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2004 Jobs Act: Overhaul of Tax Shelter Rules

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The American Jobs Creation Act of 2004 was enacted on October 22, 2004. While the Act made changes in many areas of the tax law, the rules relating to tax shelters were significantly overhauled – principally by imposing various draconian penalties that will apply to taxpayers who fail to disclose their participation in a wide range of transactions (usually, but not always, tax-motivated) that are thought to be potentially abusive.

These legislative changes are the most recent in a long series of initiatives over the past seven years by Congress, the Department of the Treasury and the Internal Revenue Service to shut down the tax shelter industry. Prior to the Act, the last legislative attempt to deter the proliferation of tax shelter transactions came in 1997 when Congress enacted enhanced registration and penalty requirements relating to certain specified tax-motivated transactions. Although the Treasury Department went on to promulgate several sets of tax shelter regulations in 2002 and 2003, Congress believed that the various rules relating to taxpayer disclosure, tax shelter registration and investor list maintenance should be revised and streamlined so as to better address the current tax shelter landscape, and enforced through the imposition of meaningful penalties. As a result, the new legislation has amended the Internal Revenue Code to require the disclosure of a wide range of potentially abusive transactions by both taxpayers and certain “material

New tax legislation imposes significant new penalties on the failure of taxpayers to disclose their participation in a wide range of potentially abusive transactions.

advisors,” and has introduced a series of substantial monetary and other penalties to punish any failure to comply with these disclosure requirements.

Reportable Transactions

The new enhanced penalty and other provisions described below will generally apply only to the extent that a taxpayer has participated in a “reportable transaction” and has failed to disclose it to the IRS as required. There are currently six different types of “reportable transactions”:

- *Listed Transactions.* Any transaction designated as such by the IRS, together with any “substantially similar” transaction. Most abusive tax avoidance transactions that have been widely used and/or highly publicized have been designated as “listed” transactions by the IRS.
- *Confidential Transactions.* Any transaction that is offered to a taxpayer under conditions of confidentiality where an advisor, who is paid a specified minimum fee, places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction that is designed to protect the confidentiality of the advisor’s tax strategy.
- *Contingent Fee Transactions.* Any transaction for which (i) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained, or (ii) the fees are contingent on the intended tax consequences from the transaction being sustained.
- *Loss Transactions.* Any transaction that results in (i) a corporate taxpayer (or a partnership with only corporate partners) claiming a loss of at least \$10 million in any single year or \$20 million in any combination of years, (ii) any other taxpayer (e.g., an individual, trust, S corporation, etc.) claiming

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a loss of at least \$2 million in any single year or \$4 million in any combination of years, or (iii) an individual or trust claiming a foreign currency translation loss of at least \$50,000 in any single year. The IRS has specifically exempted certain types of loss-producing transactions from this category (for example, certain casualty losses).

- *Transactions Resulting in Significant Book/Tax Differences.* Any transaction in which the tax treatment differs (or is expected to differ) by more than \$10 million from its treatment for GAAP purposes in any year. This category applies only to taxpayers that are reporting companies under the Securities Exchange Act of 1934 or business entities that have (alone or in combination with certain related persons) \$250 million or more in gross assets. The IRS has specifically exempted certain types of book/tax difference transactions from this category (for example, book/tax differences arising from tax-free reorganizations, like-kind exchanges, etc.).
- *Tax Credit Transactions.* Any transaction that results in a tax credit exceeding \$250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.

Under applicable reporting rules, a taxpayer must disclose participation in a reportable transaction by filing a statement on IRS Form 8886 with the taxpayer's annual income tax return or, under some circumstances, by completing the new Schedule M-3.

Enhanced Taxpayer Penalties

The 2004 Jobs Act has imposed two significant new penalties relating to reportable transactions:

- *Penalty for Failure to Report.* New section 6707A provides for significant stand-alone penalties if a taxpayer fails to disclose participation in a reportable transaction. The basic penalty is \$10,000 in the case of individuals and \$50,000 in the case of all other taxpayers, but the penalty is increased to \$100,000 and \$200,000, respectively, if the undisclosed reportable transaction is a "listed" transaction. This penalty cannot generally be abated or rescinded by the IRS except in extremely limited circumstances – the unreported transaction must not be a "listed" transaction, and the IRS Commissioner must make a written determination that the rescission of the penalty would promote compliance with the requirements of the tax law and effective tax

administration. Furthermore, all rescissions of this penalty must be reported by the IRS annually to the Congressional tax-writing committees. It remains to be seen whether these procedural roadblocks will ensure that the IRS rescinds this penalty only very infrequently. Any IRS refusal to rescind the penalty is not subject to judicial review.

- *Increased Accuracy-Related Penalty.* New section 6662A provides for a new accuracy-related penalty for understatements of tax resulting from listed transactions or other reportable transactions that have a "significant tax avoidance purpose." The penalty is generally 20 percent of the amount of the understatement, increased to 30 percent if the underlying reportable transaction was not disclosed as required. This penalty is subject to a heightened "reasonable cause" exception that requires, among other things, that the taxpayer have a "reasonable belief" that the treatment of the transaction was more likely than not correct. In determining whether the requisite "reasonable belief" exists, a taxpayer is not entitled to rely upon the favorable opinion of certain "disqualified tax advisors."

Other Significant Changes

In addition to the enhanced penalties referred to above, the Act made certain other key changes relating to various aspects of reportable transactions:

- *Extension of Statute of Limitations.* Normally, there is a three-year statute of limitations relating to tax deficiencies. In order to discourage taxpayers from engaging in undisclosed tax-motivated transactions in hopes that the statute of limitations will run prior to any IRS challenge, the Act provides that if a taxpayer does not disclose its participation in a "listed" transaction, the statute of limitations will not expire until one year following the earlier of (i) the date on which the taxpayer discloses the transaction to the IRS, or (ii) the date on which a "material advisor" discloses certain information relating to the transaction to the IRS pursuant to the advisor's own independent disclosure obligations.
- *SEC Disclosure.* If an SEC reporting company incurs a penalty under section 6707A for failure to disclose a listed transaction, or incurs either a 30 percent accuracy-related penalty under section 6662A or a gross valuation misstatement penalty under section 6662(h) relating to a non-disclosed

listed transaction or non-disclosed reportable avoidance transaction, then the company is required to disclose the imposition of the penalty to the SEC – even if the penalty amount could not be considered material in the context of the company’s financial statements. Failure to disclose the imposition of one of these penalties to the SEC as required will itself trigger an additional \$200,000 penalty.

- *Denial of Interest Deduction.* No deduction is allowed for any interest payable on an understatement of tax arising from an undisclosed listed transaction or other reportable transaction that had a “significant tax avoidance purpose.”

Material Available On-Line

The following legislative material is available at www.pmstax.com/gen/hr4520 with the indicated file names and sizes:

- Pages 160-172 of H.Rpt. 108-755 (the Conference Report) containing sections 811-822 of the Act, enacting the new tax shelter provisions [[ConfAgmtShltr.pdf](#), 83K].
- Pages 582-604 of H.Rpt. 108-755 (the Conference Report) containing the portion of the Explanatory Statement regarding the new tax shelter provisions [[ConfExpShltr.pdf](#), 92K].

