

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Tax Penalties Legislative Proposals

Reportable Avoidance Transactions

Reasonable Cause Exception

Information Reporting Penalties for Foreign Trusts

Tax Shelters

Developed by:

Tax Penalties Reform Task Force

Patti Burquest, Chair

J. Edward Swails, Vice Chair

Mary Blatch

Harve Lewis

Kathy Petronchak

Todd Simmens

Anita Soucy

Melanie Lauridsen, AICPA Technical Manager

Eileen Sherr, AICPA Senior Technical Manager

Approved by:

Tax Executive Committee

April 11, 2013

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¹ See also the April 2013 updated [AICPA Report on Civil Tax Penalties: The Need for Reform](#) that is being submitted to Congress with these [tax penalties legislative proposals](#) submission.

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Introduction

These AICPA legislative proposals regarding tax penalties should be read in combination with the attached April 2013 updated [AICPA Report on Civil Tax Penalties: The Need for Reform](#) (AICPA Report). The AICPA Report covers our concern that the government's understandable interest in combating abusive tax shelters has resulted in a civil tax penalty regime that is not sufficiently geared toward encouraging voluntary compliance. In the AICPA Report, we express our concerns about the current state of civil tax penalties and offer general suggestions for improvement. Specifically, we address the following issues:

- The trend away from voluntary compliance as the primary purpose of civil tax penalties;
- The lack of clear standards in some penalties;
- The fact that some penalties are disproportionate both in amount and severity;
- The fact that some penalties are overbroad, deter remedial and other good conduct, and punish innocent conduct;
- The trend toward strict liability;
- An erosion of basic procedural due process;
- Inconsistencies between penalty standards and the role of tax professionals;
- The increase in automated assessment of penalties that can lead to unwarranted assessments;
- The need for better coordination and oversight of penalty administration;
- The bias in favor of asserting penalties;
- The need to improve Internal Revenue Service (IRS or "Service") guidance and training; and
- The need for the IRS to increase its efforts to educate taxpayers and tax professionals.

We provide our comments in the AICPA Report with an eye toward improving overall tax policy and administration. To that end, we strongly encourage an inclusive and transparent framework for approaching this difficult task, similar to the collaborative efforts that culminated in Improved Penalty and Compliance Tax Act of 1989 (IMPACT). We urge Congress, Treasury and the Internal Revenue Service to work with taxpayers, practitioners, professional organizations and other stakeholders in developing a systematic and thoughtful approach to civil tax penalty reform and penalty administration.² To help initiate the process of considering specific tax penalty areas to address, we have developed the four legislative proposals set forth below for Congress to consider, and welcome discussing these further with those interested in this area.

² See the [AICPA tax penalties legislative proposals](#), submitted to Congress in April 2013, included in the submission with this [April 2013 updated AICPA Report on Civil Tax Penalties](#).

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Proposal

Allow a reasonable cause exception to the IRC sections 6707A and 6662A penalties for all reportable transactions, and provide for judicial review where such relief is denied.

Present Law

Taxpayers who fail to disclose a reportable transaction are subject to a penalty under section 6707A of the Internal Revenue Code. For penalties assessed after 2006, the amount of the penalty is 75% of the decrease in tax shown on the return as a result of the transaction (or the decrease that would have been the result if the transaction had been respected for federal tax purposes). If the transaction is a listed transaction (or substantially similar to a listed transaction), the maximum penalty is \$100,000 for individuals and \$200,000 for all other taxpayers. In the case of reportable transactions other than listed transactions, the maximum penalty is \$10,000 for individuals and \$50,000 for all other taxpayers. The minimum penalty is \$5,000 for individuals and \$10,000 for all other taxpayers.

The section 6707A penalty applies even if there is no tax due with respect to the reportable transaction that has not been disclosed. There is no reasonable cause exception to the penalty. The Commissioner may, however, rescind all or a portion of a penalty, but only in the case of transactions other than listed transactions, where rescinding the penalty would promote efficient tax administration and only after the taxpayer submits a lengthy and burdensome application. In the case of listed transactions, the Internal Revenue Service (IRS or “Service”) has no discretion to rescind the penalty. The statute precludes judicial review where the Commission decides not to rescind the penalty.

