
Internal Revenue Service

Accuracy - Related Penalties For Taxpayers Involved In Tax Shelter Transactions

Audit Technique Guide (ATG)

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**Accuracy - Related Penalties For Taxpayers
Involved In Tax Shelter Transactions
*Audit Technique Guide***

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Chapter 1: Introduction

Coverage

This audit technique guide (“ATG”) was developed to support the field in the consistent development and application of penalties when a taxpayer was involved in an abusive tax shelter, including “technical” tax shelters. This ATG is a Service-wide document, discussing penalty policy and considerations applicable to all taxpayers involved in tax shelter transactions.

This guide is not intended to be all inclusive. In most cases, the examiner should refer to additional sources of information, including listing notices and disclosure initiatives, even if there is a thorough discussion of the issue in this guide.

Although this ATG includes information from existing position papers, audit technique guides, and CPE materials that deal with specific listed transactions and identified transactions that have not been listed, it is not intended to replace these materials. The examiner should consult the penalty handbook, related audit technique guides, appeals settlement guidelines, as well as subject matter advisors, technical advisors and local Chief Counsel Attorneys.

Overview

The consideration and assertion of penalties in audits involving tax shelters is vital to the Service’s efforts in addressing the proliferation of tax shelters. Appropriate administration of penalties seeks to ensure fairness and consistency in the administration of the tax law and seeks to effectively discourage noncompliant behavior. Examiners and managers should not use penalties as a bargaining point in the development or processing of cases. See Service Penalty Policy Statement (P–1–18) at Exhibit 1.

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

- Encourage voluntary compliance;
- Conserve IRS resources due to early disposition of tax shelter issues;
- Provide clear guidance to taxpayers and practitioners;
- Ensure consistent and fair treatment of the issues; and
- Ensure that noncompliant behavior is penalized in appropriate circumstances.

Focus

This ATG focuses primarily on components of the accuracy-related penalty under IRC § 6662, the fraud penalty under IRC § 6663 and the definitions and special rules under IRC § 6664. Consider and develop the following penalties, if they apply:

- Failure to file or to pay under IRC § 6651 (See IRM 20.1.2)
- Failure to pay estimated taxes under IRC §§ 6654 or 6655 (See IRM 20.1.3)
- Frivolous income tax return under IRC § 6702 (See IRM 20.1.10)
- Failure to include tax shelter identification number on a return under IRC § 6707(b)(2) (See IRM 20.1.10)

In cases involving offshore arrangements, consider and develop the following penalties, if they apply:

- Failure to file information returns under IRC §§ 6038, 6038A, 6038B, 6038C or 6039F (See IRM 20.1.9)
- Failure to file information with respect to certain foreign trusts under IRC § 6677 (See IRM 20.1.9)
- Failure to file returns, etc., with respect to foreign corporations or foreign partnerships under IRC § 6679 (See IRM 20.1.9)
- Failure to file report of foreign bank and financial accounts under 31 USC § 5321(a)(5)(B)

In the most egregious cases, the examiner should consider whether criminal penalties might apply and the case should be referred to Criminal Investigation for further development of these issues. Some criminal penalties that may apply include:

- Attempt to evade or defeat tax under IRC § 7201
- Willful failure to file return, supply information, or pay tax under IRC § 7203
- Fraudulent returns, statements, or other documents under IRC § 7207
- Failure to obey summons under IRC § 7210

More information relating to penalty issues may be found on the IRS webpage at http://abusiveshelter.web.irs.gov/ATG/Penalties_atg.htm.

Tax Shelters

A tax strategy or scheme that shelters income from normal taxation is a tax shelter. Depending on the facts and legal analysis, a specific transaction or

scheme may represent either lawful tax avoidance or unlawful tax evasion. For purposes of IRC § 6662, tax shelter includes, among other things, any plan or arrangement a significant purpose of which is the avoidance or evasion of Federal income tax. See discussion of the IRC § 6662 definition of tax shelter, *infra*.

A tax transaction or scheme that shelters income from normal taxation by taking a tax position that is not supported by tax law or manipulates the law in a manner that is not consistent with the intent of the law is considered to be an abusive tax shelter. Abusive tax shelters take various forms.

“Schemes or scams” are some of the easiest abusive tax shelters to detect and generally fall under the “too good to be true” category. These transactions are clearly unallowable or have no existing basis in law. Some of the schemes and scams that the Service has detected include claim of right (Rev. Rul. 2004-29); corporation sole (Rev. Rul. 2004-27); home-based business (Rev. Rul. 2004-32); removal from the tax system and chargeback debts (Rev. Rul. 2004-31); reparations (Rev. Rul. 2004-33); Section 861 (Rev. Rul. 2004-30); Section 911 (Rev. Rul. 2004-28); zero returns (Rev. Rul. 2004-34); and other frivolous arguments. In a news release and on the IRS webpage, the IRS publicizes, each year, the “dirty dozen” warning taxpayers of 12 common scams. The examiner should refer to this list and other sources, including “The Truth about Frivolous Tax Arguments,” located on the IRS webpage, when determining whether a taxpayer has engaged in a scheme or scam or has advanced other frivolous tax arguments.

