TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

The Internal Revenue Service Provided Interim Guidance and Plans to Take Additional Actions to Implement New Tax Shelter Penalty Provisions

March 2006

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

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TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

March 30, 2006

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

Michael R. Phillips

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Provided Interim Guidance and Plans to Take Additional Actions to Implement New Tax Shelter Penalty Provisions (Audit # 200530023)

This report presents the results of our review of Provision 811 (Penalty for Failing to Disclose Reportable Transactions) of the American Jobs Creation Act of 2004 (AJCA).[1] The overall objective of this review was to determine whether the Internal Revenue Service (IRS) effectively completed the planned actions to implement Provision 811 of the AJCA regarding the penalty for failing to disclose reportable transactions.

Synopsis

Tax shelters have become a considerable problem for the IRS and have added significantly to the tax gap.[2] At the Federal level, the potential tax loss from abusive tax shelters is estimated to be $129 billion.[3] Because of the magnitude of this problem, Congress and the IRS have been searching for ways to discourage abusive tax shelter transactions.

On October 22, 2004, President Bush signed the AJCA. This new legislation contains many provisions that will affect abusive tax shelter promoters, advisors, and investors. Among the many provisions of this Act, Provision 811 imposed a new, independent penalty on taxpayers

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[1] Pub. L. No. 108-357, 118 Stat. 1418 (2004).

[2] *Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters* (GAO-04-104T, dated October 2003).

[3] *Tax Shelters: Services Provided by External Auditors* (GAO-05-171, dated February 2005).

who fail to disclose a reportable transaction.[4] Provision 811 provides meaningful penalties for noncompliance that were previously lacking in the IRS' initiative to discourage abusive tax shelters. It was intended that the imposition of this penalty would provide an additional incentive for taxpayers to comply with tax shelter disclosure provisions.[5]

The penalty for failing to disclose a reportable transaction (other than a listed transaction) is $10,000 in the case of an individual and $50,000 in any other case. The amount is increased to $100,000 and $200,000, respectively, if the failure is with respect to a listed transaction.

Because of the significance of Provision 811 to tax administration, and because the penalties could significantly affect taxpayers, it was important that the IRS implement this Provision timely and accurately.

In summary, the IRS developed and provided interim guidance and established controls related to the implementation of Provision 811. The IRS provided much of the required guidance in multiple news releases, notices, revenue procedures, and form revisions from January 2005 through January 2006 and is anticipating issuing further guidance and final forms and instructions later in 2006. The date of enactment of the AJCA gave the IRS limited time to issue complete guidance to taxpayers.

Although the IRS developed and provided interim guidance and established controls related to the implementation of Provision 811, many additional actions are still needed, with some scheduled for 2 years after enactment of the Act. For example, the IRS is studying the feasibility of identifying taxpayers subject to the penalty during the "filing" phase of operations through modifications to Master File[6] systems and campus[7] return processing procedures and is working towards securing data through *e-file*.[8] In addition, the IRS is writing a draft of new regulations under Internal Revenue Code § 6707A[9] to define various terms that will directly affect the penalty application and is making revisions to forms and related instructions.

The IRS revised the instructions for many business tax returns to include information on reportable transactions, applicable penalty information, and the related forms corporations may have to file. However, as of January 31, 2006, revisions to the instructions for U.S. Life

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[4] Reportable transactions include (1) listed transactions (identified in IRS published guidance), (2) confidential transactions, (3) transactions with contractual protection, (4) loss transactions, (5) transactions with a significant book-tax difference, and (6) transactions with a brief asset holding period. See Appendix IV.
[5] This information is from House Committee Report *H.R. Rep. No. 108-548, Part I.*
[6] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[7] The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
[8] The electronic filing of tax information with personal computers and tax preparation software.
[9] AJCA Provision 811 resulted in adding § 6707A, Penalty for Failure to Include Reportable Transaction Information with Return, to the Internal Revenue Code. 26 U.S.C. § 6707A (2004).

Insurance Company Income Tax Return (Form 1120-L) and U.S. Property and Casualty Insurance Company Income Tax Return (Form 1120-PC) were in draft form and needed to be finalized and posted to the IRS web site.

Recommendations

We made no recommendations to this report. However, key IRS management officials reviewed it prior to issuance.

