extends the statute of limitation on assessment with respect to undisclosed listed transactions. Finally, it contains various other provisions related to practice before the IRS, tax shelter promoters, and disclosure requirements. Below is a more detailed discussion of the provisions in the JOBS Act relating to tax shelters.

Higher Penalty for Failing to Disclose Reportable Transactions

I.R.C. § 6011 requires taxpayers to disclose reportable transactions in which the taxpayer participates. Currently, the only penalty for non-disclosure is the possible imposition of the substantial understatement penalty of I.R.C. § 6662. However, the substantial understatement penalty does not apply if the tax effect of the transaction does not inappropriately reduce a taxpayer’s tax liability. There is no penalty for just failing to disclose a reportable transaction. The JOBS Act creates I.R.C.

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§ 6707A, which imposes a penalty on any taxpayer who fails to include with any return or statement the required information on a reportable transaction (as determined under regulations prescribed under I.R.C. § 6011). This penalty is \$10,000 for a natural person and \$50,000 for all others. For failure to disclose a listed transaction, the penalty is increased to \$100,000 for a natural person and \$200,000 for all others. Unlike current law, these penalties apply regardless of whether the underlying transaction results in an understatement of tax. Moreover, if there is an understatement of tax, these penalties are imposed in addition to any other accuracy-related penalties.

The JOBS Act provides the IRS Commissioner with the power to rescind any portion of the penalty if: (1) the violation does not involve a listed transaction; and (2) rescinding the penalty would promote compliance and effective tax administration. If a penalty is rescinded, the Commissioner must keep and file the opinion with respect to the determination including: (1) a statement of facts and circumstances surrounding the violation; (2) the reasons for the rescission; and (3) the amount of penalty rescinded. Notwithstanding any other provision of law, the Commissioner's final determination may not be reviewed in any judicial proceeding.

In addition, the JOBS Act requires taxpayers to disclose, on their periodic reports required under section 13 or 15(d) of the Securities and Exchange Act of 1934, the payment of: (1) a penalty imposed for failing to disclose a listed transaction or reportable transaction; (2) an understatement penalty resulting from a failure to disclose a listed transaction or reportable transaction; and (3) a gross valuation misstatement penalty resulting from a failure to disclose a listed transaction or reportable transaction. These disclosures must be made regardless of the materiality of the penalty and must be disclosed the earlier of either the taxpayer having exhausted administrative and judicial remedies or having made payment. Failure to disclose the penalty will be treated as a failure to disclose a listed transaction.

Finally, the JOBS Act requires the IRS Commissioner to report annually to the House Committee on Ways and Means and the Senate Committee on Finance with a summary of the total number and aggregate amount of penalties imposed and rescinded and the reasons for the rescissions.

These provisions are effective for returns and statements due after the final date of enactment of the JOBS Act.

Material Advisor and Registration of Tax Shelter Arrangements

Currently, under I.R.C. § 6111, a promoter is required to register a transaction with the IRS no later than the day on which the first offering for sale of interests in the tax shelter occurs. The IRS then issues a tax shelter identification number that is required to be given to the investor, who in turn is required to include the ID number on any tax return in which a tax benefit from the shelter is claimed.

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For this purpose, a promoter is defined as a tax shelter organizer (i.e., a person who discovers, creates, investigates, or initiates the investment, or carries out those plans through negotiations or transactions with others, and any other person who participates in the organization, management or sale of a tax shelter listed transaction). See Treas. Reg. § 301.6111-1T, Q&A 26 through 39. For tax shelters that are listed transactions, a promoter must comply with the registration requirements when the tax shelter promoter receives fees in excess of \$100,000 in the aggregate. The fees counted against the threshold include all consideration received, including contingent fees and fees received for related transactions. There is a presumption that the fees exceed \$100,000 unless the promoters can demonstrate otherwise. A penalty of 50% of the aggregate promoter fees from the tax shelter, as described above, is imposed on the promoter for failing to register the tax shelter. I.R.C. § 6707(a)(3). The penalty can be increased to 75% of the aggregate fees if the promoter fails to register the tax shelter or files false information with the registration intentionally.

The JOBS Act amends I.R.C. § 6111 to require a material advisor to file an information return for each reportable transaction. The information return must include: (1) the information identifying and describing the transaction; (2) information describing any potential tax benefits expected to result from the transaction; and (3) such other information as provided in regulations. The JOBS Act defines a material advisor as any person who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction and directly or indirectly earns gross income in excess of \$50,000 for a reportable transaction that provides tax benefits to natural persons and \$250,000 for all other cases. If a material advisor fails to file an information return or files false or incomplete information, new I.R.C. § 6707 imposes a \$50,000 penalty. If the penalty is for a listed transaction, the amount increases to the greater of \$200,000 or 50% (75% if there is intentional disregard of the statute) of the gross income of the person who provides aid, assistance, or advice with respect to the listed transaction. The IRS Commissioner has the power to rescind any portion of the penalty.

