IV.A.5. ACCURACY-RELATED AND FRAUD PENALTIES

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Introduction

Overview

Consideration of penalties is very important in the audit of abusive tax shelter cases. Application of penalties in these cases is entirely consistent with the Service's Penalty Policy Statement (P–1–18), which is attached as Exhibit IV.A.5-1.

Penalties should be considered and developed simultaneously with the development of the tax shelter transaction, and not at the conclusion of the audit. Proper consideration and application of penalties will:

- Encourage voluntary compliance;
- Conserve I.R.S. resources due to early disposition of tax shelter issues;
- Provide clear guidance to taxpayers and practitioners;
- Ensure consistent and fair treatment of the issues;
- Maintain the integrity of the "listed transaction" notice system; and
- Ensure that non-compliant behavior is penalized in appropriate circumstances.

Facts and Documentation to be Developed During the Examination

Consideration of penalties must be documented in all abusive tax shelter examinations of both individual and corporate investors**.** A penalty case **must** be developed as the audit progresses. Only after all facts and circumstances surrounding a penalty case have been developed can a determination be made as to the application of the penalty.

On December 20, 2001, the LMSB Commissioner issued a memorandum (see attached at Exhibit IV.A.5-2) providing new guidelines for the consideration of the accuracy-related penalty in LMSB examinations. This memo requires agents to develop the accuracy-related penalty in all cases in which there is an underpayment of tax attributable to a listed transaction.

Suggested audit techniques for proper penalty development are included below.

Accuracy-Related Penalty – IRC §6662

In General

IRC § 6662 imposes an accuracy-related penalty on any portion of an underpayment attributable to one or more of the following:

(1) negligence or disregard of the rules and regulations;
(2) any substantial understatement of income tax;
(3) any substantial valuation misstatement;
(4) any substantial overstatement of pension liabilities; and
(5) any substantial estate or gift tax valuation understatement.

IRC § 6662 - Accuracy-Related Penalty (Continued)

Since the Negligence / Disregard of Rules & Regulations, Substantial Understatement and Substantial Valuation Misstatement components of the accuracy–related penalty will be applicable in most tax shelter examinations, they are the primary focus of this chapter. The following table provides references to the IRM Penalty Handbook for the other components of the accuracy-related penalty:

Penalty Component	IRM Reference	Page #
Overstatement of Pension Liabilities	20.1.5.10	27
Estate or Gift Tax Valuation Understatement	20.1.5.11	29

Penalty Amount

The amount of the accuracy-related penalty is 20 percent of the portion of the underpayment resulting from the above misconduct. The penalty rate can be increased to 40 percent in certain circumstances involving valuation misstatements.

Only one 20 percent penalty may be imposed on any portion of an underpayment, even if that portion is attributable to more than one of the prohibited behaviors; stacking penalties is not permitted. For example, if a portion of an underpayment is attributable to both negligence and a substantial understatement of income tax, the maximum accuracy-related penalty is 20 percent of that portion (Treas. Reg. § 1.6662-1(c)). In addition, the accuracy-related penalty does not apply to any portion of an underpayment on which a penalty is imposed for fraud under IRC § 6663.

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Reasonable Cause / Good Faith Exception - In General

The accuracy-related penalty does not apply with respect to any portion of an underpayment if it is shown that there was reasonable cause for such portion of an underpayment and that the taxpayer acted in good faith with respect to such portion. The determination of whether the taxpayer acted with reasonable cause and in good faith depends upon the pertinent facts and circumstances. Generally, the most important factor is the taxpayer's effort to assess the proper tax liability.

The reasonable cause provisions of IRC § 6664(c) apply to **all** components of the accuracy-related penalty. Special rules are described below regarding limitations on this exception in cases involving tax shelters.

Reliance on Advice – In General

The Reasonable Cause / Good Faith exception includes situations involving a taxpayer's reliance on advice. 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.

"Advice" is defined by Treas. Reg. 1.6664–4(c) as any communication, including the opinion of a professional tax advisor, setting forth an analysis or conclusion by a person other than the taxpayer and on which the taxpayer relied in preparing the return. Advice does not have to be in any particular form.

Under Treas. Reg. 1.6664–4(c)(1), taxpayers may meet the reasonable cause exception if they reasonably relied on advice that was based upon:

- Reasonable factual or legal assumptions,
- All pertinent facts and circumstances, and
- The law as it relates to the facts and circumstances.

Special rules are described below regarding reliance on advice in cases involving corporate tax shelters.

Negligence or Disregard of Rules and Regulations

In General

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the tax law, exercise ordinary and reasonable care in tax return preparation, or keep adequate books and records. Negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a reported item "which would seem to a reasonable and prudent person to be 'too good to be true' under the circumstances." (Treas. Reg. § 1.6662–3(b)(1)).

For example, 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 (by thoroughly investigating the bona fide economic aspects of the transaction or reasonably relying on professional advice that the losses are allowable).