Copies of this report are also being sent to the IRS managers affected by the report finding. Please contact me at (202) 622-6510 if you have questions or Curtis Hagan, Assistant Inspector General for Audit (Small Business and Corporate Programs,), at (202) 622-3837.

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Background

On October 22, 2004, President Bush signed the American Jobs Creation Act of 2004 (AJCA).[1] Among the many provisions of this Act, Provision 811 (Penalty for Failing to Disclose Reportable Transactions) imposed a new, independent penalty on taxpayers who fail to disclose a reportable transaction.[2] It was intended that the imposition of this penalty would provide an additional incentive for taxpayers to comply with tax shelter disclosure provisions.[3]

Taxpayers must disclose reportable transactions on a Reportable Transaction Disclosure Statement (Form 8886) and must also send a copy of the form to the Internal Revenue Service (IRS) Office of Tax Shelter Analysis. The penalty for failing to disclose a reportable transaction (other than a listed transaction) is $10,000 in the case of an individual and $50,000 in any other case. The amount is increased to $100,000 and $200,000, respectively, if the failure is with respect to a listed transaction.

The IRS is required to submit an annual report to Congress summarizing the total number and aggregate amount of penalties imposed and rescinded under Internal Revenue Code (I.R.C.) § 6707A.[4] The Provision is effective for returns and statements due after October 22, 2004, and that were not filed before such date.

The Small Business/Self-Employed Division was the operating division assigned the primary responsibility for implementation of Provision 811. The Small Business/Self-Employed Division's actions to implement Provision 811 involved multiple action items, including providing training and guidance to IRS employees and taxpayers, coordinating extensively with various IRS functions, creating and revising forms and publications, and generally taking the necessary actions to effectively implement this Provision.

This review was performed at the IRS office in Holtsville, New York, covering the Small Business/Self-Employed Division's responsibility in implementing Provision 811 during the period July 2005 through January 2006. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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[1] Pub. L. No. 108-357, 118 Stat. 1418 (2004).
[2] Reportable transactions include (1) listed transactions (identified in IRS published guidance), (2) confidential transactions, (3) transactions with contractual protection, (4) loss transactions, (5) transactions with a significant book-tax difference, and (6) transactions with a brief asset holding period. See Appendix IV.
[3] This information is from the House Committee Report *H.R. Rep. No. 108-548, Part 1*.
[4] 26 U.S.C. § 6707A (2004).

Results of Review

The Internal Revenue Service Provided Interim Guidance and Established Controls Related to Implementation of Provision 811

The timing of enactment of the legislation involving Provision 811 gave the IRS limited time to issue complete guidance to taxpayers that would be affected by the imposition of this penalty. After enactment of Provision 811, the IRS designated guidance for this Provision as a top-priority item and made a significant staffing commitment, including having officials at the highest levels begin a coordinated effort to identify and prioritize issues needing guidance under the new Provision.

The IRS focused on addressing those priority issues and targeted the issuance of two priority notices: the first notice primarily provided interim guidance related to the new failure to disclose reportable transactions penalty, and the second notice primarily provided guidance to persons who may be required to disclose those penalties on reports filed with the Securities and Exchange Commission.

On January 19, 2005, approximately 3 months after enactment of Provision 811, the IRS issued Notice 2005-11 alerting taxpayers to new I.R.C. § 6707A.[5] The Notice outlined the existing regulatory disclosure rules and the new failure to disclose penalty; it also provided interim guidance regarding the imposition and rescission of penalties to taxpayers who are required to disclose reportable transactions. This Notice was made available to major national and tax media and was included on the IRS web site (IRS.gov).

On August 15, 2005, the IRS issued Revenue Procedure 2005-51 providing guidance to persons who may be required to pay penalties under I.R.C. § 6707A and who may be required under I.R.C. § 6707A(e) to disclose those penalties on reports filed with the Securities and Exchange Commission. This Revenue Procedure described the report on which the disclosures must be made, the information that must be disclosed, and the deadlines by which persons must make the disclosures to avoid additional penalties under I.R.C. § 6707A(e).

On October 13, 2005, the IRS posted a preliminary draft of Form 8886 to the Draft Forms web site. The first redesign of Form 8886 and related instructions was completed in January 2006, and additional revisions are expected to be completed by December 2006.