Under section 6662A, taxpayers who have understatements attributable to certain reportable transactions are subject to a penalty of 20% (if the transaction was disclosed) and 30% (if the transaction was not disclosed). A more stringent reasonable cause exception for a penalty under section 6662A is provided in section 6664, but only where the transaction is adequately disclosed, there is substantial authority for the treatment, and the taxpayer had a reasonable belief that the treatment was more likely than not proper. In the case of a listed transaction, reasonable cause is not available, similar to the penalty under section 6707A.

Description of Proposals

Amend section 6707A to provide that no penalty shall be imposed if it is shown that there was reasonable cause for the failure to disclose and that the taxpayer acted in good faith, for all types of reportable transactions. Allow judicial review if the reasonable cause exception is denied.

Amend section 6664 to provide that no accuracy-related penalty shall be imposed where there was reasonable cause for the understatement and the taxpayer acted in good faith, for all types of reportable transactions, irrespective of whether the transaction was adequately disclosed, and irrespective of the level of assurance of the treatment.

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Analysis

Congress provided a clear articulation of penalty policies when it amended the Code in 1989 to reform the penalty structure. While the goals driving the subsequent enactment of section 6707A and amendment of section 6664 are laudable, structurally these amendments are not in line with the 1989 penalty policies. Specifically, section 6707A does not have a reasonable cause exception. Section 6707A(d) grants the Commissioner the ability to rescind the penalty, but only with respect to a reportable transaction other than a listed transaction and providing the Commissioner determines that rescinding the penalty would promote compliance with the requirements of the Code and effective tax administration. Thus, rescission is available in very limited circumstances and only through a lengthy and burdensome application process. Furthermore, section 6707A(d)(2) prohibits judicial review of the Commissioner's exercise of discretion with respect to the rescission of these penalties.³ In the case of the section 6662A accuracy-related penalty for reportable transactions, the reasonable cause exception is limited in ways that effectively make it so limited as to be almost nonexistent. First, the position must be supported by at least a "more likely than not" level of confidence. Second, the taxpayer is unable to rely on the opinion of an advisor to establish that the level of confidence has been satisfied if either the advisor or the opinion is "disqualified."⁴ The more stringent reasonable cause provisions for penalties under section 6662A are not consistent with the reasonable cause provisions throughout the Code, including section 6664.⁵

Moreover, we believe the absence of judicial review when the Service has assessed a penalty under section 6707A lacks procedural due process and notions of fair tax administration.

As a fundamental principle, the AICPA is opposed to strict liability penalties because such penalties are unduly harsh and do not allow for abatement due to reasonable cause, such as an inadvertent act of the taxpayer or circumstances beyond the taxpayer's control. We believe that fairness and effective tax administration require the IRS to retain the authority to exercise discretion in assessing and abating penalties. Additionally, under the current reportable

³ IRC section 6707(d)(2). However, a taxpayer may litigate the issue of whether the transaction was reportable and subject to the penalty at all (H.R. Conf. Rep. No. 108-755).

⁴ See section 6664(d).

⁵ AICPA has included a proposal to modify the definition of "tax shelter" to include only "abusive" transactions. AICPA is recommending that there be one reasonable cause standard generally applicable to accuracy-related penalties (IRC sec. 6662) and understatements attributable to reportable avoidance transactions (IRC sec. 6662A). Consistent with these proposals, we propose that Treasury and IRS modify Treas. Reg. secs. 1.6662-4(b)(4)(ii) and 1.6664-4(f) and eliminate the rules differentiating tax shelters from other types of transactions, except that AICPA would anticipate that the fact that a transaction may be deemed to be "abusive" would be a factor given weight in determining whether a taxpayer has acted reasonably and in good faith.

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transaction penalty structure, there is no mechanism to allow taxpayers to bring themselves into compliance once they discover their error after the due date or to voluntarily come forward.

Conclusion/Recommendation

Section 6707A should be amended to allow an exception to the penalty if there was reasonable cause for the failure and the taxpayer acted in good faith for all types of reportable transactions, and to allow for judicial review in cases where reasonable cause was denied. Moreover, section 6664 should be amended to provide a general reasonable cause exception for all types of reportable transactions, irrespective of whether the transaction was adequately disclosed or the level of assurance.