The term abusive tax shelter commonly refers to a tax transaction or scheme that is highly technical and represents a strategy that is often marketed by an accounting or law firm. A “technical” tax shelter is distinguishable from a “scheme or scam” that finds no support in either the law or the facts. In the case of a technical tax shelter, the promoted tax benefits from the transaction may be supported by a strained, technical reading of the Code, regulations or rulings. In many cases, however, the promoted tax benefits are not actually available because the form of the transaction does not reflect its substance. In other cases, a tax avoidance strategy may find support in a possible interpretation of the law, although not the reading of the Code and regulations intended by Congress or the Secretary.

Technical tax shelters include “listed transactions” and other potentially abusive tax shelter transactions that have not been listed. A “listed transaction” is a transaction that the Service has officially notified taxpayers by notice, regulation, or other form of published guidance as potentially abusive and therefore subject to the disclosure requirements of the regulations under IRC § 6011. A listed transaction may include a transaction that is the same as or substantially similar to one of the types of transactions that the Service has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of

published guidance as a listed transaction for purposes of IRC §§ 6011 and 6112.

A technical tax shelter may take many different forms and can utilize many different structures. A single comprehensive definition of abusive tax shelters is difficult to formulate. Nevertheless, abusive technical tax shelters may have the following characteristics:

- Lack of meaningful economic risk of loss or potential for gain;
- Inconsistent financial and accounting treatment;
- Presence of tax-indifferent parties;
- Complexity without a reasonable business purpose;
- Unnecessary steps or novel investments;
- Promotion or marketing of tax benefits as a central component;
- Confidentiality;
- High transaction costs;
- Risk reduction arrangements.

An abusive tax scheme is a specific tax transaction or scheme that reduces tax liability by taking a tax position that is not supported by tax law or manipulates the law in a manner inconsistent with the intent of the law. Abusive tax transactions or schemes may apply to either a large number of taxpayers or a limited number of taxpayers. These strategies and schemes may be organized and marketed and, if so, are often referred to as an abusive tax shelter.

Penalty Policy: Facts and Documentation to be Developed During the Examination

Consideration of penalties must be documented in all taxpayer examinations, including those involving tax shelters. A penalty **must** be developed as the audit progresses. Only after all facts and circumstances surrounding a penalty have been developed can a determination be made as to the application of appropriate penalties.

Audit technique guidelines for proper penalty development in LMSB and SB/SE examinations are included below.

Large and Mid-Size Businesses (LMSB)

On December 20, 2001, the LMSB Commissioner issued a memorandum providing guidelines for the consideration of the accuracy-related penalty in LMSB examinations. See Exhibit 2. This memorandum requires agents to develop the accuracy-related penalty in all cases in which there is an underpayment of tax attributable to a listed transaction. On July 10, 2003, the LMSB Commissioner issued a memorandum providing that examiners should not

develop the accuracy-related penalty in cases where the taxpayer filed and was considered qualified under the terms of Announcement 2002-2. This determination should be confirmed by the team manager, with no other approval required. See Exhibit 3. The July 10, 2003 memorandum provides that, for cases not qualifying for treatment under the Disclosure Initiative outlined in Announcement 2002-2, consideration of penalties remains **mandatory**. See discussion of Announcement 2002-2, *infra*. If an underpayment of tax is attributable to a taxpayer's participation in a listed transaction, the examiner must develop the accuracy-related penalty issues and prepare a written report supporting the recommendation to impose or not to impose the penalty. When an LMSB examiner identifies a new potentially abusive tax shelter transaction or promoter information, the examiner must contact LMSB Field Counsel as well as the Office of Tax Shelter Analysis (OTSA). See also Joint LMSB-SB/SE Memorandum dated August 21, 2003 at Exhibit 4.

For a corporate tax shelter case involving a listed transaction, the decision to impose or not impose an accuracy-related penalty must be approved by the respective Director of Field Operations (DFO), in accordance with LMSB Commissioner Memorandum dated December 20, 2001. See Exhibit 2.

Small Business/Self Employed (SB/SE)

Examiners should send promoter information to the Lead Development Center and contact the appropriate Technical Advisor in Compliance Policy, Reporting Enforcement, who is responsible for coordinating and assisting in the identification of the shelters. See Joint LMSB-SB/SE Memorandum dated August 21, 2003 at Exhibit 4.

SB/SE employees should follow existing penalty provisions regarding managerial approval for imposing penalties in a tax shelter involving a **listed transaction**. See Joint LMSB-SB/SE Memorandum dated August 21, 2003. Existing penalty provisions for managerial approval of penalties are found in the IRM at 20.1.1.2.3 (Rev. 05/29/2002).

Managerial Approval of Penalties

IRC § 6751(b) requires that all penalties assessed after June 30, 2001, must first be **personally approved in writing** by either the immediate supervisor of the individual making the determination or a designated higher level official. See IRM 20.1.7.1.5(7).

