APPEALS

COORDINATED ISSUE PROGRAM

SETTLEMENT GUIDELINES

INDUSTRY: **Leasing Promotions**

ISSUE: **Penalty - Lease Stripping Transactions**

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APPROVED:

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for **DIRECTOR, TECHNICAL GUIDANCE** **DATE**

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DIRECTOR, TECHNICAL SERVICES **DATE**

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SETTLEMENT POSITION
PENALTY – LEASE STRIPPING TRANSACTIONS
UIL 9300.03-00

STATEMENT OF ISSUE

Whether the accuracy-related penalty under section 6662 should apply to taxpayers who participate in Lease Stripping Transactions?

DISCUSSION

The Compliance Coordinated Issue Paper (CIP), effective July 21, 2000, and the Appeals Settlement Guidelines (ASG), effective May 21, 2003, for Lease Stripping Transactions, address the abuses of lease stripping transactions but do not address the accuracy-related penalty under section 6662 IRC. Compliance is asserting the accuracy-related penalties on lease stripping cases. Penalties related to lease stripping transactions were designated as an Appeals Coordinated Issue (ACI) on March 17, 2004.

The resolution of the penalty is highly dependent upon the facts and circumstances. The following is a discussion on the legal theories advanced by the Service with respect to the accuracy-related penalty.
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1. The Accuracy-Related Penalty

Section 6662 IRC imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to, among other things: (1) negligence or disregard of rules or regulations, (2) any substantial understatement of income tax, and (3) any substantial valuation misstatement under chapter 1. Treas. Reg. § 1.6662-2(c) provides that there is no stacking of the accuracy related penalty components. Thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is 20% (40% in the case of a gross valuation misstatement), even if that portion of the underpayment is attributable to more than one type of misconduct (e.g., negligence and substantial valuation misstatement). The accuracy-related penalty provided by section 6662 does not apply to any portion of an underpayment on which a penalty is imposed for fraud under section 6663. Section 6662(b).

<u>Negligence or intentional disregard of rules and regulations</u>

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. <u>See</u> section 6662(c) and Treas. Reg. § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. <u>See</u> <u>Marcello v. Commissioner</u>, 380 F.2d 499 (5th Cir. 1967), aff'g, 43 T.C. 168 (1964); <u>Neely v. Commissioner</u>, 85 T.C. 934, 947 (1985).

Treas. Reg. § 1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. If the facts establish that a taxpayer reported losses from a transaction that lacked economic substance or reported losses or deductions from assets with bases traceable to lease stripping transactions that would have seemed, to a reasonable and prudent person, to be "too good to be true," then the accuracy-related penalty attributable to negligence may be applicable if the taxpayer failed to make a reasonable attempt to ascertain the correctness of the claimed losses or deductions.

The phrase "disregard of rules and regulations" includes any careless, reckless, or intentional disregard of rules and regulations. The term "rules and regulations" includes the provisions of the Internal Revenue Code and revenue rulings or notices issued by the Internal Revenue Service and published in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-3(b)(2). Therefore, if the facts indicate that a taxpayer took a return position contrary to any published notice or revenue ruling, the taxpayer may be subject to the accuracy-related penalty for an underpayment attributable to disregard of rules and regulations, if the return position was taken subsequent to the issuance of a notice or revenue ruling.

The accuracy-related penalty for disregard of rules and regulations will not be imposed on any portion of underpayment due to a position contrary to rules and regulations if: (1) the position is disclosed on a properly completed Form 8275 or Form 8275-R (the latter is used for a position contrary to regulations) and (2), in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of a regulation. This adequate disclosure exception applies only if the taxpayer has a reasonable basis for the position and keeps adequate records to substantiate items correctly. Treas. Reg. § 1.6662-3(c)(1). Further, a taxpayer who takes a position contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits. Treas. Reg. § 1.6662-3(b)(2).

Substantial understatement

A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 in the case of corporations other than S corporations or personal holding companies). Section 6662(d)(1). Understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority for such treatment, and (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return or an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item. Section 6662(d)(2)(B).