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Proposal

Allow a reasonable cause exception to the IRC section 6676 penalty for erroneous claim for refund or credit.

Present Law

Section 6676 authorizes the IRS to impose a 20% penalty on any “excessive amount” of a claim for refund or credit made by a taxpayer if that claim lacks a reasonable basis. Section 6676 defines “excessive amount” as the portion of the refund or credit that exceeds the allowable amount. The penalty does not apply to claims for the earned income credit, and is a strict liability penalty for transactions lacking economic substance (they are deemed to lack a reasonable basis). The statute does not define reasonable basis. To date, the Treasury Department has not issued any regulations under section 6676.

Description of Proposal

Section 6676 should be amended to permit relief in the case of an incorrect claim for refund or credit made in good faith if the taxpayer had reasonable cause for the error. The reasonable cause exception should be similar to that found in IRC section 6664, applying to the accuracy-related penalties on underpayments.

Analysis

The section 6676 penalty was enacted as a complement to IRC section 6662, which only applies where an underpayment arises, not to claims for refunds. As currently enacted, the only defense to a section 6676 penalty is that the taxpayer had a reasonable basis upon which to claim the refund or credit. We believe this is an unduly harsh result, as similar accuracy-related penalties allow a taxpayer to defend against the imposition of the penalty based on the level of confidence as well as other general reasonable cause factors, such as good faith.

Adding a reasonable cause exception to section 6676 would benefit corporate and individual taxpayers alike. It should be noted that although the earned income credit is specifically exempted from this penalty, there have been numerous refundable credits introduced since 2007, the year the erroneous refund penalty was enacted. Fairness and effective tax administration require the IRS to retain discretion in assessing and abating penalties. This is especially true in the case of the section 6676 penalty, which is immediately assessable and not subject to deficiency procedures.

Conclusion/Recommendation

Section 6676 should be amended to allow an exception to the penalty if the taxpayer, acting in good faith, had reasonable cause for claiming the incorrect refund or credit.

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Proposal

Provide that the Forms 3520 and 3520-A non-filing penalties under IRC sections 6677 and 6039F are consistent with other foreign information reporting penalties such as the Form 5471 penalty of \$10,000 per violation if neither fraud nor bad faith are involved.

Present Law

Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, is filed by a U.S. person (and executors of estates of U.S. decedents) to report certain transactions with a foreign trust, ownership of a foreign trust (under the rules of IRC sections 671 through 679), or receipt of certain gifts or bequests from certain foreign persons. A separate Form 3520 must be filed for transactions with each foreign trust. Form 3520 is typically due on the same date as the U.S. person's income tax return, and can only be extended with the income tax return extension. If the U.S. person is a deceased individual, Form 3520 is due on the date that Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, is due, including extensions, or, if no Form 706 is required, the date on which Form 706 would be due if one were required to be filed.

Under IRC section 6501(c)(8), if a complete Form 3520 is not filed by the due date, including extensions, the time for assessment of any tax imposed with respect to any event or period to which the information required to be reported in Parts I through III of such Form 3520 relates, will not expire before the date that is 3 years after the date on which the required information is reported.

Penalties may apply even though Form 3520 is an information return and no tax is due with such form.

Under IRC section 6677, a penalty generally applies if Form 3520 is not timely filed or if the information is incomplete or incorrect. Generally, the initial penalty is equal to the greater of \$10,000 or:

- 35% of the gross value of any property transferred to a foreign trust for failure by a U.S. transferor to report the creation of or transfer to a foreign trust, or
- 35% of the gross value of the distributions received from a foreign trust for failure by a U.S. person to report receipt of the distribution, or
- 5% of the gross value of the portion of the trust's assets treated as owned by a U.S. person for failure by the U.S. person to report the U.S. owner information.

Additional penalties are imposed if the noncompliance continues after the IRS mails a notice of failure to comply with the required reporting.

If the taxpayer can demonstrate that the failure to comply was due to reasonable cause and not willful neglect, penalties may be abated. Under IRC section 6677(d), the fact that a foreign

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country would impose penalties for disclosing the required information is not reasonable cause. Similarly, reluctance on the part of a foreign fiduciary or provisions in the trust instrument that prevent the disclosure of required information are not considered reasonable cause.

