The recent Green Book shows that the Presidential Administration is advocating **all stick, and no carrot,** when it comes to disclosures to the IRS.

TAX DISCLOSURES: NEW PROPOSALS REGARDING **FORM 8275-R**

Replacing Sticks with Carrots

HALE E. SHEPPARD, ESQ. The two major tools used to shape taxpayer behavior are rewards and punishments, otherwise known as carrots and sticks. In recent years, the Internal Revenue Service ("IRS") has relied heavily on the latter, based in the belief that severely penalizing taxpayers for violations results in more overall compliance and tax revenue. That theory is open to debate. What is undeniable, though, is that the current Presidential Administration has announced that it plans to stay the course when it comes to what some might label aggressive tax positions.

This article explains the regulations compelling disclosures to the IRS about "reportable transactions," practical effects of such regulations, traditional incentives for taxpayers to disclose voluntarily return positions that are novel and/or contrary to existing IRS guidance, and the new proposal by the Presidential Administration to substitute sticks for carrots in certain situations.

Sticking it to Them

The IRS has been wielding a big stick for decades when it comes to forcing taxpayers to divulge participation in so-called reportable transactions.

Evolution of the Regulations

Taxpayers must file various returns, statements, forms, lists, etc. in accordance with the applicable regulations.[1] For those who participate in what the IRS has categorized as reportable transactions, filing duties include Form 8886 (Reportable Transaction Disclosure Statement).[2] How did we get here?

The IRS has published several versions of regulations in connection with reportable transactions over the years.[3] The first set, issued in March 2000, focused on disclosure statements for *corporate* taxpayers.[4] The IRS was concerned about the proliferation of tax shelters, and the regulations were intended to give the IRS early notification of large corporate transactions that "may be indicative of such tax shelter activity."[5] The regulations identified two types of reportable transactions: Those that the IRS had specifically identified as tax-avoidance transactions and those that warranted further scrutiny because they possessed qualities common in tax shelters. Transactions in the second category consisted of those that would reduce a taxpayer's federal income tax liability by more than $5 million in any single year or by a total of more than $10 million, and had at least two of five characteristics highlighted by the IRS.[6]

The IRS decided to expand the reach of the disclosure requirements in June 2002. From that point forward, they would apply not only to corporations, but also to individuals, trusts, partnerships, and S corporations that participated in reportable transactions.[7]

The IRS changed course in October 2002 when it discovered, unsurprisingly, that taxpayers were interpreting the five characteristics of tax shelters in an "overly narrow manner," but interpreting the exceptions to such characteristics in an "overly broad manner."[8] The IRS created rules that were more objective in an effort to remedy this.[9]

The IRS issued final regulations in March 2003.[10] In doing so, the IRS indicated that, after considering public commentary, it decided to decrease the number of items on the list of reportable transactions.[11]

In summary, the IRS has been using the stick for more than two decades, obligating taxpayers who participate in reportable transactions to file Form 8886 and other relevant materials. Those who fail to do so face serious penalties, extended assessment periods, and more, as explained below.

Real Life Example

In December 2016, the IRS announced in Notice 2017-10 that it intended to challenge what it coined syndicated conservation easements ("SCETs") because they supposedly constitute "tax-avoidance transactions" involving overvaluations of donations.[12] The effect of Notice 2017-10 was that SCETs became "listed transactions," which is just one type of reportable transaction.[13] Accordingly, participants, material advisors, and others involved with SCETs became subject to additional reporting and record-keeping requirements.

Effect on Participants

Notice 2017-10 had various effects on those who participated in SCETs.