The provisions apply to material advisors that provide material aid, assistance, or advice after the date of enactment of the JOBS Act. The penalties will apply to returns due after the date of enactment of the JOBS Act.

Penalty for Failure to Maintain Investor Lists

Currently, under I.R.C. § 6112, an organizer or seller of a tax shelter is required to maintain a list of investors in tax shelters that are listed transactions and to make the list available to the IRS, regardless of whether the tax shelter is confidential. A person is an organizer or seller, for this purpose, if that person is a material advisor (i.e., if that person is required to register under I.R.C. § 6111 or if that person receives or expects to receive the minimum fee (\$25,000 if all participants in the transaction are corporations or \$10,000 for transactions that include other parties) and makes certain tax

statements with respect to the transaction). See Treas. Reg. § 301.6112-1(c)(1) and (3). Upon request, the list of investors is to be furnished to the IRS within 20 business days without the protections of the summons procedure. See Treas. Reg. § 301.6112-1(g). The penalty for failure to maintain a tax shelter investor list without reasonable cause is \$50 for each investor with respect to whom there is a failure, subject to a maximum penalty of \$100,000 per calendar year. I.R.C. § 6708.

The JOBS Act modifies I.R.C. § 6112 to require, for each listed transaction, that a material advisor (as defined in I.R.C. § 6112) must maintain a list that: (1) identifies each person to whom the advisor acts as a material advisor; and (2) contains other information as requested by the Treasury Department. Under the JOBS Act, a material advisor that fails to make this list available to the IRS within 20 days of a written request will be subject to penalty in the amount of \$10,000 per day until the list is produced. This penalty also applies to the production of an incomplete list. If the failure to produce the list is due to reasonable cause, the penalty may be waived.

These provisions apply to material advisors that provide material aid, assistance, or advice after the date of enactment of the JOBS Act. The penalties will apply to returns due after the date of enactment of the JOBS Act.

New Promoter Penalty

Currently, I.R.C. § 6700(a) provides that a \$1,000 penalty is imposed against any person who organizes, assists in the organization of, or participates in the sale of any interest in a partnership or other entity, any investment plan, or arrangement, or other plan or arrangement, and makes or provides a qualifying false or fraudulent statement or a gross valuation overstatement. This penalty on gross valuation overstatement can be waived upon a showing that there was a reasonable basis for the valuation and it was made in good faith.

The JOBS Act modifies this promoter penalty to equal 50% of the gross income derived by the person from activity that involves a statement on the tax benefits of participating in a plan or arrangement if the person knows or has reason to know that the statement is false or fraudulent. The 50% penalty does not apply to gross valuation overstatements.

The modified penalty is effective for activities after the date of enactment of the JOBS Act.

Substantial Underpayment Penalty for Transactions that Are Not Reportable

Under current law, I.R.C. § 6662 provides a 20% accuracy-related penalty to any substantial understatement of tax, defined as the greater of a 10% understatement of the correct tax or \$5,000 (\$10,000 generally for corporations). The JOBS Act modifies I.R.C. § 6662 to provide that a corporate taxpayer will be charged with the 20% accuracy-related penalty when it has either: (1) an

understatement greater than 10% of the total tax or \$10,000 (whichever is greater); or (2) an understatement of \$10 million. This penalty does not apply to reportable transactions, which are governed by new I.R.C. § 6662A.

This provision is effective for tax years ending after the date of enactment of the JOBS Act.

New Accuracy-Related Penalty for Understatements in Income for Reportable Transactions

The JOBS Act adds I.R.C. § 6662A, which provides a new accuracy-related penalty for understatements that applies to listed transactions and reportable transactions with a significant tax avoidance purpose. The penalty rate and defenses available are different and depend upon whether the transaction was adequately disclosed.