Disregard of rules or regulations relates to the taxpayer's failure to follow the appropriate law in completing the return, and reflects a disregard of the Code, temporary or final regulations, notices, or revenue rulings (other than notices of proposed rule making). The term "disregard" includes careless, reckless, or intentional disregard (Treas. Reg. § 1.6662–3(b)(2)).

Substantial Understatement

In General

If the correct income tax liability for a taxable year exceeds the amount reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement, unless exceptions to the penalty exist.

Substantial Understatement Exceptions – In General

In determining whether a substantial understatement exists, the amount of the understatement generally is reduced by any portion attributable to an item if: (1) the treatment of the item is supported by **substantial authority**; **or** (2) facts relevant to the tax treatment of the item were **adequately disclosed** and there was a **reasonable basis** for its tax treatment.

Substantial Authority Exception – In General

The accuracy-related penalty attributable to substantial understatement generally will not be asserted if there is substantial authority for the tax treatment of an item or return position. See the attached Exhibit IV.A.5-3 for a list of those authorities which are acceptable for purposes of determining whether there is substantial authority for the tax treatment of an item.

Substantial authority for the tax treatment of an item will exist if there is substantial authority at the time the return containing the item is filed or there was substantial authority on the last day of the taxable year to which the return relates. A taxpayer's claim of substantial authority may not be acceptable, however, if there was a misstatement or omission of a material fact or the facts that subsequently develop are materially different from the facts on which the written determination was based.

See IRM 20.1.5.8.4.1 (at page 18) for additional information about the substantial authority exception to the IRC § 6662(d) penalty.

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Adequate Disclosure / Reasonable Basis Exception – In General

Generally, the accuracy-related penalty attributable to a substantial understatement will not be asserted on any part of the underpayment attributable to an item that is adequately disclosed and where there is a reasonable basis for the taxpayer's position for the item. As is described below, this exception does not apply to a substantial understatement attributable to a tax shelter (as defined in IRC § 6662(d)(2)(C)(iii) and Treas. Reg. § 1.6662–4(g)(2)).

The methods in which a taxpayer's position may be adequately disclosed are identified in Treas. Reg. § 1.6662-3(c)(2). For instance, the taxpayer may adequately disclosure by using Form 8275 or 8275-R, in which the relevant statute or regulation are identified.

See IRM 20.1.5.8.4.2 (at page 20) for additional information about the adequate disclosure exception to the IRC § 6662(d) penalty.

Substantial Understatement Exceptions – Tax Shelters

In the case of items attributable to tax shelters of taxpayers other than corporations, the substantial authority exception does not apply, and the adequate disclosure / reasonable basis exception applies only if the taxpayer also reasonably believed that the tax treatment of the item was more likely than not the proper treatment. IRC § 6662(d)(2)(C)(i).

In the case of items of corporate taxpayers attributable to tax shelters, neither the substantial authority nor the adequate disclosure / reasonable basis exception apply (IRC § 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.

Substantial Valuation Misstatement

In General

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 $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. IRC § 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." IRC § 6662(h)(2)(A). If there is a gross valuation misstatement, then the 20 percent penalty under IRC § 6662(a) is increased to 40percent. (IRC § 6662(h)(1).

This penalty does not apply to the extent that the reasonable cause and good faith exception to this penalty set forth in Treas. Reg. § 1.6664-4.

Reasonable Cause / Good Faith Exception- Corporate Tax Shelters

Definition of Tax Shelter for Purposes of IRC § 6662

For transactions entered into after August 6, 1997, 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 (IRC § 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)). This prior standard is more difficult for the government to meet.

Reasonable Cause / Good Faith Exception - Corporate Tax Shelters

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 the excerpt from Treas. Reg. § 1.6664-4(e) which is attached as Exhibit IV.A.5-4). 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). Examples of what would and would not constitute reasonable cause in this context are included on the attached Exhibit IV.A.5-5.

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 reasonable belief standard is met if:

- the corporation analyzed pertinent facts and relevant authorities to conclude in good faith that there would be a greater than 50 percent likelihood ("more likely than not") that the tax treatment of the item would be upheld if challenged by the IRS; or

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Reasonable Cause / Good Faith Exception - Corporate Tax Shelters (Continued)

- the corporation reasonably relied in good faith on the opinion of a professional tax advisor who analyzed all the pertinent facts and authorities, and who unambiguously states that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged by IRS.

Reliance on Advice – Corporate Tax Shelters

A taxpayer is not considered to have reasonably relied in good faith on the opinion of a professional tax advisor unless the advisor considered all facts and circumstances and the advice is not based on unreasonable factual or legal assumptions. Even if these two conditions are present, they do not necessarily establish that the taxpayer reasonably relied on the opinion in good faith. For example, reliance is not reasonable or in good faith if the taxpayer knew or should have known that the advisor lacked knowledge in the relevant aspects of the tax law. (Treas. Reg. § 1.6662-4(g)(4)(ii)).