On January 6, 2006, the IRS issued Notice 2006-6, notifying taxpayers and material advisors of the removal of the book-tax difference category of reportable transactions.[6] Taxpayers will no

[5] AJCA Provision 811 resulted in adding § 6707A, Penalty for Failure to Include Reportable Transaction Information with Return, to the I.R.C.
[6] See Appendix IV for an explanation of this reportable transaction.

longer have to disclose transactions with a significant book-tax difference on or after the date of this Notice.

The IRS established a joint task group to coordinate the activities required to implement Provision 811. In addition to Large and Mid-Size Business Division employees, the group is comprised of Small Business/Self-Employed Division and Tax Exempt and Government Entities Division employees. Cross-divisional discussions are currently underway to identify and correct any gaps in the respective implementation action plans, including the identification of any other actions that may be needed.

The Large and Mid-Size Business Division created for its employees an AJCA webpage on its web site that contained links to notices, news releases, fact sheets, and other existing technical guidance relating to the Act.

In addition, the IRS has the Legislative Implementation Tracking System, which is an IRS Intranet-based planning and monitoring system for implementation of tax legislation. It is designed to enable the responsible offices to monitor legislation that has a significant impact on the IRS. The web site has the required actions with estimated due dates and indicates the functions responsible for taking the necessary actions to implement any provision. Also, the web site shows which action items are on time or running behind schedule.

Additional actions are needed to fully implement Provision 811

Although the IRS developed and provided interim guidance and established controls related to the implementation of Provision 811, many additional actions are still needed, with some scheduled for 2 years after enactment of the Act.

The determination of whether a person entered into a reportable transaction and whether the transaction was listed requires an audit of the taxpayer. Inasmuch as I.R.C. § 6707A is effective for returns due and filed after October 22, 2004, no penalties can be assessed until the IRS has had time to conduct audits of taxpayers' returns.

To expedite the identification of taxpayers subject to penalties under I.R.C. § 6707A, the Office of Tax Shelter Analysis is studying the feasibility of expanding this capability to include compliance activities performed during the "filing" phase of operations through (1) Master File[7] systems enhancements and (2) modifications to campus[8] return processing procedures. Some of the Master File enhancements being considered include (1) installing Computer Condition

[7] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[8] The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

Codes[9] to establish the fact of filing, (2) transcribing the Form 8886, and (3) establishing an Integrated Data Retrieval System[10] Command Code to extract transcribed data. The targeted completion date for these Master File enhancements is December 2006.

The Office of Tax Shelter Analysis is working towards securing data through *e-file*;[11] however, this will continue into the 2007 filing year and is linked to the rollout of *e-file* capability for all returns by all operating divisions.

Also, a draft of new regulations under I.R.C. § 6707A is in the process of being written to define various terms that will directly affect the penalty application. The target date for completion is June 30, 2006. Publication of the regulations by the target date may be affected by the IRS' progress on other projects implementing the AJCA.

The IRS revised the instructions for many business tax returns to include information on reportable transactions, applicable penalty information, and the related forms corporations may have to file. As of January 31, 2006, revisions to the instructions for U.S. Life Insurance Company Income Tax Return (Form 1120-L) and U.S. Property and Casualty Insurance Company Income Tax Return (Form 1120-PC) were in draft form and needed to be finalized and posted to the IRS web site. Revisions to Form 8886 and related instructions are scheduled to be completed by December 2006.

[9] Computer Condition Codes are assigned by tax examiners or are computer generated during the processing of the return. They identify a special condition or computation for the computer. Computer Condition Codes post to the Master File.

[10] IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

[11] The electronic filing of tax information with personal computers and tax preparation software.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) effectively completed the planned actions to implement Provision 811 of the American Jobs Creation Act of 2004 (AJCA)[1] regarding the penalty for failing to disclose reportable transactions. To accomplish this objective, we:

I. Evaluated whether the IRS had identified and scheduled the actions necessary to implement Provision 811.

   A. Reviewed tax legislation created by the AJCA regarding the penalty for failing to disclose reportable transactions.

      1. Identified the new provisions of the Act related to the penalty for failing to disclose reportable transactions and related requirements and limitations.

      2. Reviewed House Committee Report *H.R. Rep. No. 108-548, Part 1* and Conference Committee Report *H.R. Conf. Rep. No. 108-755*.