The JOBS Act imposes a 20% accuracy-related penalty for understatements resulting from disclosed listed transactions and reportable transactions with a significant purpose to avoid or evade tax. The penalty does not apply only if: (1) the taxpayer adequately disclosed the relevant facts affecting the tax treatment; (2) there is or was substantial authority for the claimed tax treatment; and (3) the taxpayer reasonably believed that the claimed tax deduction was more likely than not the proper treatment based upon the facts and law in existence at the time the tax return was filed and related solely to taxpayer's chance of success on the merits. This new reasonable cause and good faith exception is a much more demanding standard than the current exception provided in I.R.C. § 6664(c), which provides that taxpayers can avoid the imposition of the accuracy-related penalty if only: (1) the treatment of the item is or was supported by substantial authority; and (2) the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment. In addition, the JOBS Act provides that a taxpayer may not rely on an opinion of a tax advisor if the opinion is either provided by a disqualified tax advisor or is a disqualified opinion. A "disqualified tax advisor" is any advisor who: (1) is a material advisor who participates in the organization, management, promotion, or sale of the transaction or is related to any such person; (2) is compensated directly or indirectly by a material advisor with respect to the transaction; (3) has a fee arrangement which is contingent on all or part of the intended tax benefits being sustained; or (4) has a disqualifying financial interest, as determined under regulations. A "disqualified opinion" is defined as an opinion that: (1) is based on unreasonable factual or legal assumptions; (2) unreasonably relies upon representations, findings or agreements of the taxpayer or any other person; (3) does not identify or consider all relevant facts; or (4) fails to meet any other requirement prescribed by the Secretary of the Treasury.

Taxpayers who fail to disclose any listed or reportable transaction adequately will not be eligible for a reasonable cause exception and are strictly liable for a penalty equal to 30% of the understatement.

This provision is effective for tax years ending after the date of enactment of the JOBS Act.

Tax Shelter Exception to Confidentiality Privileges Relating to Taxpayer Communications

I.R.C. § 7525 states that, generally, the common law privilege that applies to communications between a taxpayer and an attorney also applies to communications between a taxpayer and a federally authorized tax practitioner to the extent the communication would be privileged if it were between a taxpayer and attorney. Currently, I.R.C. § 7525(a) provides that this privilege does not apply to communications related to corporate tax shelters. The JOBS Act expands the corporate tax shelter rule by making I.R.C. § 7525(a) applicable to all shelters. Consequently, the code no longer provides any confidentiality protections for communications related to tax shelters. This provision does not affect common law privileges.

This provision is effective for communications taking place on or after the date of enactment of the JOBS Act.

New Statute of Limitation for Unreported Listed Transactions

Subject to certain exceptions for fraud or substantial omissions, I.R.C. § 6501 provides that taxes must be assessed within three years after the date the return is filed. Tax cannot be assessed or collected if the IRS does not act within the required time periods. The JOBS Act modifies I.R.C. § 6501 to extend the statute of limitations for listed transactions if the taxpayer fails to disclose the transaction as required by I.R.C. § 6011. The new statute of limitations expires one year after the earlier of the date on which the Secretary is furnished the required information or the date the material advisor meets the list maintenance requirements of I.R.C. § 6112 relating to the transaction with respect to the taxpayer.

This provision is effective for tax years in which the period for assessing a deficiency did not expire before the date of enactment of the JOBS Act.

Modification of Actions to Enjoin Specified Conduct Related to Tax Shelters and Reportable Transactions

Currently, I.R.C. § 7408 authorizes civil actions to enjoin any person from promoting abusive tax shelters (I.R.C. § 6700) or aiding or abetting the understatement of tax liability (I.R.C. § 6701). The JOBS Act expands I.R.C. § 7408 to include civil actions to enjoin material advisors with respect

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to the reporting requirements for reportable and listed transactions and the keeping of investor lists. The JOBS Act also permits civil actions for injunction related to violations under Circular 230.

This provision is effective the day after the date of enactment of the JOBS Act.

Penalty on Failure to Report Interests in Foreign Financial Accounts

Citizens, residents, or persons doing business in the United States must keep records and file reports when they make a transaction or maintain an account with a foreign entity. Currently, 31 U.S.C. § 5321 imposes, on any person that willfully violates this reporting requirement, a penalty in the amount of the transaction or the value of the account. The penalty amount is subject to a minimum of \$25,000 and a maximum of \$100,000. The JOBS Act amends 31 U.S.C. § 5321 to impose an additional civil penalty on persons that violate this reporting act without regard for willfulness. The new penalty is capped at \$10,000. If the violation is willful, this amount is increased to the greater of \$100,000 or 50% of the amount involved.

This provision is effective for violations occurring after the date of enactment of the JOBS Act.

Monetary Censures Permitted for Circular 230 Violations

The JOBS Act modifies 31 U.S.C. § 330(b) to permit the Treasury Department to censure any tax representative who violates Circular 230, which provides regulations for individuals practicing before the Treasury, and to impose a monetary penalty on an individual or on the employer, firm, or entity that the individual represents if it knew or reasonably should have known about the conduct giving rise to the penalty. This penalty is limited to the amount of gross income derived from the conduct giving rise to the penalty.

This provision is effective the day after the date of enactment of the JOBS Act.

Please call with questions.