In the case of a failure to report foreign gifts described in IRC section 6039F, a penalty equal to 5% of the amount of such foreign gifts received by a U.S. person applies for each month for which the failure to report continues until the amount is reported (not to exceed a total of 25%). The penalty is imposed on the recipient of the gift and not on the donor. If the taxpayer can demonstrate that the failure to comply was due to reasonable cause and not willful neglect, the penalty may be abated.

In addition, if information is required to be reported under IRC section 6048, penalties may be imposed under IRC section 6662(j) for undisclosed foreign financial asset understatements. If the taxpayer can demonstrate that the failure to comply was due to reasonable cause with respect to such portion of the underpayment and the taxpayer acted in good faith with respect to such portion of the underpayment, the penalty on such portion of an underpayment can be abated. IRC section 6664(c) is relevant under these circumstances as well.

The Form 3520-A, Annual Information Return of a Foreign Trust with a U.S. Owner, provides information about the foreign trust, its U.S. beneficiaries, and any U.S. person who is treated as an owner of any portion of the foreign trust. A foreign trust with a U.S. owner must file Form 3520-A in order for the U.S. owner to satisfy its annual information reporting requirements under IRC section 6048(b). Each U.S. person treated as an owner of any portion of a foreign trust under IRC sections 671 through 679 is responsible for ensuring that the foreign trust files Form 3520-A and furnishes the required annual statements to its U.S. owners and U.S. beneficiaries. (There is a filing exception for certain Canadian savings plans.) A complete Form 3520-A (including the statements on pages 3 and 4) must be filed with the IRS by the 15th day of the 3rd month after the end of the trust's tax year. In addition, copies of the Foreign Grantor Trust Owner Statement (page 3 of Form 3520-A) and the Foreign Grantor Trust Beneficiary Statement (page 4 of Form 3520-A) need to be provided to the U.S. owners and U.S. beneficiaries by the 15th day of the 3rd month after the end of the trust's tax year.

Section 6677(b) imposes penalties regarding failure to file the Form 3520-A, stating that the U.S. owner is subject to an initial penalty equal to the greater of \$10,000 or 5% of the gross value of the portion of the trust's assets treated as owned by the U.S. person at the close of that tax year, if the foreign trust: (a) fails to file a timely Form 3520-A, or (b) does not furnish all of the information required by section 6048(b) or includes incorrect information. Additional penalties under IRC section 6677 are imposed if the noncompliance continues after the IRS mails a notice of failure to comply with the required reporting. In addition, criminal penalties may be imposed under sections 7203, 7206, and 7207 for failure to file on time and for filing a false or fraudulent return. Penalties may also be imposed under section 6662(j) for undisclosed foreign financial asset understatements. If the taxpayer can demonstrate that the failure to comply was due to reasonable cause and not willful neglect, penalties can be abated. However, the fact that a foreign country would impose penalties for disclosing the required information is not reasonable

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cause. Similarly, reluctance on the part of a foreign fiduciary or provisions in the trust instrument that prevent the disclosure of required information are not reasonable cause.

Currently, IRC section 6038(b)(1) provides for a monetary penalty of \$10,000 for each Form 5471 (Information Return of U.S. Persons With Respect To Certain Foreign Corporations) that is filed after the due date of the income tax return (including extensions) or does not include the complete and accurate information described in IRC section 6038(a). Similar to Form 3520, Form 5471 is an informational form and no tax is due with such form.

Description of Proposal

The section 6677 and section 6039F Form 3520 penalties (information reporting on foreign gifts and transactions) and Form 3520-A penalty (information reporting of foreign trusts with U.S. owners) should be amended to be identical to the section 6038(b)(1) language providing a \$10,000 (not to exceed the gross reportable amount) maximum penalty per violation that generally applies if neither fraud nor bad faith are involved and the Forms 3520 and 3520-A are not timely filed or if the information is incomplete or incorrect. This language would be consistent with other information reporting penalties concerning foreign entities (such as the Form 5471 penalty for Information Return of U.S. Persons With Respect To Certain Foreign Corporations).

Analysis

The current penalty structure for non-filing or late filing of Forms 3520 and 3520-A is too harsh and is inconsistent with the penalties imposed for non-willful violations with respect to similar information returns concerning foreign entities. (The penalty for non-filing of Form 5471 is a maximum of \$10,000 per violation.)