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Chapter 2: 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 or regulations;
- (2) any substantial understatement of income tax;
- (3) any substantial valuation misstatement under Chapter 1 of the Code;
- (4) any substantial overstatement of pension liabilities; and
- (5) any substantial estate or gift tax valuation understatement.

See Exhibit 5 for a summary of IRC § 6662 and the related reasonable cause and good faith exception under IRC § 6664.

IRC § 6662 - Accuracy-Related Penalty

This ATG focuses primarily on the Negligence or Disregard of Rules or Regulations, Substantial Understatement and Substantial Valuation Misstatement components of the accuracy-related penalty that are most likely to apply in examinations relating to tax shelters. The following table provides references to the IRM Penalty Handbook for the other components of the accuracy-related penalty in the event they are applicable to a particular case under examination:

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

The accuracy-related penalty applies only if a return is filed, except that the penalty does not apply in the case of a return prepared by the Secretary under IRC § 6020(b). IRC § 6664(b); see also Treas. Reg. § 1.6662-2(a). The taxpayer also may not be subject to the accuracy-related penalty if the taxpayer had reasonable cause and acted in good faith under IRC § 6664(c). The reasonable cause and good faith exception under IRC § 6664(c) applies to all components of the accuracy-related penalty, with special rules for a substantial understatement attributable to a tax shelter item of a corporation.

Penalty Amount

The amount of the accuracy-related penalty is 20 percent of the portion of the underpayment resulting from the misconduct. The penalty rate is increased to 40 percent in certain circumstances involving gross valuation misstatements. Stacking of the accuracy-related penalties is not permitted. The maximum amount of the accuracy-related penalty imposed on a portion of an underpayment of tax is 20 percent (or 40 percent in the case of a gross valuation misstatement) of that portion of the underpayment, even if that portion of the underpayment is attributable to more than one type of misconduct proscribed under IRC § 6662. The Service may, and should, however, assert the penalty for the underpayment based on each prohibited behavior, in the alternative, that applies. For example, if a portion of an underpayment is attributable to both negligence and a substantial understatement of income tax, the Service may rely on both theories (asserting the second theory in the alternative) in imposing the penalty, although the maximum accuracy-related penalty that may be imposed is 20 percent of that portion of the underpayment. Treas. Reg. § 1.6662-2(c).

The accuracy-related penalty also does not apply to any portion of an underpayment on which a penalty is imposed for fraud under IRC § 6663.

Definition of Underpayment

Underpayment means the amount by which any tax imposed exceeds the excess of (1) the sum of (A) the amount shown as the tax by the taxpayer on his return, plus (B) amounts not so shown previously assessed (or collected without assessment), over (2) the amount of rebates made. IRC § 6664(a).

Treas. Reg. § 1.6664-2(c)(2) provides that the amount shown as tax on an income tax return includes amounts shown as additional tax on a “qualified amended return” (unless the additional amount shown was omitted on the original return because of a fraudulent position on the original return). Treas. Reg. § 1.6664-2(c)(3) defines “qualified amended return” as an amended return filed after the due date of the return for the tax year (determined without regard to an extension of time to file) and before the time the taxpayer is first contacted by the Service concerning an examination of the original return, and, in the case of a tax shelter item, before the time a promoter described in IRC § 6700(a) is contacted by the Service concerning an examination of the shelter activity.

On April 30, 2004, the Service announced additional period of time after which a taxpayer is no longer permitted to file a qualified amended return. See Notice 2004-38, 2004-21 I.R.B. 1. Under Notice 2004-38 and in addition to the current requirements, a taxpayer must file a qualified amended return before the earliest of: (1) the date on which a third party is served a John Doe summons described in IRC § 7609(f) with respect to the return reflecting the transactions or tax items that are the subject of the summons or (2) the date of contact (date on which any

person required to register a tax shelter under IRC § 6111(a) is first contacted by the Service for examination of an activity described in IRC § 6707(a) or the date of request (date on which any person described in IRC § 6112(a) receives a request from the Service for information required to be included on a list under IRC § 6112. Treasury and the Service will issue temporary regulations that will modify the definition of qualified amended return as reflected in Notice 2004-34. See Treas. Reg. § 1.6664-2(c) for further discussion of qualified amended returns.

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Chapter 3: Negligence or Disregard of Rules or Regulations

Negligence

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 suggested if 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)(ii).

For example, the facts may 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." 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 or other relevant actual aspects of the transaction. Consultation with a tax advisor, regardless of the advisor's independence, is not, standing alone, conclusive evidence of a thorough investigation by the taxpayer. All relevant facts, including the nature of the tax investment, the independence of the tax advisor, the competence of the tax advisor, the quality of the opinion, and the sophistication of the taxpayer must be considered.

The penalty for negligence does not apply if the taxpayer's position has a reasonable basis. If a return position is reasonably based on one or more of the authorities in Treas. Reg. § 1.6662-4(d)(3)(iii), the position will generally satisfy the reasonable basis standard even though it does not rise to the level of substantial authority. The penalty for negligence may, however, apply if the taxpayer fails to keep adequate books and records to substantiate the items properly.