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Reliance on Advice – Corporate Tax Shelters - Continued

Further, 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 which 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. § 1.6662-4(g)(4)(ii)).

Moreover importantly, the professional tax advisor must be "independent." It is well settled that reliance on accountants, lawyers or other professionals who were also "sales representatives for the investment" or "**promoters**" of the "investment" is unreasonable and does not avoid the imposition of penalties. Goldman v. Commissioner, 39 F.3d 402 (2nd Cir. 1994); Pasternak v. Commissioner, 990 F.2d 893, 903 (6th Cir. 1993)(finding reliance on **promoters or their agents** unreasonable, as "advice of such persons can hardly be described as that of 'independent professionals'"); Roberson v. Commissioner, 98-1 U.S.T.C. 50,269 (6th Cir. 1998) (court dismissed taxpayer's purported reliance on advice of tax professional because professional's status **as "promoter with a financial interest" in the investment**); Rybak v. Commissioner, 91 T.C. 524, 565 (1988) (negligence penalty sustained where taxpayers relied only upon advice of persons who were **not independent of promoters**); Illes v. Commissioner, 982 F.2d 163 (6th Cir. 1992) (taxpayer found negligent reliance upon professional with personal **stake in venture** not reasonable); Gilmore & Wilson Construction Co. v. Commissioner, 99-1 U.S.T.C. 50,186 (10th Cir. 1999) (taxpayer liable for negligence since reliance on representations of the **promoters and offering materials** unreasonable).

In the event that the corporate taxpayer meets the "substantial authority" and "reasonable belief" requirements, that is still not dispositive of whether it acted with reasonable cause if the corporation's participation in the tax shelter lacked significant business purpose or if the corporation claimed benefits that were unreasonable in comparison to the initial investment in the tax shelter (Treas. Reg. § 1.6664-4(e)(3)).

Announcement 2002-2 Disclosure Initiative

Introduction

On December 21, 2001, the Service announced a **Disclosure Initiative** under which the IRS will waive accuracy-related penalties for transactions that produce an underpayment of tax and that the taxpayers disclose to the IRS during period the initiative is in effect. (See Announcement 2002-2, 2002-2 I.R.B. which is attached as Exhibit IV.A.5-6).

For a limited period, Announcement 2002-2 provided an administrative basis under which a taxpayer could avoid the accuracy-related penalty for an underpayment of tax.. The IRS will waive the IRC § 6662 penalty if the taxpayer disclosed an item before the earlier of April 23, 2002, or the date the item was an issue raised during an examination.

"Issues Raised During An Examination"

For purposes of the announcement, an item was an issue raised during an examination if the agent communicated to the taxpayer knowledge about the specific item, or on or before December 21, 2001, the agent had made a request to the taxpayer for information, and the taxpayer could not make a complete response to the request without giving the agent knowledge of the item.

Applicability of Announcement 2002-2

By its express terms, Announcement 2002-2 does not apply to an item that was an issue raised during an examination whether or not the taxpayer itself had disclosed the existence of the item before December 21, 2001. The announcement provides no special rule for CIC taxpayers that disclosed the existence of an item before December 21, 2001, whether on its return, under Rev. Proc. 94-69, or in some other manner.

Consequently, if a CIC taxpayer did not disclose an item under Announcement 2002-2, there is no formal or informal administrative policy of waiving the accuracy-related penalty in the case of a CIC taxpayer solely because the taxpayer disclosed to the examination team the existence of the item. It is the position of LMSB Division Counsel that if there is an underpayment of tax attributable to a listed transaction and the taxpayer did not (including because it was unable to) disclose the transaction under Announcement 2002-2, then the penalty issue should be developed. This position is consistent with the penalty consideration memorandum from the Commissioner of LMSB dated December 20, 2001.

Fraud Penalty – IRC § 6663

Introduction

IRC § 6663(a) provides that if any underpayment of tax is due to fraud, a penalty is imposed equal to 75 percent of the portion of the underpayment due to fraud. For purposes of IRC § 6663, a portion of the underpayment will be considered to be due to fraud, where it is the result of intent to evade tax.

Unlike IRC § 6662, which defines the terms "negligence" and "disregard," IRC § 6663 does not define "fraud." Courts have long recognized that the essence of the fraud penalty is the taxpayer's state of mind. Precisely what state of mind the Service must prove has been variously described, but most definitions require "intent to evade tax." Intent is distinguished from inadvertence, reliance on incorrect professional advice, honest difference of opinion, negligence or carelessness

For purposes of brevity, this chapter does not include an expansive discussion of the fraud penalty. If an examiner encounters facts and circumstances in a tax shelter audit that are so egregious that they appear to rise to the level of badges of fraud, the following links to the IRM Penalty Handbook should be considered:

Handbook Title	IRM Reference
Recognizing and Developing Fraud	25.1.2
Criminal Referrals	25.1.3
Civil Fraud	25.1.6

Audit Techniques - Development of Potential Penalty Issues For Tax Shelter Cases

Objective

In developing your penalty case, you need to determine what efforts the taxpayer made to determine the correctness of the return position. Your objective is to determine accountability for the return position, and determine whether the paper trail corroborates the taxpayer's position.

