

February–March 2010

Journal of
**TAX PRACTICE
& PROCEDURE**

Published Bimonthly by CCH, a Wolters Kluwer business

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S.G. Smith: Taxpayers Must Pay the Listed Transaction Penalty and Sue for a Refund

By Bruce Givner and Ken Barish

Bruce Givner and Ken Barish discuss a recent Tax Court case, *S.G. Smith*, holding that taxpayers must pay the listed transaction penalty and then sue for a refund.

Introduction

In a long-awaited case of first impression,¹ Tax Court Judge Diane Kroupa ruled on December 21, 2009, that when the IRS imposes the \$100,000 penalty on an individual² for failing to report³ a listed (or “substantially similar”) transaction (\$200,000 in the case of any other taxpayer, e.g., a corporation⁴), the taxpayer’s only recourse to contest the penalty pre-collection is to pay the tax and sue for a refund.

Background

Enactment

Code Sec. 6707A, entitled “Penalty for failure to include reportable transaction information with return,” was added to the Code by the American Jobs Creation Act of 2004.⁵ It was effective for “returns and statements the due date for which is after 10/22/2004 and which were not filed before such date.”

Two-Tier Penalty

Code Sec. 6707A begins by imposing a penalty on “Any person who fails to include on any return or statement any information with respect to a reportable transaction which is required under section 6011 to be included with such return or statement”⁶ The amount of the penalty is \$10,000 “in the case of

a natural person” and \$50,000 “in any other case.”⁷ However, if the reportable transaction is, instead, the more disfavored *listed* transaction, then the penalty amount increases to \$100,000 and \$200,000, respectively.

The Forms

The form which taxpayers are required to file to report reportable and listed transactions is Form 8886, *Reportable Transaction Disclosure Statement*. This form must be filed with the taxpayer’s income tax return and, for the first year, the Office of Tax Shelter Analysis (OTSA). Failure to file Form 8886 with OTSA, in the first year of the transaction, will result in the imposition of the Code Sec. 6707A penalty even if it is filed with the taxpayer’s tax return.⁸

Rescission

Listed Transactions

One of the most interesting, and controversial, aspects of the new law is subsection (d). Code Sec. 6707A(d)(1) provides that the IRS may not rescind a penalty for a listed transaction. However, the IRS has the discretion to rescind the penalty if other reportable transactions go unreported.

No Judicial Access

Code Sec. 6707A(d)(2) provides that “any determination under this subsection [about a rescission of the penalty] may not be reviewed in any judicial proceeding.” The statute did not prevent a taxpayer

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from going to court to contest the imposition of the penalty. However, it was unclear how the taxpayer would get to court. That is why we have been waiting for *Smith*.

Reasonable Cause

Code Sec. 6664(c) is familiar to most practitioners. It provides that "no penalty shall be imposed ... with respect to any portion of an underpayment if it is shown that there was a *reasonable cause* for such portion and that the taxpayer acted in *good faith* with respect to such portion." (Emphasis added.) However, this reasonable cause relief is unavailable to taxpayers for the Code Sec. 6707A penalty. Under the Code Sec. 6707A statute the taxpayer is left to pursue whether the transaction is either a reportable or listed transaction and whether the required Form 8886 was filed.

Penalty Stacking

A taxpayer who gets caught by Code Sec. 6707A may face a tidal wave of penalties. In *Smith*, the taxpayer was hit with both the regular Code Sec. 6662 accuracy-related penalty of 20 percent and the 30-percent penalty under Code Sec. 6662A, "Imposition of accuracy-related penalty on understatements with respect to reportable transactions." (However, we cannot tell from the figures in the case precisely what portion of the deficiency was subject to each penalty.)

Note. Code Sec. 6662A was also added by the American Jobs Creation Act of 2004.

Statute of Limitations

Code Sec. 6501(c)(10) provides that if a taxpayer fails to disclose on a return or statement for any tax year only information required under Code Sec. 6011, with respect to a listed transaction, as defined in Code Sec. 6707(A)(c)(2), the period of limitations for assessment of any tax imposed with respect to the transaction does not expire until one year after the IRS is furnished the information so required. In a recent fully reviewed decision, the Tax Court held that Code Sec. 6501(c)(10) is effective for tax years for which the period for assessing a deficiency did not expire before October 22, 2004.⁹ In so ruling, the Tax Court denied the petitioners' argument that because Code Sec. 6707A applies only to returns and statements due after October 22, 2004. Code

Sec. 6501(c)(10) cannot apply to any transaction for which a return or statement was due on or before October 22, 2004.

State Penalties

California adopted its own version of (i) Code Sec. 6707A in Revenue & Taxation Code §19772, entitled "Failure to include reportable transactions information; penalty; modifications to federal provisions; rescission of all or portion of penalty by the Chief Counsel" (the dollar amounts are \$15,000 and \$30,000, and only apply to those with taxable income of greater than \$200,000); and (ii) Code Sec. 6662A in Revenue & Taxation Code §19164.5, entitled "Reportable transaction accuracy-related penalty; application and modification of federal provisions."

