



Large and Mid-Size
Business Division

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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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, even if the taxpayer's return position has sufficient legal justification to meet the minimum requirements of section 6664(c)(1). See T.D. 8877, 2000-11 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 further information regarding these guidelines, contact David Harris, Manager of the Office of Tax Shelter Analysis at (202) 283-8386 (not a toll-free call).