Disregard of Rules or Regulations

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, revenue rulings or notices (other than notices of

proposed rule making). The term “disregard” includes careless, reckless, or intentional disregard. Treas. Reg. § 1.6662–3(b)(2).

Except for a reportable transaction, as defined in the regulations under IRC § 6011, entered into on or after January 1, 2003, and reported on a return filed after December 31, 2003, there is no penalty for a position contrary to a revenue ruling or notice published in the IRB if the position has a realistic possibility of being sustained on its merits. Otherwise, a taxpayer may not avoid a penalty for disregard of a rule or regulation on the basis that the position had a realistic possibility of being sustained on its merits.

Adequate Disclosure

The penalty for negligence or disregard of rules or regulations does not apply if the taxpayer adequately discloses the position on Form 8275 or 8275-R (as appropriate). In the case of a transaction entered into on or after January 1, 2003, and reported on a return filed after December 31, 2003, taxpayers also must disclose reportable transactions on Form 8886, as required under the IRC § 6011 regulations.

The penalty does not apply to a position that is contrary to a regulation if the taxpayer discloses the position and the position represents a good faith challenge to the regulation. A good faith challenge to the validity of a regulation generally requires a showing that the taxpayer conducted a careful analysis of reasonably available authorities relating to the issue, including statutory language, legislative history, the underlying Treasury decision, relevant case law (including case law pertaining to the presumption of validity to which regulations are entitled), and the persuasiveness of the rationale supporting the contrary position.

The adequate disclosure exception does not apply if the position with respect to a rule or regulation does not have a reasonable basis or if the taxpayer fails to keep adequate books and records or fails to substantiate records properly.

Chapter 4: 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 a corporation other than an S corporation or personal holding company), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.

Definition of Tax Shelter for Purposes of IRC § 6662(d)

For transactions entered into on or 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 is whether tax avoidance or evasion was the **principal purpose** of the entity, plan, or arrangement. Treas. Reg. § 1.6662-4(g)(2)(i). The former **principal purpose** standard is more difficult for the government to meet than the current significant purpose standard.

Typical of tax shelters are transactions structured with little or no motive for the realization of economic gain, and transactions that utilize mismatching of income and deductions, overvalued assets or assets with values subject to substantial uncertainty, certain nonrecourse financing, financial techniques that do not conform to standard commercial business practices, or the characterization of the substance of the transaction. See generally Treas. Reg. § 1.6662-4(g)(2)(i)(c).

Substantial Authority Exception

There is an exception to the penalty attributable to a substantial understatement when the substantial understatement relates to a tax shelter item of a taxpayer other than a corporation. Specifically, the examiner should not assert the penalty if there is substantial authority for the tax treatment of an item or return position **and** the taxpayer reasonably believed that the tax treatment was more likely than not the proper tax treatment.

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. There is substantial authority if the weight of the authorities supporting the treatment of the item is substantial in relation to the weight of the authorities supporting the contrary treatment. See Exhibit 6 for a list of those authorities.

A taxpayer is considered to reasonably believe that the tax treatment of an item is more likely than not the proper treatment if --

- the taxpayer analyzes the pertinent facts and authorities and, in reliance on 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 Service; or
- the taxpayer 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 and unambiguously states that the tax advisor concludes that there is a better than 50 percent likelihood that the tax treatment of the item will be upheld if challenged by the Service. (See discussion of IRC § 6664 below for additional information relating to what constitutes reasonable reliance.)

In the case of tax shelter items attributable to a pass-through entity, the actions taken by the entity (e.g., the general partners of a partnership) to establish reasonable belief are deemed taken by the taxpayer.

No exception under IRC § 6662 applies to any item of a corporation which is attributable to a tax shelter. 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 and good faith exception under IRC § 6664 applies. (See Treas. Reg. § 1.6662-4(g)(1)(ii)(B) for special rules relating to transactions entered into by a corporation prior to December 9, 1994.)

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

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Chapter 5: Substantial Valuation Misstatement

In General

For the accuracy-related penalty to apply in the case of a substantial valuation misstatement, the portion of the underpayment attributable to a substantial valuation misstatement must exceed \$5,000 (\$10,000 in the case of a corporation other than an S corporation or a personal holding company).

A substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of such value or adjusted basis. IRC § 6662(e)(1)(A). See IRC § 6662(e)(1)(B) relating to substantial valuation misstatements relating to IRC § 482 property.

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 40 percent. IRC § 6662(h)(1).

There is no disclosure exception to this penalty. See Treas. Reg. § 1.6662-5(a). The only exception is reasonable cause and good faith under IRC § 6664.

Chapter 6: 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.

IRC § 6663 does not define “fraud.” Courts have long recognized that the essence of the fraud penalty is the taxpayer’s state of mind. The state of mind required has been described in various ways, 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 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

In addition, examiners should coordinate closely with local Chief Counsel attorneys on cases involving potential fraud.