Similar to Code Sec. 6707A, the state statute provides the California Franchise Tax Board (FTB) may rescind all or any portion of the penalty for failing to disclose a reportable transaction, other than a listed transaction, and the taxpayer cannot appeal or challenge the Chief Counsel's refusal to rescind the penalty before the State Board of Equalization or in court.

Note. California went beyond the federal government, anticipating what Congress is likely to pass next year, and added a penalty for "noneconomic substance transaction understatements." Rev. & Tax. Code §19774. The penalty is 40 percent for such a transaction, reduced to 20 percent if it is "adequately disclosed." The key definition is as follows: "A transaction shall be treated as lacking economic substance if the taxpayer does not have a valid nontax California business purpose for entering into the transaction." (California is partial: A valid nontax New York business purpose is inadequate.)

IRS Reaction

The IRS has publicly stated that it is (i) aware of the harsh impact that Code Sec. 6707A has on taxpayers and (ii) concerned about the imposition of a large penalty without regard to the tax benefit associated with the transaction and the taxpayer's knowledge or intent.¹⁰ Partly to ensure the flow of information without fear of penalty, the IRS, in 2006, formulated a new transaction category, Transactions of Interest (TOI). These are transactions that the IRS believes have the potential

for tax avoidance or evasion but about which the IRS lacks sufficient information to determine whether the transaction should be identified specifically as tax avoidance transactions. However, this new category also displays how broadly the IRS intends on using its powers to obtain information.

Pending Legislation

June 2009

In a June 12, 2009, letter to Commissioner Shulman, Senate Finance Chair Max Baucus (D-MT), Ranking Member Chuck Grassley (R-IA), Ways and Means Oversight Subcommittee Chair John Lewis (D-GA) and Ranking Member Charles Boustany (R-LA) supported the Small Business Council of America, the ABA Section of Taxation, National Taxpayer Advocate Nina Olsen and others who have complained that Code Sec. 6707A leads to unfair and absurd results.¹¹

The letter noted that the penalty applies without regard to whether the taxpayer has knowledge that the transaction was listed, without regard to whether the transaction is reported correctly on the taxpayer's return and even if the taxpayer derived little or no tax savings from the transaction. They complained that it can result in disproportionate penalties for small businesses that invested in listed transactions that produced modest tax benefits, and may not even have been aware of the transaction's listed status. The letter said a "bipartisan, bicameral commitment" was under way to enact legislation that would ease Code Sec. 6707A's application. In the meantime, they asked the IRS to use its discretion to suspend efforts to collect Code Sec. 6707A liabilities in cases where the annual tax benefits resulting from the listed transactions are less than \$100,000 for individuals and \$200,000 in other cases.

July 2009

In a July 6, 2009, letter, Commissioner Shulman told lawmakers he would suspend collection efforts for listed transactions through September 30, 2009, where the tax benefits from the transaction is less than \$100,000 for individuals and \$200,000 for corporations, as Congress works on legislation to even out

the penalties under Code Sec. 6707A. However, he cautioned that the audits would continue.¹²

September 2009

In a September, 24, 2009, letter to Senate Finance Committee Chair Max Baucus (D-MT), Commissioner Shulman said the suspension of collection enforcement efforts will extend through December 31, 2009. The Commissioner acknowledged that IRS personnel were uncomfortable with the penalty's harshness in individual cases.¹³

November 2009

On November 16, 2009, the Small Business Penalty Relief Act of 2009 (H.R. 4068, S. 2771) was introduced by Senate Finance Chair Baucus and ranking member Grassley, along with Sen. Mike Crapo (R-ID), and House Ways and Means Oversight Subcommittee Chair John Lewis (D-GA) and ranking member Charles Boustany (R-LA). It would amend Code Sec. 6707A so that the penalty would be 75 percent of the tax benefit

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received, with a minimum penalty of \$10,000 for corporations and \$5,000 for individuals. The maximum penalty would be \$200,000 for corporations and \$100,000 for individuals. The legislation would apply to all penalties assessed after December 31, 2006.

February 2010

On February 9, 2010, the Senate unanimously passed S. 2917, the Small Business Penalty Fairness Act of 2009. The House of Representatives is likely to approve the legislation. The provisions are substantially the same as the Small Business Penalty Relief Act of 2009, introduced in November 2009.

S.G. Smith

This is a brief opinion, barely 1,500 words, not counting footnotes. The opinion does not tell us the nature of the transaction which resulted in the deficiency notices and notices of assessment of the listed transaction penalties of \$100,000 for Dr. and Mrs. Smith for 2004, 2005 and 2006, and

\$200,000 for Dr. Smith's corporation for each of the same years.

In response to the notices, the taxpayers filed a petition in Tax Court challenging the deficiency notice and the notices of assessment. The IRS filed a Motion To Dismiss for Lack of Jurisdiction and to Strike as to the Code Sec. 6707A penalties because the Tax Court lacks jurisdiction.