Of course, every effort should be made to apply penalties in a fair and consistent manner. Penalties should not be applied as "bargaining chips" or because the taxpayer was uncooperative during the examination.

Inquiries Relating to Reasonable Cause and Good Faith

In determining whether the taxpayer has a bona fide reasonable cause / good faith defense against the accuracy-related penalty, you should obtain documentation showing that its tax treatment was more-likely-than-not proper. This documentation should address the following questions:

> Why did the taxpayer enter into the transaction/ structure the transaction/ adopt the accounting treatment/ characterize the assets in the manner the taxpayer did? Is there a legitimate business purpose other than tax savings?
>
> What process did the taxpayer use to get approval to enter into a transaction of this size or dollar amount? Was this process complied with for the suspect transaction? Get copies of approval documents for the suspect transaction, and compare them with similar approval documents of like-size company transactions for the same time period.
>
> Who in the tax department was responsible for the decision to take the reporting position in question? Did the tax department get advice from outside consultants? From whom?
>
> Is the IRS' position which is believed to be contrary to the taxpayer's position a longstanding position or very recent position? How widely disseminated was the Service position? What evidence is there in the return preparation workpapers that the Tax Department knew about the existence of this contrary position? Are there in-house, tax advisor and/or consultant memoranda questioning the proposed return position?

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Inquiries Relating to Reliance on Advice

In determining whether the taxpayer's claim of reliance of upon advice constitutes reasonable cause or good faith, you should obtain documentation that addresses the following questions:

Did the taxpayer seek independent legal advice on the feasibility of the transaction or merely rely upon a legal opinion provided by the outside vendor of the product at issue?

What kind of scrutiny did the taxpayer do of the outside advice before it was adopted? Did the taxpayer have meetings or prepare analyses?

How was the compensation for the outside advice determined (e.g., time based, a flat fee, a percentage of the tax savings, etc.)?

What facts and assumptions did the taxpayer make available about the transaction to the provider of the suspect advice?

Penalty Notice Requirements

Except for any addition to tax under IRC §§ 6651, 6654, or 6655, or any other penalty automatically calculated through electronic means, IRC § 6751 requires that all penalties assessed after December 31, 2000 **must include** the name of any penalty assessed, the Code section that authorizes the penalty, and a computation explaining the penalty shown on the notice.

Managerial Approval of Penalties

IRC § 6751 also requires that all penalties assessed after December 31, 2000 must first be **personally approved in writing** by either the immediate supervisor of the individual making the determination or a designated higher level official.

For a corporate tax shelter case involving a **listed transaction**, the decision to impose or not impose an IRC § 6662 penalty must be approved by the respective Director of Field Operations (DFO), in accordance with the December 21, 2001 memorandum from the LMSB Commissioner (see attached at Exhibit IV.A.5-2) .

Exhibit IV.A.5-1 - Penalty Policy Statement (P–1–18)

Penalties constitute one important tool of the Internal Revenue Service in pursuing its mission of collecting the proper amount of tax revenue at the least cost. Penalties support the Service's mission only if penalties enhance voluntary compliance. Even though other results, such as raising of revenue, punishment, or reimbursement of the costs of enforcement, may also arise when penalties are asserted, the Service will design, administer, and evaluate penalty programs solely on the basis of whether they do the best possible job of encouraging compliant conduct.

In the interest of an effective tax system, the Service uses penalties to encourage voluntary compliance by: (1) helping taxpayers understand that compliant conduct is appropriate and that non-compliant conduct is not; (2) deterring noncompliance by imposing costs on it; and (3) establishing the fairness of the tax system by justly penalizing the non-compliant taxpayer.

To this end, the IRS administers a penalty system that is designed to:

— ensure consistency;
— ensure accuracy of results in light of the facts and the law;
— provide methods for the taxpayer to have his or her interests heard and considered;
— require impartiality and a commitment to achieve the correct decision;
— allow for prompt reversal of initial determinations when sufficient information has been presented to indicate that the penalty is not appropriate;
— ensure that penalties are used for their proper purpose and not as bargaining points in the development or processing of cases.

The Service maintains an ongoing effort to develop, monitor, and revise programs designed to assist taxpayers in complying with legal requirements and, thus, avoid penalties.
To ensure consistency, the Service prescribes and uses a single set of guidelines in a Penalty Handbook which will be followed by all operational and processing functions. Prior to implementation, changes to the Penalty Handbook must be reviewed for consistency with Service Policy and approved by the Penalties and Interest Office.

The Service collects statistical and demographic information to evaluate penalties and penalty administration and how they relate to the goal of voluntary compliance. The Service continually evaluates the impact of the penalty program on compliance and recommends changes when thestatutes or administration of penalties are not effectively promoting voluntary compliance.