Concept of Participation

Notice 2017-10 requires taxpayers who participate in an SCET or a substantially similar transaction to file Form 8886.[14] For these purposes, a taxpayer has "participated" in an SCET if the taxpayer's tax return reflects the tax consequences or a tax strategy described in Notice 2017-10. For instance, a partner who receives a Schedule K-1 (Partner's Share of Income, Deductions, Credits, Etc.) from a partnership that has engaged in an SCET is considered to have participated in the transaction.[15] Notice 2017-10 indicates that participants in SCETs include (i) investors/partners, (ii) the partnerships that actually donated the conservation easements, as well as any affiliated partnerships in situations involving multi-tier structures, and (iii) any other person whose tax return reflects tax consequences or a tax strategy described as an SCET.[16]

Past and Future Years

If a reportable transaction results in a loss that is *carried back* to a prior year, then the taxpayer must enclose Form 8886 with the application for tentative refund or amended return for the prior year.[17] Conversely, if a taxpayer participates in an SCET in one year and *carries forward* a portion of the relevant charitable deduction to later years, then the taxpayer would be participating in the SCET in the later years and would thus need to file Form 8886.

Disclosure-Related Penalties

Notice 2017-10 contains multiple threats about the downsides of non-compliance. For instance, it explains that if participants fail to file timely, complete, and accurate Forms 8886, then the IRS generally can assert a penalty equal to 75 percent of the tax savings resulting from their participation.[18] In the case of a listed transaction, like an SCET, the maximum penalty for individual taxpayers is $100,000, while the maximum for entities is $200,000.[19]

Importantly, the IRS does *not* have authority to rescind or abate a penalty

Hale E. Sheppard, Esq. (B.S., M.A., J.D., LL.M., LL.M.T.) is a Shareholder in the Tax Controversy Section and Chair of the International Tax Section of Chamberlain Hrdlicka. Hale specializes in tax audits, tax appeals, tax litigation, and international tax. You can reach Hale by phone at (404) 658-5441 or by e-mail at hale.sheppard@chamberlainlaw.com.

assessed against a listed transaction, like an SCET.[20] Also, no "reasonable cause" exception to the penalty exists. Thus, if the IRS assesses Form 8886 penalties, then participants generally cannot fight them as they would other penalties, by filing a Protest Letter and addressing matters with the Appeals Office and/or by filing a Petition with the Tax Court. Rather, they must dispute the penalties through the collection process or by fully paying the penalties, filing a Claim for Refund, and, if the IRS ignores or rejects the Claim for Refund, by filing a refund suit in court.[21]

Income-Related Penalties

If a taxpayer participates in a reportable transaction, and the IRS later disallows the benefits claimed, then the IRS can assess a penalty equal to 20 percent of the tax increase.[22] This penalty rate increases to 30 percent if the participant fails to file a Form 8886.[23]

Extended Assessment Periods

In addition to the financial penalties described above, if a participant fails to enclose a timely, complete, and accurate Form 8886 with his tax return, then the assessment period with respect to such tax return can remain open a long time. Specifically, the period stays open until one year after, the earlier of, when the participant eventually files Form 8886, or when the material advisor provides the IRS with the required list of data about the SCET and its participants in response to a written request from the IRS.[24] The regulations explain the types of taxes, penalties, and interest that the IRS can assess in situations involving Form 8886 violations:

> *If the period of limitations on assessment for a taxable year remains open [because of an unfiled Form 8886], the [IRS] has authority to assess* any *tax with respect to the listed transaction in that year. This includes, but is not limited to, adjustments made to the tax consequences claimed on the return, plus interest, additions to tax, additional amounts, and penalties that are related to the listed transaction or adjustments made to the tax consequences. This also includes any item to the extent the item is affected by the listed transaction,* even if it is unrelated to the listed transaction . . .[25]

Record Retention for Participants

The regulations mandate that participants retain a copy of "all documents and other records" related to the transaction disclosed on Form 8886 that "are material to an understanding of the tax treatment or tax structure of the transaction."[26] The participant must retain the materials until the assessment period for the final year for which he must file a Form 8886 has expired.[27] The items that participants must retain include (i) marketing materials, (ii) written analyses used in decision-making related to the transaction, (iii) correspondence and any agreements between the taxpayer and any advisor, lender, or other party to the transaction, (iv) documents discussing, referencing, or demonstrating the purported tax benefits arising from the transaction, and (v) documents referring to the business purposes for the transaction.[28]