Chapter 7: Reasonable Cause and Good Faith – IRC § 6664

Reasonable Cause & Good Faith Exception - In General

Section 6664(c) provides an exception, applicable to all types of taxpayers, to the imposition of any accuracy-related penalty if the taxpayer shows that there was reasonable cause and the taxpayer acted in good faith. Special rules, described below, apply to items of a corporation attributable to a tax shelter resulting in a substantial understatement.

The determination of whether the taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all relevant facts and circumstances. See Treas. Reg. § 1.6664-4(b)(1). The most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Other factors to consider are the taxpayer's experience, knowledge, sophistication and education and the taxpayer's reliance on the advice of a tax advisor.

All relevant facts, including the nature of the tax investment, the complexity of the tax issues, issues of independence of a tax advisor, the competence of a tax advisor, the sophistication of the taxpayer, and the quality of an opinion, must be developed to determine whether the taxpayer was reasonable and acted in good faith.

Examples of types of conduct that may, or may not, constitute reasonable cause in this context are described in Exhibit 7.

On December 30, 2003, Treasury and the Service amended the IRC § 6664 regulations to provide that the failure to disclose a reportable transaction, on Form 8886, "Reportable Transaction Disclosure Statement," is a strong indication that the taxpayer did not act in good faith with respect to the portion of an underpayment attributable to a reportable transaction, as defined under IRC § 6011. See below for a discussion of reliance on advice, in general, and reportable transactions, in particular. In addition, Treas. Reg. § 1.6664-4(c)(iii) provides that a taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith unless the taxpayer adequately disclosed, in accordance with Treas. Reg. § 1.6662-3(c)(2), the position that the regulation in question is invalid.

Taxpayer's effort to assess the proper tax liability

Generally, the most important factor in determining whether the taxpayer has reasonable cause and acted in good faith is the extent of the taxpayer's effort to assess the proper tax liability. See Treas. Reg. § 1.6664-4(b)(1); see also *Larson v. Commissioner*, T.C. Memo 2002-295. For example, reliance on erroneous information reported on an information return indicates reasonable cause and good faith, provided that the taxpayer did not know or have reason to know that the information was incorrect. Similarly, an isolated computational or transcription error may indicate reasonable cause and good faith.

Generally, there is reasonable cause and good faith if the taxpayer relies on erroneous information inadvertently included in data compiled by various divisions of a multidivisional corporation or in financial books and records prepared by those divisions. The corporation, however, must have employed internal controls and procedures, reasonable under the circumstances, which were designed to identify factual errors. See, e.g., *Vandeyacht v. Commissioner*, T.C. Memo. 1994-148 (taxpayers not required to duplicate work done by bookkeepers and accountants; ordinary business care and prudence require taxpayers to take precautions to prevent inaccuracies in income tax returns and books and records used to prepare them).

Experience, Knowledge, Sophistication and Education of Taxpayer

Circumstances that may suggest reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the facts, including the experience, knowledge, sophistication and education of the taxpayer. The taxpayer's mental and physical condition, as well as sophistication with respect to the tax laws at the time the return was filed, are relevant in deciding whether the taxpayer acted with reasonable cause. See *Kees v. Commissioner*, T.C. Memo. 1999-41.

If the taxpayer is misguided, unsophisticated in tax law, and acts in good faith, a penalty is not warranted. See *Collins v. Commissioner*, 857 F.2d 1383 (9th Cir. 1988); cf. *Spears v. Commissioner*, T.C. Memo. 1996-341 (court was unconvinced by the claim of highly sophisticated, able, and successful taxpayers that they acted reasonably in failing to inquire about their investment and simply relying on offering circulars and accountant, despite warnings in offering materials and explanations by accountant about limitations of accountant's investigation).

Reliance on Advice

Reliance upon a tax opinion provided by a tax advisor may serve as a basis for the reasonable cause and good faith exception to the accuracy-related penalty. The reliance, however, must be objectively reasonable. For example, the

taxpayer must supply the advisor with all the necessary information to assess the tax matter. Similarly, if the advisor suffers from a conflict of interest or lack of expertise that the taxpayer knew or should have known, the taxpayer might not have acted reasonably in relying on that advisor. See Treas. Reg. § 1.6664-4(c); *Neonatology Associates, P.A. v. Commissioner*, 299 F.3d 221 (3rd Cir. 2002). The advice also must be based on all pertinent facts and circumstances and the law as it relates to those facts and circumstances.

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 on 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. See Treas. Reg. § 1.6662-4(g)(4)(ii). Similarly, the advice must not be based on an assumption that the transaction has a business purpose other than tax avoidance.

Whether a taxpayer reasonably relied on an opinion or advice cannot be determined without reviewing the opinion(s). At times, a taxpayer may refuse to turn over an opinion the taxpayer claims to have relied on or the taxpayer may assert a privilege claim. If the taxpayer does so, seek the assistance of subject matter technical advisors or local Chief Counsel attorneys.