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Exhibit IV.A.5-2 - LMSB Commissioner Penalty Memo – December 20, 2001

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE

December 20, 2001

MEMORANDUM FOR Large and Mid-Size Business Division Executives, Managers, & Examiners

FROM: Larry R. Langdon, Commissioner, Large and Mid-Size Business Division, LM

SUBJECT: Consideration of Penalties in Listed Transactions and other Abusive Tax Shelter Cases

This memorandum accompanies the Disclosure Initiative that will be announced tomorrow by the IRS. Under the Disclosure Initiative, the IRS will waive the accuracy-related penalty for transactions that produce an underpayment of tax and that taxpayers disclose to the IRS during the period the initiative is in effect. See Announcement 2002-2, 2002-2 I.R.B., for the details of the initiative. Disclosure is critical to the IRS's ability to efficiently and judiciously use its resources to administer the tax laws.

Properly and judiciously used, penalties enhance voluntary compliance. Complementing the Disclosure Initiative, this memorandum provides guidelines for the consideration of the accuracy-related penalty under section 6662 in examinations involving listed transactions and other potentially abusive tax shelters. Together with the Disclosure Initiative, these penalty guidelines create a compliance incentive by ensuring that in appropriate circumstances we will use the penalty tools already available to us. I am issuing these penalty guidelines to ensure that penalties are considered and applied consistently, impartially, and fairly among all taxpayers. See Penalty Policy Statement (P-1-18) and the Penalty Handbook (IRM 120.1.1.2).

Chapter 5.3 of the Penalty Handbook (IRM 102.1.5.3) contains requirements to be followed in examinations in which penalties are a consideration because an adjustment has been made to a tax return. Subject to the guidelines described below in this memorandum, the requirements contained at IRM 120.1.5.3 apply to all Large and Mid-Size Business (LMSB) taxpayers, including Coordinated Industry Case (CIC) taxpayers. Revisions will be made to the Internal Revenue Manual to incorporate these new guidelines

GUIDELINES

1. Examiners must consider the accuracy-related penalty under section 6662 for underpayments attributable to a taxpayer's participation in a listed transaction.

Transactions that are the same as, or substantially similar to, listed transactions within the meaning of § 1.6011-4T(b)(2) of the temporary Income Tax Regulations are tax avoidance transactions. See § 1.6011-4T(b)(2); Notice 2001-51, 2001- 34 I.R.B. 190. However, depending on the facts, a taxpayer's participation in a listed transaction may not result in an underpayment of tax. If an underpayment of tax is attributable to a taxpayer's participation in a listed transaction, the examiner must develop the accuracy-related penalty issue and prepare a written report supporting the recommendation to impose or not to impose the penalty.

In developing the penalty issue, the examiner must give the taxpayer the opportunity to demonstrate that the penalty does not apply. Depending on the ground(s) for imposing the accuracy-related penalty, the examiner must assess a number of factors, including whether the taxpayer has shown that (i) the transaction was not a tax shelter and thus not subject to the provisions in sections 6662 and 6664 that apply to a substantial understatement attributable to a tax shelter, (ii) the taxpayer was not negligent, (iii) the taxpayer satisfied the requirements of section 6662(d)(2)(B) and (C) (in the case of a noncorporate taxpayer with a substantial understatement attributable to a tax shelter), or (iv) the taxpayer satisfied the requirements of the reasonable cause and good faith exception under section 6664(c).

In all cases in which there is an underpayment attributable to a listed transaction, the Director of Field Operations (DFO) must approve the decision to impose or not to impose the accuracy-related penalty.

2. Cases involving potentially abusive tax shelters should be coordinated with the Office of Tax Shelter Analysis.

Section 6662 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 arrangement is the avoidance or evasion of Federal income tax. This definition provides little guidance to assist an examiner in determining whether a transaction is an abusive tax shelter for which the imposition of a penalty is appropriate.

An aid in evaluating a transaction is § 1.6011- 4T(b)(3), which lists five characteristics that may be indicative of tax shelter activity. See T.D. 8877, 2000-11 I.R.B. 747. A transaction in which two or more of these characteristics are present (the threshold for reportable transactions other than listed transactions) is not necessarily a tax shelter and may not be one for which any adjustment to the taxpayer's return position is warranted. An examiner should carefully scrutinize, however, a transaction that gives rise to an underpayment where business purpose for the transaction was lacking, or where it is apparent that tax avoidance was a significant purpose of the taxpayer's participation in the transaction and the tax benefits claimed by the taxpayer are unusual or not of a kind clearly contemplated under the Code.

Once examiners have identified and evaluated the facts regarding a potentially abusive tax shelter, they must contact LMSB field counsel and the Office of Tax Shelter Analysis (OTSA), which is responsible for coordinating and assisting in the identification of tax shelters. If the examiner concludes that the accuracy-related penalty should be imposed, the DFO must approve that decision.