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1 Section 6011(a); Treas. Reg. § 301.6011-1.
2 Treas. Reg. § 301.6011-4.
3 *See T.D. 8875 (March 2, 2000); T.D. 8876 (March 2, 2000); T.D. 8877 (March 2, 2000); T.D. 8896 (Aug. 16, 2000); T.D. 8961 (Aug. 7, 2001); T.D. 9000 (June 18, 2002); T.D. 9017 (Oct. 22, 2002); T.D. 9018 (Oct. 22, 2002); T.D. 9046 (March 4, 2003); T.D. 9108 (Dec. 30, 2003); T.D. 9350 (Aug. 3, 2007).*
4 T.D. 8877 (March 2, 2000); REG-103735-00.
5 T.D. 8877 (March 2, 2000), Preamble.
6 Id.
7 T.D. 9000 (June 18, 2002), Preamble; Temp. Reg. § 1.6011-1T(a)(1).
8 T.D. 9017 (Oct. 22, 2002), Preamble.
9 Id.
10 T.D. 9046 (March 4, 2003).
11 Id.
12 Notice 2017-10, Preamble and Section 1.
13 Section 6707A(c)(2); Treas. Reg. § 1.6011-4(b)(2).
14 Participants are allowed to file a "protective" disclosure if they are uncertain as to whether a particular transaction is considered an SCET. *See Treas. Reg.* § 1.6011-4(f)(2).
15 Treas. Reg. § 1.6011-4(e)(1).
16 Notice 2017-10, Section 3.
17 Treas. Reg. § 301.6707A-1(c)(1) and (c)(2), Example 3.
18 Section 6707A(a), (b); Treas. Reg. § 301.6707A-1(a).
19 Section 6707A(b)(2); Treas. Reg. § 301.6707A-1(a). The minimum penalty is $5,000 for individuals and $10,000 for entities. *See Section 6707A(b)(3); Treas. Reg.* § 301.6707A-1(a).
20 Section 6707A(d)(1).
21 *See, e.g., Barzillai v. United States, 137 Fed Cl. 788, 121 AFTR 2d 2018-1582 (April 30, 2018); Larson v. United States, 888 F.3d 578, 121 AFTR 2d 2018-1598 (April 25, 2018).*
22 Section 6662A(a).
23 Section 6662A(c).
24 Section 6501(c)(10).
25 Treas. Reg. § 301.6501(c)-1(g)(7) (emphasis added); *See also Treas. Reg.* § 301.6501(c)-1(g)(8) (Example 14).
26 Treas. Reg. § 1.6011-4(g)(1).
27 Id.
28 Treas. Reg. § 1.6011-4(g)(1).

"Substantially Similar" Transactions

The standards in Notice 2017-10, as well as the duties to file Form 8886, apply not only to SCETs, but also to all transactions that are "substantially similar" thereto. This term broadly encompasses any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on a similar tax strategy.[29] The regulations underscore that (i) the term "substantially similar" must be broadly construed in favor of making disclosures to the IRS, (ii) receipt of a tax/legal opinion regarding the tax consequences of a transaction is not relevant to whether such transaction is the same as or substantially similar to another transaction, and (iii) a transaction may be substantially similar to a listed transaction, even though it involves different entities and/or applies different tax provisions.[30] The regulations contain several examples demonstrating just how liberally the IRS interprets the notion of substantially similar.[31]

The IRS, consistent with the regulations described in the preceding paragraph, has issued multiple Private Letter Rulings, Field Service Advisories, General Counsel Memos, and Chief Counsel Advisories concluding that particular transactions are "substantially similar" to one listed transaction or another.[32]

The courts, likewise, have expansively interpreted the concept of "substantially similar" transactions in upholding IRS penalties assessed for unfiled Form 8886. There are numerous cases on point.[33]

Carrots Out, Sticks In

As explained above, the IRS has utilized for decades a big stick (in the form of mandatory disclosure requirements, recording-keeping duties, severe penalties, and extended assessment periods) when dealing with reportable transactions and those that are "substantially similar" thereto. By contrast, the IRS historically has offered a carrot when it comes to positions taken by taxpayers that are aggressive and/or contrary to existing rules and regulations.