Reportable Transactions

The failure of a taxpayer to disclose a reportable transaction is a strong indication that the taxpayer did not act in good faith with respect to the portion of an underpayment attributable to a reportable transaction, as defined under IRC § 6011. A taxpayer may argue that the failure to disclose was based on the advice of a tax advisor concluding that the transaction was not reportable.

A taxpayer's reliance on an opinion that a transaction is not reportable must be reasonable and made in good faith. An opinion providing that a transaction is not reportable, and, therefore, need not be disclosed is subject to the same scrutiny as the underlying tax opinion or advice. The taxpayer must demonstrate reasonable cause and good faith as discussed in this ATG.

Nontax Matters

Where a tax benefit depends on nontax factors, the taxpayer has a duty to investigate the underlying factors rather than simply relying on statements of another person, such as a promoter. See *Novinger v. Commissioner*, T.C. Memo. 1991-289. Further, if the tax advisor is not versed in these nontax matters, mere reliance on the tax advisor does not suffice. See *Addington v.*

United States, 205 F.3d 54 (2d Cir. 2000); *Collins v. Commissioner*, 857 F.2d 1383 (9th Cir. 1988).

Advisor Independence

Although a tax advisor's lack of independence is not alone a basis for rejecting a taxpayer's claim of reasonable cause and good faith, the fact that a taxpayer knew or should have known of the advisor's lack of independence is strong evidence that the taxpayer may not have relied in good faith upon the advisor's opinion. *Goldman v. Commissioner*, 39 F.3d 402 (2d 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); *Neonatology Associates, P.A. v. Commissioner*, 299 F.3d 221 (3rd Cir. 2002) (reliance may be unreasonable when placed upon insiders, promoters, or their offering materials, or when the person relied upon has an inherent conflict of interest that the taxpayer knew or should have known about).

Similarly, the fact that a taxpayer consulted an independent tax advisor is not, standing alone, conclusive evidence of reasonable cause and good faith if additional facts suggest that the advice is not dependable. *Edwards v. Commissioner*, T.C. Memo. 2002-169; *Spears v. Commissioner*, T.C. Memo. 1996-341, *aff'd* 98-1 USTC ¶ 50,108 (2d Cir. 1997). For example, a taxpayer may not rely on an independent tax advisor if the taxpayer knew or should have known that the tax advisor lacked sufficient expertise, the taxpayer did not provide the advisor with all necessary information, the information the advisor was provided was not accurate, or the taxpayer knew or had reason to know that the transaction was "too good to be true." *Baldwin v. Commissioner*, T.C. Memo. 2002-162; *Spears v. Commissioner*, T.C. Memo. 1996-341, *aff'd* 98-1 USTC ¶ 50,108 (2d Cir. 1997).

Special Rules for Tax Shelter items of a Corporation

If a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the accuracy-related penalty applies to that portion of the understatement unless the reasonable cause and good faith exception applies.

See Treas. Reg. § 1.6664-4(f) at Exhibit 8. 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(f)(1).

A corporation's legal justification may be taken into account 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 the treatment was more likely than not the proper treatment. Treas. Reg. § 1.6664-4(f)(2)(i)(B).

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**
- 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. (See Treas. Reg. § 1.6664-4(c) for requirements with respect to the opinion of a professional tax advisor).

Satisfaction of the minimum requirements for legal justification is an important factor in determining whether a corporation acted with reasonable cause and in good faith, but not necessarily dispositive. See Treas. Reg. § 1.6664-4(f)(3). For example, the taxpayer's participation in a tax shelter lacking a significant business purpose or the taxpayer is claiming benefits that are unreasonable in comparison to the taxpayer's investment should be considered. Failure to satisfy the minimum standards will, however, preclude a finding of reasonable cause and good faith based (in whole or in part) on a corporation's legal justification. See Treas. Reg. § 1.6664-4(f)(2)(i).

If a corporation does not claim legal justification, then other facts and circumstances also may be taken into account regardless of whether the minimum requirements for legal justification are met. See Treas. Reg. § 1.6664-4(f)(4).

Chapter 8: Announcement 2002-2

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 taxpayer discloses to the IRS during the period within which the initiative was in effect. See Announcement 2002-2, 2002-2 I.R.B. at Exhibit 9.

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 accuracy-related 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 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 taxpayer was not eligible under Announcement 2002-2 but disclosed regardless, there is no formal or informal administrative policy of waiving the accuracy-related penalty in the case of a taxpayer solely because the taxpayer disclosed to the examination team the existence of the item. Accordingly, 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, and then the penalty issue should be developed. The fact that the taxpayer did disclose may, however, be a mitigating factor in some circumstances. This position is consistent with the penalty

consideration memorandum from the Commissioner of LMSB dated December 20, 2001. See Exhibit 2.

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Chapter 9: Policy Statements

IRS Commissioner Memorandum dated December 29, 2003

On December 29, 2003, the Commissioner issued a memorandum outlining the Service's penalty policy concerning reliance on certain tax shelter opinions. The memorandum provides that the Service will question the reasonableness and good faith of taxpayers who know or have reason to know that the tax advisor has a financial arrangement or a referral agreement with a tax shelter promoter. See Commissioner Memorandum dated December 29, 2003 at Exhibit 10.