3. Factors to consider in evaluating the reasonable cause and good faith exception of section 6664(c).

Sections 6662 and 6664 impose higher standards on taxpayers for a substantial understatement attributable to a tax shelter. (These higher standards do not apply in the case of any other basis for imposing an accuracy-related penalty attributable to a tax shelter.) For a corporation, the only relief from the substantial understatement penalty attributable to a tax shelter is found in section 6664(c)(1), which provides that no penalty shall be imposed with respect to any portion of an underpayment if the taxpayer can show that there was reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

The determination of whether a corporation acted with reasonable cause and in good faith regarding its treatment of a tax shelter is based on all of the pertinent facts and circumstances. Legal justification is one factor that may be taken into account in establishing whether a corporation acted with reasonable cause and in good faith. Facts and circumstances other than legal justification may also be considered, as appropriate, in determining whether a corporation acted with reasonable cause and in good faith with respect to a tax shelter item regardless of whether it satisfied the minimum requirements for legal justification. See § 1.6664-4(e).

To rely on legal justification, a corporation must demonstrate, at a minimum, that (1) there was substantial authority for its tax treatment of the item, and (2) based on all of the facts and circumstances, the corporation reasonably believed, at the time the return was filed, that the tax treatment of the item was more likely than not the proper tax treatment. A corporation's failure to satisfy these minimum requirements precludes a finding of reasonable cause and good faith based on legal justification. See § 1.6664-4(e)(2)(i).

Satisfaction of the minimum requirements for legal justification is not necessarily dispositive however. For example, depending on the circumstances, satisfaction of the minimum requirements may not be dispositive if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed tax benefits that are unreasonable in comparison to the taxpayer's investment in the tax shelter, or if the taxpayer agreed with the organizer or promoter of the tax shelter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter. See § 1.6664-4(e)(3) In addition to legal justification, an important factor is whether the corporation disclosed the transaction to the Service. Under § 1.6011-4T, corporations are required to disclose reportable transactions -- transactions that satisfy the projected tax effect requirement and (1) are the same as, or substantially similar to; listed transactions, or (2) have at least 2 of 5 specified characteristics and do not satisfy certain exceptions. See § 1.6011-4T(b). Compliance with § 1.6011-4T may indicate that a taxpayer has acted in good faith with respect to an underpayment attributable to the disclosed transaction. Conversely, if a taxpayer has an underpayment attributable to a reportable transaction that was not properly disclosed on its return, the nondisclosure could indicate that the taxpayer has not acted in good faith with respect to the underpayment, minimum requirements of section 6664(c)(1). See T.D. 8877, 200-11 I.R.B. 747. A corporation that did not disclose a reportable transaction nevertheless may be able to demonstrate that it acted with reasonable cause and in good faith. For example, a corporation that did not disclose a reportable transaction may show that it reasonably believed that it satisfied one of the exceptions in § 1.6011- 4T(b)(3)(ii).

To assist in determining whether a corporation satisfied the special rules for the reasonable cause and good faith exception for a substantial understatement attributable to a tax shelter, examiners should consult with LMSB field counsel.

CONTACT INFORMATION

For information regarding these guidelines, contact David Harris, Manager of the Office of Tax Shelter Analysis at (202) 283- 8386 (not a toll-free call).

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Exhibit IV.A.5-3 – Substantial Authority List

Except in cases described in Treas. Reg. § 1.6662-4 (d)(3)(iv) concerning written determinations, only the following are authority for purposes of determining whether there is substantial authority for the tax treatment of an item:

- Applicable provisions of the Internal Revenue Code and other statutory provisions;
- proposed, temporary and final regulations construing such statutes;
- revenue rulings and revenue procedures;
- tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties;
- court cases;
- congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers;
- General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book);
- private letter rulings and technical advice memoranda issued after October 31, 1976;
- actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin);
- Internal Revenue Service information or press releases; and
- notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin.

Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority. The authorities underlying such expressions of opinion where applicable to the facts of a particular case, however, may give rise to substantial authority for the tax treatment of an item.

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Exhibit IV.A.5-4 - Excerpt from Treas. Reg. §1.6664-4(e) – Special rules for substantial understatement penalty attributable to tax shelter items of corporations—

(1) *In general; facts and circumstances.* The determination of whether a corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item (as defined in §1.6662-4(g)(3)) is based on all pertinent facts and circumstances. Paragraphs (e)(2), (3), and (4) of this section set forth rules that apply, in the case of a penalty attributable to a substantial understatement of income tax (within the meaning of section 6662(d)), in determining whether a corporation acted with reasonable cause and in good faith with respect to a tax shelter item.

(2) *Reasonable cause based on legal justification—*

(i) *Minimum requirements.* A corporation's legal justification (as defined in paragraph (e)(2)(ii) of this section) 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 only if the authority requirement of paragraph (e) (2) (i)(A) of this section and the belief requirement of paragraph (e)(2)(i)(B) of this section are satisfied (the minimum requirements). Thus, a failure to satisfy the minimum requirements will preclude a finding of reasonable cause and good faith based (in whole or in part) on the corporation's legal justification.