Summary of Relevant Rules

The IRS can assert an accuracy-related penalty on a tax underpayment if it is attributable to certain types of misconduct by the taxpayer.[34] In the case of an individual taxpayer, an "underpayment" generally means the difference between the tax liability that the taxpayer reported on his Form 1040 (U.S. Individual Income Tax Return) and the tax liability he should have reported, if he had completed his Form 1040 correctly.[35] For example, where the taxpayer's true tax liability was $100,000 but he only reported $80,000 on his Form 1040, then the IRS ordinarily could assert a penalty of $4,000 (*i.e.*, a $20,000 tax understatement times 20 percent).

One way for a taxpayer to dodge certain penalties, including those for disregarding tax rules or regulations or for substantially understating the amount of tax due on a particular return, is to bring matters to the IRS's attention pro-actively, *even though doing so is not required.*[36] Specifically, as long as a situation does not implicate a "tax shelter," a taxpayer normally can escape these penalties if he properly discloses his position to the IRS, he has a reasonable basis for the position, and he maintains adequate books, records and other support for the position.[37] A taxpayer makes a disclosure to the IRS in this context by enclosing a Form 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement) with the relevant tax return.[38] When it comes to substantial understatement sanctions, the IRS can issue an annual Revenue Procedure or otherwise describe the circumstances under which disclosure on a return, alone, is adequate. However, if the Revenue Procedure or other guidance does not include an item, then disclosure is sufficient only if made on a completed Form 8275 or 8275-R, as appropriate, attached to a return.[39]

Congress explained its thought process in creating the disclosure exception for penalties:

> *The Committee believes that the application of standardized exception criteria to the negligence component of the accuracy-related penalty will result in several consequences that are beneficial to taxpayers. First, the complete, item-specific disclosure of a non-frivolous position on a tax return may generally be considered to permit an exception from the negligence penalty insofar as such disclosure would tend to demonstrate that there was no intentional disregarding of the rules or regulations. Disclosure must be full and substantive, parallel to the disclosure required under the substantial understatement component of the accuracy-related penalty; completing and filling in a tax form is by itself insufficient disclosure for this purpose. In addition, the disclosure must be clearly identified as being made to avoid the imposition of the accuracy-related penalty. Imposition of the negligence component of the accuracy-related penalty would not be eligible for the exception due to disclosure where the taxpayer fails to keep proper books and records or to substantiate items properly. Second, the application of the standardized exception criteria to the negligence component of the accuracy-related penalty may also permit a taxpayer to avoid imposition of that penalty where the taxpayer makes a good-faith challenge to the validity of an IRS regulation, if the taxpayer discloses (in the manner just described) that the taxpayer is taking the position and makes specific reference to the regulation being challenged.*[40]

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[29] Treas. Reg. § 301.6011-4(c)(4).

[30] Id.

[31] Treas. Reg. § 301.6011-4(c)(4), Example s.

[32] *See, e.g., Private Letter Ruling 201017076 (substantial similarity to Notice 95-34), Field Service Advice 200218014 (substantial similarity to Notice 2001-16), Chief Counsel Advice 200712044 (substantial similarity to Notice 2005-13), and Chief Counsel Advice 200929005 (substantial similarity to Notice 2004-8).*

[33] *See, e.g., Polowniak v. Commissioner, T.C. Memo 2016-31 (substantial similarity to Notice 2004-8); Blak Investments et al. v. Commissioner, 133 T.C. 431 (2009) (substantial similarity to Notice 2000-44); Our Country Home Enterprises, Inc. v. Commissioner, 145 T.C. 1 (2015) (substantial similarity to Notice 2007-83); Turnham v. United States, 123 AFTR 2d 2019-2042 (D.C. Alabama 2019) (substantial similarity to Notice 95-34); and Interior Glass Systems, Inc. v. United States, 123 AFTR 2d 2019-XXXX (9th Cir. 2019) (substantial similarity to Notice 2007-83).*

[34] Section 6662(a).

[35] Section 6664(a); Treas. Reg. § 1.6664-2(a). The definition of "underpayment" is considerably more complicated, but a simplified and abbreviated version suffices to make the critical points in this article.