LMSB Commissioner Memorandum dated December 20, 2001

On December 20, 2001, the LMSB Commissioner issued a memorandum setting forth guidelines for the consideration of penalties in listed transactions and other abusive tax shelter cases. See LMSB Commissioner Memorandum dated December 20, 2001 at Exhibit 2. The memorandum establishes that:

- Examiners must consider the accuracy-related penalty under IRC § 6662 for underpayments attributable to a taxpayer's participation in a listed transaction.
- 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.
- The examiner must give the taxpayer a chance to demonstrate that the penalty does not apply.
- The examiner must assess several factors, including whether: the taxpayer has shown that the transaction was not a tax shelter; the taxpayer was not negligent; the taxpayer met the requirements of IRC §§ 6662(d)(2)(C); or the taxpayer met the requirements of the reasonable cause and good faith exception under IRC § 6664(c).
- In any case where 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.
- To assist in determining whether a corporate taxpayer satisfies 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.

All cases involving potentially abusive tax shelters must be coordinated with LMSB field counsel and the Office of Tax Shelter Analysis ("OTSA").

LMSB Commissioner Memorandum dated July 10, 2003

On July 10, 2003, the LMSB Commissioner issued a memorandum providing that examiners should not develop the accuracy-related penalty in cases where the taxpayer filed and was considered qualified under the terms of Announcement 2002-2. This determination should be confirmed by the team manager, with no other approval required. See LMSB Commissioner Memorandum dated July 10, 2003 at Exhibit 3.

The memorandum provides that, for cases not qualifying for treatment under the Disclosure Initiative in Announcement 2002-2, consideration of penalties remains **mandatory**. 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. The DFO must approve the decision to impose or not to impose the accuracy-related penalty. In any case involving a potentially abusive tax shelter, the examiner should identify the facts regarding the shelter and then contact LMSB field counsel and OTSA for coordination. The DFO must approve the examiner's decision to impose the accuracy-related penalty in such circumstances.

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Chapter 10: Audit Techniques – Development of Potential Penalty Issues for Tax Shelter Cases

Objective

In developing a penalty, the examiner needs to determine what efforts the taxpayer made to determine the correctness of the return position. The examiner's 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 accuracy-related penalty

Examiners should obtain information and documentation relating to the following:

Does the taxpayer have an underpayment of tax?

- What was the amount shown on the return? Did the taxpayer file a qualified amended return?
- Are there any amounts assessed before the return was filed that were not shown on the return, such as termination assessment under IRC § 6861 or a jeopardy assessment under IRC § 6861?
- Are there any rebates?

Was the taxpayer negligent?

- Did the taxpayer make a reasonable attempt to comply with the Federal tax laws?
- Is the return position reasonably based on one or more authorities? What type of authority? Does the taxpayer have contemporaneous documentation to demonstrate consideration of authorities?
- Did the taxpayer disclose the return position on Form 8275? Did the taxpayer disclose a reportable transaction on Form 8886?
- Did the taxpayer keep adequate books and records?
- Can the taxpayer substantiate the items properly?
- Is the transaction one which would appear to a reasonable person "too good to be true"?

- Does the taxpayer have an approval process to enter into a transaction of the size or dollar amount involved? Did the taxpayer comply with this approval process? Obtain copies of approval documents. Compare documents to similar approval documents of like size company or taxpayer transactions for the same time period.
- Who was responsible for the decision to take the reporting position? Did the taxpayer obtain advice from outside counsel or other tax professional? From whom? What is the relationship, if any, between the outside counsel and the promoter? Did the promoter refer the taxpayer to outside counsel? Did the taxpayer's inside counsel review or comment on the tax aspects of the transaction? Did the taxpayer obtain the views of tax professionals other than the promoter, the promoter's agent or persons otherwise having a financial interest in the promotion?
- After the transaction began, what did the taxpayer do to monitor its progress? Did the taxpayer have a "checksheet" or evaluation process in place to see that the various steps in the transaction were accomplished?
- Did the taxpayer obtain an appraisal or other valuation?
- Are there in-house, tax advisor and/or consultant memoranda questioning the proposed return position?

Did the taxpayer disregard a rule or regulation?

- Did the taxpayer carelessly, recklessly or intentionally disregard a revenue ruling or a notice (other than a notice of proposed rulemaking)?
- Does the taxpayer's position which is contrary to a revenue ruling or notice have a 1 in 3 likelihood of being sustained on the merits?
- Did the taxpayer disclose the position that is contrary to a revenue ruling or notice on Form 8275?
- Is the transaction reportable?
- Did the taxpayer carelessly, recklessly or intentionally disregard a regulation?
- Is the taxpayer taking the position that a regulation is invalid?
- Does the position represent a good faith challenge to a regulation?
- Did the taxpayer disclose the position that is contrary to a regulation on Form 8275-R? Did the taxpayer disclose the position that the regulation is invalid on Form 8275-R?
- Did the taxpayer disclose a reportable transaction on Form 8886?
- Is the Service's position which is believed to be contrary to the taxpayer's position a longstanding position or very recent position? In what manner was the Service's position disseminated?
- What evidence is there in the return preparation workpapers that the taxpayer knew about the existence of a contrary position?