Forms 3520 and 3520-A are information returns (i.e., there is no tax due). Often, there is no taxable event; therefore, the taxpayer does not realize anything needs to be reported. In other cases, the taxpayers report the taxable event on their income tax return, but do not realize that a Form 3520 or Form 3520-A is required to be filed, or assumed the trustee filed the necessary paperwork. In cases where income taxes are also due, we note that the underpayment penalties would also apply if the required information was not reported on the income tax return.

The current information reporting Forms 3520 and 3520-A non-filing penalties under IRC sections 6677 and 6039F are too severe. For example, a distribution of \$1 million from a foreign trust that is not properly reported by the U.S. recipient on Form 3520 can result in a penalty of \$350,000 (35%) without considering the reasons for any failure, even if the distribution is included in taxable income on the U.S. recipient's Form 1040, U.S. Individual Income Tax Return.

Currently, the harsh penalties discourage, rather than encourage, taxpayers from coming forward to report the transaction. For example, if someone received a non-taxable bequest from a non-

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U.S. parent, innocently did not realize that it needed to be reported on Form 3520, and [finds out years later that it needed to be reported, that person could be discouraged from reporting it] because of the excessively large penalty. In addition, since the Form 3520 cannot be extended separately from the individual's income tax return, and the Form 3520-A is due March 15, many taxpayers do not realize they have a Form 3520 and Form 3520-A reporting requirement until the deadline has passed, once again discouraging reporting.

The IRS is immediately sending notices in these types of situations, assuming there was a willful failure to file. The collection of the penalty swiftly occurs. The taxpayer then has to demonstrate reasonable cause to have the penalty abated. While taxpayers are entitled to appeal the imposition of the penalty, the process is difficult, costly and poses a significant burden on many small taxpayers in particular. Additionally, IRS notices may cause unnecessary taxpayer confusion.

If penalties are imposed, a more reasonable penalty like the section 6038(b) for Form 5471 with a \$10,000 (not to exceed the gross reportable amount) per violation maximum penalty is more appropriate if no fraud is involved. Targeted, proportionate penalties that clearly articulate standards of behavior and are administered in an even-handed and reasonable manner encourage (rather than discourage) voluntary compliance with the tax laws. Providing the Secretary of the Treasury with some discretion in assessing such penalties when appropriate would also encourage more voluntary reporting.

Conclusion/Recommendation

Sections 6677 and 6039F should be amended to provide that the penalties with respect to non-filing or late filing of informational forms for foreign gifts and transactions with foreign trusts and information reporting for foreign trusts with U.S. owners are similar to the section 6038(b)(1) penalties for failure to properly file other informational forms for transactions with foreign entities. A \$10,000 (not to exceed the gross reportable amount) maximum penalty per violation should generally apply if Forms 3520 and 3520-A are not timely filed or if the information is incomplete or incorrect and if neither fraud nor bad faith is involved.

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Proposal

Define the term “tax shelter” in the accuracy-related penalty provisions of the Internal Revenue Code to clarify that the term only applies to abusive transactions.

Present Law

Section 6662(d)(2)(C)(ii) of the Code defines a “tax shelter” as “a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.” This definition was established in 1997 – prior to then, the arrangement had to have “the principal purpose” of tax avoidance or evasion to be a “tax shelter.” The Code does not define what a “significant purpose” of tax avoidance is, and there is no regulatory guidance that interprets or applies the term.

Description of Proposal

“Tax shelter” should be defined so that it only applies to transactions involving an abusive application of the Federal income tax laws. The determination of whether a transaction is a “tax shelter” should depend upon all pertinent facts and circumstances. The definition should provide a list (or direct the Secretary to establish a list in the regulations) of factors indicative of “tax shelter” status and affirm that an entity, plan or arrangement is not a tax shelter if the tax benefits attained are consistent with statute and Congressional intent. (See attached detailed additional information.)

Analysis

The broad and uncertain definition of “tax shelter” in the Code and the Treasury Regulations impedes the goal of voluntary compliance that civil tax penalties are designed to achieve. It has the potential to discourage taxpayers from entering into legitimate transactions, undermine transparency, and lead to the assertion of penalties when they may not be warranted by the facts and circumstances of a particular case. Limiting the “tax shelter” definition to abusive transactions, elaborating on indications of abusiveness, and establishing a facts and circumstances application of the term balances the government’s interest in retaining some flexibility in applying the “tax shelter” term with the need for greater clarity in this area. (See below Appendix of detailed additional information.)