In the case of any item of a taxpayer other than a corporation which is attributable to a tax shelter, exception (2) above does not apply and exception (1) applies only if the taxpayer also reasonably believed that the tax treatment of the item was more likely than not the proper treatment. Section 6662(d)(2)(C)(i). In the case of items of corporate taxpayers attributable to tax shelters, neither exception (1) nor (2) above applies. Section 6662(d)(2)(C)(ii). Therefore, if a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the accuracy related penalty applies to the understatement unless the reasonable cause exception applies. See Treas. Reg. § 1.6664-4(e) for special rules relating to the definition of reasonable cause in the case of a tax shelter item of a corporation.

The definition of tax shelter includes, among other things, any plan or arrangement a significant purpose of which is the avoidance or evasion of federal income tax. Section 6662(d)(2)(C)(iii). For transactions entered into before August 6, 1997, the relevant standard was whether tax avoidance or evasion was the "principal purpose" of the entity, plan, or arrangement. Treas. Reg. § 1.6662-4(g)(2)(i). If the facts establish that an understatement attributable to the disallowance of losses or deductions from assets with bases traceable to lease stripping transactions exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 in the case of corporations other than S corporations or personal holding companies), a substantial understatement penalty may be applicable.

Substantial valuation misstatement

For the accuracy-related penalty attributable to a substantial valuation misstatement to apply, the portion of the underpayment attributable to a substantial valuation misstatement must exceed $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). A substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of such value or adjusted basis. Section 6662(e)(1)(A). If the value or adjusted basis of any property claimed on a return is 400 percent or more of the amount determined to be the correct amount of such value or adjusted basis, the valuation misstatement constitutes a "gross valuation misstatement." Section 6662(h)(2)(A). If there is a gross valuation misstatement, then the 20% penalty under section 6662(a) is increased to 40%. Section 6662(h)(1). One of the circumstances in which a valuation misstatement may exist is when a taxpayer's claimed basis is disallowed for lack of economic substance. Gilman v. Commissioner, 933 F.2d 143 (2d Cir. 1991), cert. denied, 502 U.S. 1031 (1992). If the facts establish that the claimed adjusted basis of an asset with a basis traceable to a lease stripping transaction is 200 percent or more of the correct amount, then a substantial valuation misstatement exists; if the facts establish that the claimed adjusted basis of an asset with a basis traceable to a lease stripping transaction is 400 percent or more of the correct amount, then a gross valuation misstatement exists.

2. The Reasonable Cause Exception

The accuracy-related penalty does not apply with respect to any portion of an underpayment with respect to which it is shown that there was reasonable cause and that the taxpayer acted in good faith. Section 6664(c)(1). The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Treas. Reg. § 1.6664-4(b)(1). Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Id.

Reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. Reliance on professional advice, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. See also United States v. Boyle, 469 U.S. 241 (1985) (reasonable cause is established when a taxpayer shows that he reasonably relied on the advice of an accountant or attorney). In determining whether a taxpayer has reasonably relied on professional tax advice as to the tax treatment of an item, all facts and circumstances must be taken into account. Treas. Reg. § 1.6664-4(b)(1).

The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purpose (and the relative weight of such purpose) for entering into a transaction and for structuring a transaction in a particular manner. A taxpayer will not be considered to have reasonably relied in good faith on professional tax advice if the taxpayer fails to disclose a fact it knows, or should know, to be relevant to the proper tax treatment of an item. Treas. Reg. § 1.6664-4(c)(1)(i). The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner. Treas. Reg. § 1.6664-4(c)(1)(i).

Further, where a tax benefit depends on nontax factors, the taxpayer also has a duty to investigate such underlying factors. The taxpayer cannot simply rely on statements by another person, such as a promoter. See Novinger v. Commissioner, T.C. Memo. 1991-289 (taxpayer could not avoid the negligence penalty merely because his professional advisor had read the prospectus and had advised the taxpayer that the underlying investment was feasible from a tax perspective, assuming the facts presented were true). Moreover, if the tax advisor is not versed in these nontax factors, mere reliance on the tax advisor does not suffice. See Addington v. United States, 205 F.3d 54 (2d Cir. 2000) (taxpayer's reliance on tax advisor was not reasonable given the cautionary language in offering memoranda and the tax advisor's lack of adequate knowledge to evaluate essential aspects of underlying investment); Freytag v. Commissioner, 89 T.C. 849 (1987), aff'd, 904 F.2d 1011 (5^{th} Cir. 1990) (reliance on tax advice not reasonable where taxpayer did not consult experts with respect to the bona fides of the financial aspects of the investment); Goldman v. Commissioner, 39 F.3d 402 (2d Cir. 1994) (taxpayer's reliance on accountant's advice to invest in a partnership engaged in oil and gas was not reasonable where accountant lacked industry knowledge); Collins v. Commissioner, 857 F. 2d 1383 (9^{th} Cir. 1988) (penalties upheld where advisor "knew nothing firsthand" about the venture).