[36] In this context, the term "rules or regulations" includes tax provisions in the Internal Revenue Code, temporary or final regulations, Revenue Rulings, and IRS Notices. See Treas. Reg. § 1.6662-3(b)(2).

[37] Section 6662(d)(2)(B)(ii); Treas. Reg. § 1.6662-3(c); Treas. Reg. § 1.6662-4(e); Treas. Reg. § 1.6662-4(f). The term "tax shelter" means a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement a "significant purpose" of which is to avoid or evade federal income tax. *See Section 6662(d)(2)(C)(ii); Treas. Reg.* § 1.6662-4(g)(2).

[38] Treas. Reg. § 1.6662-4(f)(1); Treas. Reg. § 1.6662-4(f)(2); Rev. Proc. 2008-14.

[39] Treas. Reg. § 1.6662-4(f)(2); *See Rev. Proc. 2008-14.*

[40] U.S. House of Representatives, Committee on the Budget. Omnibus Budget Reconciliation Act of 1989, Report 101-247, 101st Congress, 1st Session (Sept. 20, 1989), pg. 1393.

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New Proposal by Presidential Administration

The current Presidential Administration recently revealed its legislative wish list for 2023 ("Green Book").[41] It shows that the Administration seems to favor the stick, at least when it comes to taxpayers taking legal or tax positions on their returns that challenge those traditionally embraced by the IRS. The Green Book emphasizes that present law permits a taxpayer to disclose a contrary position to the IRS in order to avoid certain accuracy-related penalties, but does *not* impose "an affirmative obligation for taxpayers to inform the IRS that they are taking such a position."[42] The Green Book goes on to explain that, in recent years, a growing number of taxpayers have advanced return positions that are contrary to the rules and regulations, and the IRS often has trouble identifying such positions, unless taxpayers enclose a Form 8275-R with their returns. The Green Book further observes that "[s]ome taxpayers have eschewed penalty protection by forgoing the disclosure of positions that are contrary to a regulation in the hopes of avoiding scrutiny."[43] In other words, the Green Book recognizes that the traditional carrot of penalty elimination in exchange for taxpayers placing a veritable target on their heads is *not* appealing to some taxpayers. After doing the risk-versus-reward analysis, such taxpayers presumably concluded that it would be more beneficial for them to discreetly take a favorable, innovative, risky position on their returns, hope that the IRS is too understaffed to notice, and then raise various defenses (other than disclosure on Form 8275-R) if the IRS were to audit, disagree with the position, and assert taxes and penalties.

The Green Book suggests the following remedy. Congress should impose on taxpayers "an affirmative requirement" to file a Form 8275-R to disclose any position that is contrary to an existing rule or regulation.[44] Penalties for non-compliance would be significant and immediate, with the Green Book proposing an "assessable" penalty equal to 75 percent of the decrease in tax shown on the tax return because of the undisclosed position.[45] Moreover, the Green Book suggests that whether the courts eventually vindicate the taxpayer is irrelevant because "[t]he penalty would apply regardless of whether the taxpayer's interpretation of the regulation is ultimately upheld."[46]

Conclusion

The IRS has long used mandatory disclosures by taxpayers on Form 8886 to discourage participation in reportable transactions, including SCETs, and to carry out enforcement campaigns. The IRS has taken a different approach in the past, though, when it comes to taxpayers taking positions on returns that diverge from existing guidance. The IRS favored the carrot, offering penalty protection to taxpayers on the condition that they adequately revealed their positions on the return, Form 8275, or Form 8275-R, as appropriate. The recent Green Book shows that the Presidential Administration is advocating all stick, and no carrot, when it comes to disclosures to the IRS. Taxpayers and their advisors should be watching this important issue to see how it evolves and whether it will affect them in the future. ●

41 U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals (March 2022).

42 U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals (March 2022), pg. 80.

43 Id.

44 Id.

45 U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals (March 2022), pg. 80. The penalties would range from $10,000 to $200,000, adjusted for inflation. The IRS would not assert penalties if a taxpayer could demonstrate that it "reasonably and in good faith believed that its position is consistent with the regulation." *Id.*

46 U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals (March 2022), pg. 80.