Conclusion/Recommendation

Congress should revise the IRC section 6662(d)(2)(C)(ii) definition of a “tax shelter” to incorporate the concept that a “tax shelter” is an abusive transaction.

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ADDENDUM – Additional Information on the Tax Shelter Penalty Legislative Proposal to Define the Term “Tax Shelter” in the Accuracy-Related Penalty Provisions of the Internal Revenue Code to Clarify that the Term Only Applies to Abusive Transactions

This additional information on the definition of tax shelter includes:

- Background
- Overview
- Principles for Defining Tax Shelter
- Implications for the Tax Return Preparer Penalty
- AICPA Recommendations

Background

Section 6662(d) defines a “tax shelter” as any partnership, entity, plan, or arrangement “if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.”

The need for guidance in this area has been compounded by the 2010 enactment of a strict liability penalty on taxpayers for transactions lacking economic substance.⁶ Thus, the Code contains three sets of overlapping rules aimed at combating many of the same transactions (i.e., the section 6662(d) penalty for substantial understatements due to “tax shelters,” the section 6662A penalty for reportable avoidance transactions, and the section 6662(b)(6) penalty for transactions lacking economic substance). The existence of three overlapping penalty regimes creates significant redundancy and confusion for taxpayers, practitioners, and the IRS. It also reinforces the importance of defining the most basic of these concepts – “tax shelter” – as well as of undertaking measures in support of more comprehensive penalty reform. Clearer articulation of the “tax shelter” definition is needed. It would also benefit Treasury and IRS through more consistent and streamlined enforcement activities.

To assist with these efforts, we are providing our recommendations for the definition of “tax shelter.” The first part of this material presents an overview of the challenges taxpayers, practitioners, and the IRS confront as a result of an absence of guidance. We then recommend principles for guidance in this area.

Overview

In 1997, Congress revised the definition of “tax shelter” for purposes of the taxpayer accuracy-related penalty contained in section 6662(d) of the Code. As revised, a “tax shelter” is any partnership, entity, plan, or arrangement “if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.”⁷ Previously, an

⁶ See section 1409 of the *Health Care and Education Reconciliation Act of 2010* (March 30, 2010), which added new sections 7701(o) and 6662(b)(6) to the Code.

⁷ Section 6662(d)(2)(C)(ii).

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arrangement had to have “the principal purpose” of tax avoidance or evasion to be a “tax shelter.” Although the revised definition of “tax shelter” is more than 16 years old and has been used in other contexts, no administrative guidance has been issued to assist taxpayers and practitioners in interpreting or applying the term. For example, the taxpayer accuracy-related penalty regulations continue to define the repealed “principal purpose” standard.⁸

The absence of guidance is problematic for many reasons. First, the lack of guidance could lead the government to interpret the phrase “a significant purpose of tax avoidance” broadly to treat benign arrangements as “tax shelters” and discourage taxpayers from entering into legitimate transactions. Examples of the potential confusion include:

- Whether a transaction undertaken for business reasons is transformed into a “tax shelter” if it is structured in a tax-efficient manner (such as acquiring a company with stock instead of cash to take advantage of the tax-free reorganization provisions of the Code); and
- Whether an activity engaged in for personal or business reasons becomes a “tax shelter” if it is motivated by a desire to take advantage of tax benefits clearly contemplated by Congress (such as investing in an individual retirement account, selling stock with a built-in loss to offset gains, and accelerating purchases of equipment to qualify for a new or expiring tax credit).⁹

We do not believe that Congress, when it revised the definition of “tax shelter” in 1997, intended to subject taxpayers who engage in benign and legitimate transactions to a harsher penalty regime¹⁰ and the stigma of a sanction.¹¹ However, a broad interpretation of “a significant purpose of tax avoidance” could create that result.

Second, the absence of guidance has had the unintended consequence of undermining transparency. A broad interpretation of “tax shelter” discourages taxpayers from disclosing return positions, because the Code does not provide an exception to the taxpayer accuracy-related penalty for a substantial understatement of income tax in the case of a “tax shelter.”