(A) *Authority requirement.* The authority requirement is satisfied only if there is substantial authority (within the meaning of §1.6662-4(d)) for the tax treatment of the item.

(B) *Belief requirement.* The belief requirement is satisfied only if, based on all facts and circumstances, the corporation reasonably believed, at the time the return was filed, that the tax treatment of the item was more likely than not the proper treatment. For purposes of the preceding sentence, a corporation is considered reasonably to believe that the tax treatment of an item is more likely than not the proper-tax treatment if (without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled)--

(*1*) The corporation analyzes the pertinent facts and authorities in the manner described in §1.6662-4(d)(3)(ii), and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service; or

(*2*) The corporation reasonably relies 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 §1.6662-4(d)(3)(ii) and 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 Internal Revenue Service. (For this purpose, the requirements of paragraph (c) of this section must be met with respect to the opinion of a professional tax advisor.)

Continued

(ii) *Legal justification defined.* For purposes of this paragraph (e), *legal justification* includes any justification relating to the treatment or characterization under the Federal tax law of the tax shelter item or of the entity, plan, or arrangement that gave rise to the item. Thus, a taxpayer's belief (whether independently formed or based on the advice of others) as to the merits of the taxpayer's underlying position is a legal justification.

(3) *Minimum requirements not dispositive.* Satisfaction of the minimum requirements of paragraph (e)(2) of this section is an important factor to be considered in determining whether a corporate taxpayer acted with reasonable cause and in good faith, but is not necessarily dispositive. For example, depending on the circumstances, satisfaction of the minimum requirements may not be dispositive if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed tax benefits that are unreasonable in comparison to the taxpayer's investment in the tax shelter, or if the taxpayer agreed with the organizer or promoter of the tax shelter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter.

(4) *Other factors.* Facts and circumstances other than a corporation's legal justification may be taken into account, as appropriate, in determining whether the corporation acted with reasonable cause and in good faith with respect to a tax shelter item regardless of whether the minimum requirements of paragraph (e)(2) of this section are satisfied.

HISTORY: T.D. 8790, 63 FR 66433, 66435, Dec. 2, 1998.

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Exhibit IV.A.5-5 - Determining Reasonable Cause and Good Faith

Focus: “the extent of the taxpayer’s effort to assess taxpayer’s proper tax liability. Taxpayers are required to exercise ordinary business care and prudence, i.e., taking that degree of care that a *reasonable prudent person* would exercise.

Circumstances that may indicate reasonable cause and good faith:

- Honest misunderstanding of fact or law that is reasonable given experience and education of taxpayer.
- An isolated computational or transcription error.
- Reliance on erroneous information reported on Forms W-2, 1099, etc., provided that the taxpayer did not know or have reason to know that the information was incorrect.

Circumstances that do not necessarily demonstrate reasonable cause and good faith:

- Reliance on information
- **Reliance on advice of a professional tax advisor or appraiser.**
- Reliance on facts that unknown to Taxpayers are incorrect.
- Mere fact that there is an appraisal of the value of property.

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Exhibit IV.A.5-6 - IRS Announcement 2002-2

IRS Announcement 2002-2, I.R.B. 2002-2, (Dec. 21, 2001)

The Internal Revenue Service (IRS) announces a disclosure initiative to encourage taxpayers to disclose their tax treatment of tax shelters and other items for which the imposition of the accuracy-related penalty may be appropriate if there is an underpayment of tax. If a taxpayer discloses any item in accordance with the provisions of this announcement before April 23, 2002, the IRS will waive the accuracy-related penalty under §6662(b)(1) , (2), (3), and (4) for any underpayment of tax attributable to that item.

This disclosure initiative covers all items except items resulting from a transaction that (1) did not in fact occur, in whole or in part, but for which the taxpayer claimed a tax benefit on its return; (2) involved the taxpayer's fraudulent concealment of the amount or source of any item of gross income; (3) involved the taxpayer's concealment of its interest in, or signature or other authority over a financial account in a foreign country; (4) involved the taxpayer's concealment of a distribution from, a transfer of assets to, or that the taxpayer was a grantor of a foreign trust; or (5) involved the treatment of personal, household, or living expenses as deductible trade or business expenses.

SCOPE OF THE WAIVER

Under this disclosure initiative, the IRS will waive the accuracy-related penalty under §6662(b) for that portion of an underpayment attributable to the disclosed item and due to one or more of the following: (1) negligence or disregard of rules or regulations; (2) any substantial understatement of income tax; (3) any substantial or gross valuation misstatement under chapter 1 of the Code, except for any portion of an underpayment attributable to a net §482 transfer price adjustment, unless the standards of §6662(e)(3)(B) regarding documentation are met; and (4) any substantial overstatement of pension liabilities.