Reliance on tax advice may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of the federal tax law. Treas. Reg. § 1.6664-4(c)(1). For a taxpayer's reliance on advice to be sufficiently reasonable so as possibly to negate a section 6662(a) accuracy-related penalty, the Tax Court in Neonatology Associates P.A. v. Commissioner, 299 F.3d 221, aff'd, (3d Cir. 2002) stated that the taxpayer has to satisfy the following three-prong test: (1) the adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer gave to the advisor the necessary and accurate information, and (3) the taxpayer actually relied in good faith on the adviser's judgment.

With respect to reasonable cause for the substantial understatement penalty attributable to tax shelter items of a corporation, special rules apply; see section 6662(d)(2)(C)(iii), discussed above, for the definition of a tax shelter. The determination of whether a corporation acted with reasonable cause and good faith is based on all pertinent facts and circumstances. Treas. Reg. § 1.6664-4(e)(1). A corporation's legal justification may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item, but only if there is substantial authority within the meaning of Treas. Reg. § 1.6662-4(d) for the treatment of the item and the corporation reasonably believed, when the return was filed, that such treatment was more likely than not the proper treatment. Treas. Reg. § 1.6664-4(e)(2)(i).

The regulations provide that, in meeting the requirement of reasonably believing that the treatment of the tax shelter item was more likely than not the proper treatment, the corporation may reasonably rely in good faith on the opinion of a professional tax advisor if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in Treas. Reg. § 1.6662-4(d)(3)(ii) and the opinion unambiguously states that the tax advisor concludes that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged by the Service. Treas. Reg. § 1.6664-4(e)(2)(i)(B)(2). Therefore, if possible, the tax advisor's opinion should be obtained to determine whether these requirements are met.

Although satisfaction of the "substantial authority" and "belief" requirements is necessary to a reasonable cause finding, this may not be sufficient. For example, reasonable cause may still not exist if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed benefits that were unreasonable in comparison to the initial investment in the tax shelter, or if the taxpayer agreed with the shelter promoter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter. Treas. Reg. § 1.6664-4(e)(3).

SETTLEMENT GUIDELINES

Whether the accuracy-related penalty applies to underpayments attributable to lease stripping transactions must be determined on a case-by-case basis based upon the application of the legal standard for the penalty (as set forth above) to the specific facts and circumstances of each case.

The accuracy-related penalty has been sustained in the tax shelter area. In Nicole Rose Corp. v. Commissioner, supra, petitioner relied on qualified advisors concerning an issue of first impression. The court rejected this argument, finding that the scheme was so clear and obvious that the participation of professionals could not shelter petitioners from the penalties. Also, in Neonatology Associates P.A. v. Commissioner, supra, the court concluded that taxpayers could not prevail on a reliance-on-professional defense because they received advice only from an insurance agent who stood to profit considerably from the participation of Neonatalogy. The individual taxpayers did not make a proper investigation or exercise due diligence to verify the program's tax legitimacy.

In determining whether a penalty applies, the following factors are relevant: the sophistication of the taxpayer, whether the taxpayer obtained an outside opinion; the contents of any outside opinion; the timing of the receipt of the opinion in relation to the filing of the tax return; whether the opinion was given by an advisor connected with the promotion or promoter in contrast to the taxpayer's regular advisor; whether the promoter arranged for the opinion; the contents of the opinion; and any efforts to conceal the transaction, mislead the Service, or fail to cooperate in the examination of the transaction. If any of these factors are present then they should be considered in connection with the assertion or settlement of the accuracy related penalty.