Judge Kroupa first recounted that "[t]his Court is a court of limited jurisdiction and may exercise jurisdiction only to the extent authorized by Congress." She then reviewed the legislative history of Code Sec. 6707A, noting that "The legislative history indicates that the statute's prohibition of judicial review is not intended otherwise to limit the taxpayer's ability to litigate whether a penalty is appropriate."¹⁴

The IRS argued that because Code Sec. 6707A is in Subchapter B, entitled "Assessable Penalties," of Chapter 68 of the Code (which begins with Code Sec. 6671), the taxpayers cannot seek a redetermination in the Tax Court. Judge Kroupa disposed of that argument by pointing out that "The label of 'assessable penalty'... does not automatically bar a taxpayer from using the deficiency procedures to challenge the liability." Code Sec. 6707A does not, like some other sections in Subchapter B, explicitly prohibit the use of the deficiency procedures. However, she concluded that the very nature of the penalty is such that there is no deficiency, which is "the amount by which the tax imposed by subtitle A ... exceeds the amount shown as tax by the taxpayer upon his or her return." As we know from the complaints lodged by the Small Business Council of America, the National Taxpayer Advocate, Senator Baucus and others, the Code Sec. 6707A penalty may be assessed even if there is an overpayment of tax!¹⁵

Conclusion

Code Sec. 6707A and the other statutes (Code Secs. 6662A and 6501(c)(10)), which were enacted in the American Job Creation Act of 2004, have proven to be quite extreme for taxpayers. As it currently stands, under Code Sec. 6707A, an individual taxpayer with a corporation can be hit with a \$300,000-per-year penalty for the failure to report a transaction that may have caused a small, or even no, tax savings. For example, imagine the Subchapter "S" taxpayer that participated in a welfare benefit plan in 2004, 2005 and 2006, with a deduction of \$50,000 per year, resulting in a tax

"savings" for the individual 100 percent shareholder of \$20,000 per year. Assume this welfare benefit plan is one that the IRS felt was "substantially similar" to those described in Notice 95-34.¹⁶ The failure to file the IRS Form 8886 by both the corporation and the shareholder results in a \$100,000 per year penalty for the shareholder and \$200,000 per year penalty for the "S" corporation, which is \$900,000. The taxpayer's only recourse pre-collection is to pay the penalty and sue for a refund in the U.S. District Court or the U.S. Court of Federal Claims. How many taxpayers in that situation would have the \$900,000 with which to pay the tax, and then the \$150,000 or so to pay the lawyer to handle the suit in federal court?

Now let us assume the proposed legislation passes, and the penalties are reduced to be proportionate to the tax savings. That will be a great relief, of course. However, *Smith* means the taxpayer still faces a formidable obstacle. Take our same taxpayer as in the preceding paragraph. The IRS now imposes a reasonable penalty, in light of a \$60,000 total tax savings, of only \$45,000. The taxpayer must pay the penalty and file suit in federal court for a refund. How much in legal fees will it cost to prosecute that lawsuit and claim the refund? Even a taxpayer who is "right," to whom we all agree that refund is owed may, in the end, be financially coerced into paying and being told to "fuhgetaboutit."

Code Sec. 6707A appears to be an overreaction by Congress. As *Smith* shows, even the proposed legislation will not go far enough to put taxpayers in a reasonable position to contest the imposition of the penalty.

ENDNOTES

¹ *S.G. Smith*, 133 TC —, No. 18, Dec. 58,028 (2009).

² Code Sec. 6707A(b)(2)(A).

³ The reporting would be done on IRS Form 8886.

⁴ Code Sec. 6707A(b)(2)(B).

⁵ American Jobs Creation Act of 2004 (P.L. 108-357).

⁶ Code Sec. 6707A(a).

⁷ Code Sec. 6707A(b)(1).

⁸ See Notice 2005-11, 2005-CB 493.

⁹ *BLAK Investments*, 133 TC —, No. 19, Dec. 58,039 (2009).

¹⁰ See, for example, Janet Novack, *Hell Froze Over: This is not a mistake: The IRS says tax shelter penalties are too tough*, FORBES, June 30, 2008, at 42. See also the July 6, 2009, letter from IRS Commissioner Douglas Shulman to The Honorable John Lewis, Chairman, Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, at waysandmeans.house.gov/media/pdf/111/frlewis.pdf.

¹¹ www.finance.senate.gov/press/Bpress/2009press/prb061509.pdf.

¹² <http://finance.senate.gov/press/Bpress/2009press/prb070709.pdf>.

¹³ See CCH Tax News Headlines, item entitled "IRS Extends Current Suspension of Code Sec. 6707A Penalty Collection Through Year End," at <http://tax.cchgroup.com/news/headlines/2009/nws92509.htm>.

¹⁴ In discussing the other avenues available for judicial review of the Code Sec. 6707A penalty, the court noted that the taxpayer may sue for a refund. In addition, speaking of its own jurisdiction the court