Third, we believe based on the experience of our members that the lack of guidance with respect to the definition of “tax shelter” has contributed to the assertion of penalties even when they

⁸ See Treas. Reg. § 1.6662-4(g).

⁹ See generally N. Gesselman, *A Significant Problem Defining a “Significant Purpose” and the Significant Difficulties That Result*, 111 Tax Notes 1119 (June 5, 2006).

¹⁰ For example, even if there is scant pertinent guidance, a taxpayer must reasonably believe a return position is more likely than not to prevail, if challenged, in order to avoid a taxpayer accuracy-related penalty in the case of a tax understatement attributable to a “tax shelter” item. By contrast, outside the tax shelter context, such a penalty may be avoided if there is substantial authority for the return position or if there is a reasonable basis for the position and it is adequately disclosed. The penalty consequences are even harsher under section 6662A, which may impose a 30-percent penalty rate and utilizes a much more limited reasonable cause exception.

¹¹ See, e.g., the comments of former IRS Commissioner Lawrence Gibbs at the midyear meeting of the American Bar Association Section on Taxation, BNA Daily Tax Report (January 29, 2010), at p. G-5 (“When you tell a taxpayer that they’re facing a penalty, that’s not just an economic consequence. What you’re telling the taxpayer is that they’ve done something very, very wrong”).

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might not be warranted by the facts and circumstances of a particular case.¹² This obviously is unfair to taxpayers. It also may waste scarce IRS resources by resulting in unnecessary IRS expenditures for developing and defending penalties in non-abusive contexts.¹³

Finally, the lack of guidance on the definition of “tax shelter” makes it easier to impose and uphold a penalty, which has a chilling effect on legitimate tax planning, because there is nothing concrete in the tax law that a taxpayer or practitioner can invoke to demonstrate that the penalty is inappropriate in the event of a tax deficiency.¹⁴ One drawback of this approach is that the concept (and resulting harsher penalty consequences) may be applied inconsistently to the same or substantially similar fact patterns. More importantly, the approach tends to undermine the rule of law by ascribing penalties without standards and ultimately undermining faith in the fairness and integrity of the tax system as a whole.

Principles for Defining “Tax Shelter”

As we stated in the Report, we believe penalties should be designed and administered in accordance with certain core principles to encourage voluntary compliance with our tax laws. Penalties should articulate clear standards of behavior and be proportionate to the wrong.

While it may not be possible to eliminate all of the uncertainties in the definition of “tax shelter,” the scope of the term cannot be boundless. It is important to place contours around the definition of the term to convey that a “tax shelter” is an abusive arrangement.

Limiting the term “tax shelter” to abusive arrangements is clearly consistent with the harsher penalty regime applicable to “tax shelters.” It also is consistent with the 2008 legislative change to section 6694 to reinstitute the substantial authority standard for arrangements that are not “tax shelters.” As Treasury indicated in Notice 2009-5,¹⁵ a broad reading of “tax shelter” would permit the “tax shelter” exception in section 6694 to swallow the general rule under section 6694 that substantial authority is the penalty standard against which most return positions should be judged. This also is true for purposes of the taxpayer substantial understatement penalty in section 6662(d).

¹² The Service’s most recent Penalty Policy Statement, for example, provides that “[a]n abusive transaction is one where a **significant purpose** of the transaction is the avoidance or evasion of Federal tax.” See Penalty Policy Statement 20-1 (June 29, 2004) (emphasis in original). The intent of this language may have been to only treat abusive arrangements falling within the “a significant purpose” concept as “tax shelters,” which is something we would support. However, the language also could be read to suggest that all “significant purpose” transactions are abusive, which we do not believe is a correct or fair interpretation of the statutory provision.

¹³ See IRM 1.2.20.1.1.4.

¹⁴ The same definition is used with respect to section 7525. The issues created by the lack of a clear definition of tax shelter are illustrated by the Seventh Circuit’s decision in Valero Energy Corp. v. US, 569 F. 3rd. 626 (7th Cir. 2009). The court stated that “This definition of tax shelter is broad and could, as Valero points out, include some legitimate attempts by a company to reduce its tax burden.” In its passing reference to “some” legitimate attempts falling within the definition while implying that some do not, the court illustrated the dilemma of taxpayers and their advisors parsing out whether a particular instance is within, or without, of the class of legitimate attempts that fall within the definition.