Disclosure under this initiative does not affect whether the IRS will impose, as appropriate, any other civil penalty that may be applicable under the Code or will investigate any associated criminal conduct or recommend prosecution for violation of any criminal statute.

PERIOD OF DISCLOSURE

The IRS will waive the accuracy-related penalty if the taxpayer discloses the item before the earlier of (1) the date the item or another item arising from the same transaction is an issue raised during an examination, or (2) April 23, 2002. For purposes of this disclosure initiative, an item is an issue raised during an examination if the person examining the return (the examiner) communicates to the taxpayer knowledge about the specific item or on or before December 21, 2001, the examiner has made a request to the taxpayer for information, and the taxpayer could not make a complete response to that request without giving the examiner knowledge of the specific item.

INFORMATION REQUIRED TO MAKE A DISCLOSURE

To disclose an item under this initiative, a taxpayer must provide the following:

(1) A statement describing the material facts of the item;

(2) A statement describing the taxpayer's tax treatment of the item;

(3) The taxable years affected by the item;

(4) If the taxpayer is a Coordinated Industry Case (CIC) taxpayer, a statement that the taxpayer will agree to address the disclosed item under the Accelerated Issue Resolution process described in Rev. Proc. 94-67 , 1994-2 C.B. 800, if requested to do so by the IRS;

(5) The names and addresses of (a) any parties who promoted, solicited, or recommended the taxpayer's participation in the transaction underlying the item and who had a financial interest, including the receipt of fees, in the taxpayer's decision to participate, and (b) if known to the taxpayer, any parties who advised the promoter, solicitor or recommender with respect to that transaction;

(6) A statement agreeing to provide, if requested, copies of all of the following:

(a) All transactional documents, including agreements, contracts, instruments, schedules, and, if the taxpayer's participation in the transaction was promoted, solicited or recommended by any other party, all material received from that other party or that party's advisor(s);

(b) All internal documents or memoranda used by the taxpayer in its decision-making process, including, if applicable, information presented to the taxpayer's board of directors; and

(c) All opinions and memoranda that provide a legal analysis of the item, whether prepared by the taxpayer or a tax professional on behalf of the taxpayer; and

(7) A penalty of perjury statement that the person signing the disclosure has examined the disclosure and that to the best of that person's knowledge and belief, the information provided as part of the disclosure contains all relevant facts and is true, correct, and complete. In the case of an individual taxpayer, the declaration must be signed and dated by the taxpayer, and not the taxpayer's representative. In the case of a corporate taxpayer, the declaration must be signed and dated by an officer of the corporate taxpayer who has personal knowledge of the facts. If the corporate taxpayer is a member of an affiliated group filing consolidated returns, a penalties of perjury statement also must be signed, dated, and submitted by an officer of the common parent of the group. The person signing for a trust, a state law partnership, or a limited liability company must be, respectively, a trustee, general partner, or member-manager who has personal knowledge of the facts. A stamped signature is not permitted.

PROCEDURE FOR MAKING THE DISCLOSURE

A CIC taxpayer must submit the disclosure information to the assigned team manager and send a copy of the information to the Office of Tax Shelter Analysis.

A non-CIC taxpayer not under examination as of December 21, 2001, must send the disclosure information to the Office of Tax Shelter Analysis.

A non-CIC taxpayer under examination as of December 21, 2001, must submit the disclosure information to the examiner and send a copy of the information to the Office of Tax Shelter Analysis.

The address for the Office of Tax Shelter Analysis is LM:PFTG:OTSA, 1111 Constitution Ave, NW, Washington, DC 20224.

MISCELLANEOUS

The IRS is committed to considering and resolving disclosed items promptly. A taxpayer's disclosure of an item creates no inference that the taxpayer's tax treatment of the item was improper or that the accuracy-related penalty would apply if there is an underpayment of tax. Furthermore, taxpayers that do not disclose under this initiative are not prevented from demonstrating that they satisfy the reasonable cause exception under §6664(c) and the regulations thereunder with respect to any portion of an underpayment of tax.

PAPERWORK REDUCTION ACT

The collection of information contained in this announcement has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. §3507) under control number 1545-1764. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this announcement is in the section titled INFORMATION REQUIRED TO MAKE A DISCLOSURE. This information is required to assess the item the taxpayer is disclosing under the initiative. This information will be used to determine whether the taxpayer has reported the disclosed item properly for income tax purposes. The collection of information is required to obtain the benefit described in this announcement. The likely respondents are businesses or other for-profit institutions, small businesses or organizations, and individuals.

The estimated total annual reporting burden is 450 hours.

The estimated annual burden per respondent varies from 2 hours to 4 hours, depending on individual circumstances, with an estimated average of 3 hours. The estimated number of respondents is 150.

The estimated frequency of responses is one time per respondent.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. §6103 .

CONTACT INFORMATION

For further information regarding this announcement, contact Jozef Chilinski of the Office of Tax Shelter Analysis at (202) 283-8425 (not a toll-free call).

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