      3. Reviewed various external documents that address the AJCA.

   B. Determined what actions have been taken by the IRS to implement AJCA Provision 811.

      1. Reviewed and monitored the Legislative Implementation Tracking System.[2]

      2. Contacted the Small Business/Self-Employed Division to identify the steps planned and taken to identify actions still needed from each function to fully implement this Provision.

      3. Determined whether the IRS timely developed and revised forms, schedules, instructions, or publications, when necessary.

      4. Determined whether any Internal Revenue Manual instructions related to the implementation of this Provision may be needed.

      5. Monitored and reviewed information on the Small Business/Self-Employed Division and Large and Mid-Size Business Division web sites to identify

[1] Pub. L. No. 108-357, 118 Stat. 1418 (2004).
[2] The Legislative Implementation Tracking System is an IRS Intranet-based planning and monitoring system for implementation of tax legislation.

additional actions not included on the Legislative Implementation Tracking System.

6. Identified potential indications of the IRS' inability to meet completion dates and obtained explanations with regard to any completion dates that may appear questionable in successfully implementing this Provision in Fiscal Year 2005.
7. Determined whether interim measures are being considered in instances in which there are problems in meeting due dates or when dates have been revised to a later date.
8. Researched the Request for Information Services Tracking and Reporting System.[3] We discussed with responsible management officials whether the Request for Information Services program changes and programming instructions were implemented with regard to notice changes for Reference Number[4] 648.
9. Determined whether the IRS can identify cases that should be subject to the application of this penalty.
10. Determined whether the IRS has developed tracking systems and reports for House and Senate Committees on penalties imposed and rescinded by the IRS Commissioner.

II. Determined whether policies and procedures were established to ensure the IRS timely provided the necessary guidance to business taxpayers and practitioners to enable taxpayers to successfully comply with this Provision.

A. Discussed with IRS management whether a process or procedure has been developed to ensure the necessary guidance and information were provided to taxpayers and/or practitioners.

B. Reviewed the Notice 2005-11, New Penalty Section 6707A and Rescission Authority.

C. Reviewed information provided by the IRS to enable taxpayers to successfully comply with this Provision.

[3] The Request for Information Services Tracking and Reporting System supports the generation and tracking of Requests for Information Services from initiation to completion. It contains multiple search functions as well as standard and dynamic reporting capabilities.

[4] Reference numbers are posted to taxpayer Master File accounts in making penalty assessments to provide an audit trail that reflects the related penalty code section and the dollar amount. The reference number dictates the language on the notice and demand for payment that explains why the IRS assessed the amount showing due. It also provides information on how the taxpayer may contest the liability. The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

Appendix II

Major Contributors to This Report

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Appendix III

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Appendix IV

Description of Reportable Transactions

The term transaction includes all of the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement and includes any series of steps carried out as a part of a plan. There are six categories of reportable transactions:

Listed transaction. A transaction that is the same as or substantially similar to one of the types of transactions that the Internal Revenue Service has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction.

Confidential transaction. A transaction that is offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a minimum fee. The advisor places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction to protect the confidentiality of that advisor's tax strategies.

Transaction with contractual protection. A transaction for which the taxpayer or a related party has the right to a full or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained.

Loss transaction. Generally, any transaction resulting in the taxpayer claiming a loss of at least (A) $10 million in any single taxable year or $20 million in any combination of taxable years for corporations; (B) $10 million in any single taxable year or $20 million in any combination of taxable years for partnerships that have only corporations as partners, or $2 million in any single taxable year or $4 million in any combination of taxable years for all other partnerships, regardless of whether any losses flow through to 1 or more partners; (C) $2 million in any single taxable year or $4 million in any combination of taxable years for individuals, S corporations,[1] or trusts; or (D) $50,000 in any single taxable year for individuals or trusts claiming a foreign currency.

Transaction with a significant book-tax difference. Generally, a transaction in which the amount for tax purposes of any item or items of income, gain, expense, or loss from the transaction differs by more than $10 million on a gross basis from the amount of the item or items for book purposes in any taxable year.

Transaction involving a brief asset holding period. Any transaction resulting in the taxpayer claiming a tax credit exceeding $250,000 if the underlying asset giving rise to the credit is held by the taxpayer for 45 or fewer days.

[1] S corporations file a U.S. Income Tax Return for an S Corporation (Form 1120S).