¹⁵ 2009-1 C.B. 309.

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Implications for the Tax Return Preparer Penalty

In addition to its application to the taxpayer penalties discussed above, the concept of “tax shelter” is embedded in the tax return preparer penalty of section 6694. Specifically, if a tax return preparer prepares a return to which any part of an understatement is due to a position with respect to a transaction that may be tax shelter (as defined in section 6662(d)(2)(C)(ii)) and it was not reasonable to believe that the position more likely than not would be sustained on the merits, the preparer is subject to a penalty. Thus, the preparer penalty uses the same definition of “tax shelter” as the accuracy-related penalty. The absence of clear guidance on that definition makes it difficult for a preparer to know what standards apply to returns when it is not clear whether the client has engaged in a tax shelter. Clarity in this area would be helpful by allowing preparers to assist clients without unnecessary concern about penalties.

AICPA Recommendations

“Tax shelter” should be defined in the Code (or possibly in the Treasury Regulations that implement the tax shelter penalties). Our suggestions for the definition provide meaningful parameters around the concept of “tax shelter” and help to ameliorate potentially overbroad interpretations of the phrase “significant purpose of tax avoidance.” Any conceptual framework for the definition of “tax shelter” should:

- 1) State that the term “tax shelter” is intended to apply to an entity, plan or arrangement involving an abusive application of the Federal income tax laws, and the determination of whether a tax shelter exists depends upon all pertinent facts and circumstances;
- 2) Provide a list (or direct the Secretary to establish a list in the regulations) of factors indicative of tax shelter status. Our suggested list below is drawn largely from the Internal Revenue Manual¹⁶:
 - a) Misuse of Internal Revenue Code sections to produce clearly unintended results;
 - b) Intentional manipulation of ambiguities of the tax laws to improperly claim tax benefits;
 - c) Arrangements having no economic significance apart from Federal income tax benefits;
 - d) Valuation misstatements that ascribe a value to an asset or service that is at least twice the amount determined to be the correct amount of such value; and
 - e) False statements about the allowability of tax benefits to participants that are contrary to clearly established law.

¹⁶ See generally IRM 4.32.2.2(3).

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- 3) State that the determination of whether a transaction is a “tax shelter” is made on the basis of all pertinent facts and circumstances. Although the presence of one or more indicative factors is an important consideration to take into account in determining whether there is a “tax shelter,” the presence of an indicative factor is not necessarily dispositive of whether there is a “tax shelter.”
- 4) Affirm that an entity, plan or arrangement is not a tax shelter if the tax benefits are consistent with the statute and Congressional purpose.¹⁷
- 5) State that an entity, plan or arrangement is not considered a tax shelter merely because it results in a large Federal income tax benefit. However, a large Federal income tax benefit combined with other factors, such as the relative absence of non-tax benefits or lack of business purposes, may be indicative of the facts and circumstances sufficient to cause the entity, plan or arrangement to be considered a tax shelter.

The recommendations provided above suggest meaningful parameters around the concept of “tax shelter” and help to ameliorate potentially overbroad interpretations of the phrase “significant purpose of tax avoidance.” After careful consideration of the matter, we also believe that our recommendations reasonably balance the government’s interest in retaining some flexibility in applying the “tax shelter” test with the tax community’s need for greater clarity in this area.

¹⁷ Numerous commentators have indicated that an arrangement consistent with the statute and Congressional intent should not be viewed as a “tax shelter” under any test, because the claiming of tax benefits in this context is not tax avoidance. See, e.g., comments of the New York State Bar Association Section on Taxation on *Proposed Modifications to Section 6662 Penalty in America’s Affordable Health Choices Act of 2009* (September 22, 2009), reprinted in 2009 TNT 182-5 (September 23, 2009); and N. Gesselman, *supra* at 1126 & n.56. See also Staff of the Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the “Reconciliation Act of 2010,” as Amended, in Combination with the “Patient Protection and Affordable Care Act,”* at p. 152 & n.344 (March 21, 2010) (providing, in the context of a penalty for transactions lacking economic substance, that “[i]f the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed”).