Is there a substantial understatement?

- What is the correct income tax liability?
- What is the tax reported by the taxpayer?
- Is the taxpayer entitled to a reduction in the amount of the understatement under IRC § 6662(d)(2)(B)?

Is the amount of the understatement \$5,000 (\$10,000 for a corporation)

- or 10% of the tax required to be shown on the return?

Is the transaction a tax shelter?

- Is the transaction a plan or arrangement? Is a significant purpose of the transaction to avoid or evade Federal income tax?
- Is there a legitimate business purpose other than tax savings? To what extent was the taxpayer influenced by tax benefits as opposed to investment potential?
- Why did the taxpayer enter into the transaction?
- Why did the taxpayer structure the transaction, adopt the accounting treatment or characterize the assets in the manner that the taxpayer used?
- To what extent did the taxpayer take steps to conceal the transaction (e.g., netting inside a partnership or grantor trust)?

If the taxpayer is not a corporation, did he have substantial authority and a reasonable belief that the tax treatment of the item was more likely than not the proper treatment?

Substantial Authority:

- What authority supports the taxpayer's position? What authority contradicts the taxpayer's position? Note that different authorities carry different weight, e.g., a regulation holds greater weight than a private letter ruling.
- Did the taxpayer request, and rely on, a private letter ruling or a determination letter?
- Does the taxpayer have contemporaneous documentation?

Reasonable Belief:

- Did the taxpayer analyze the facts and authorities? Did the taxpayer reasonably conclude 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 Service?
- Did the taxpayer reasonably rely upon the opinion of a tax advisor? (See below for inquiries relating to reliance on a tax opinion.) Did the tax advisor unambiguously conclude that there is a greater than 50 percent

likelihood that the tax treatment of the item will be upheld if challenged by the Service?

Is there a valuation misstatement?

- What is the value of the property? What is the claimed value of the property?
- What is the adjusted basis of the property? What is the claimed adjusted basis of the property?

Is the underpayment due to fraud? The examiner should coordinate closely with local Chief Counsel attorneys on cases involving potential fraud.

- What was the taxpayer's intent? Did the taxpayer intend to evade tax? Was the underpayment due to inadvertence, reliance on incorrect advice, honest indifference, negligence or carelessness?

Inquiries relating to Reasonable Cause & Good Faith

What effort did the taxpayer make to assess the proper tax liability?

- Did the taxpayer rely on an erroneous information return? Is the information contained on the information return inconsistent with other information reported or otherwise furnished to the taxpayer or with the taxpayer's knowledge of the transaction?
- Was the underpayment due to an isolated mathematical error?
- Is the taxpayer's position one in which the Service would issue a private letter ruling or determination letter? If so, did the taxpayer request a private letter ruling or determination letter? What was the outcome of the private letter ruling or determination letter, e.g., favorable, adverse, withdrawal? Did the taxpayer abide by the private letter ruling or determination letter?
- Did the taxpayer attempt to conceal the transaction? If applicable, was the M-1 analysis misleading? Did the taxpayer net transactions or provide incorrect or misleading labels?
- Did the taxpayer provide the difference between financial statements and tax returns without concealment?
- Were there assurances or statements made to a third party that characterized the transaction differently for tax purposes?

What is the sophistication of the taxpayer?

- What is the taxpayer's background, business experience, sophistication and education?
- Was there an honest misunderstanding of fact or law that is reasonable in light of the facts?

- Does the taxpayer have a history of entering into sophisticated or complex tax related transactions?

Did the taxpayer rely upon the advice of a tax advisor? See below for inquiries relating to tax advice.

Are there other facts and circumstances that might apply that mitigate the taxpayer's behavior or suggest that a penalty should be imposed?

- Did the taxpayer disclose under Announcement 2002-2, even though the taxpayer was not eligible to do so? While taxpayers cannot avoid penalty consideration under Announcement 2002-2, disclosure could be a mitigating factor.
- Has the taxpayer engaged in other listed transactions or is this the only listed transaction the taxpayer has attempted?
- Was the transaction listed after the taxpayer filed the return? Did the taxpayer notify the Service of the position after it was listed?
- Are there any meeting notes, board statements, etc., consistent with the taxpayer's assertion of reasonable cause and good faith?
- If the transaction is related to another segment of the business, was the other unit consulted or informed?
- Were there assurances or statements made to third parties that characterized the transaction in a manner different from the characterization for tax purposes?
- Was the taxpayer's participation in the transaction subject to a confidentiality agreement? Provide details.

In the case of a corporation with a substantial understatement attributable to a tax shelter item:

- Can the corporation show legal justification?

Substantial Authority:

- What authority supports the taxpayer's position? What authority contradicts the taxpayer's position? Note that different authorities carry different weight, e.g., a regulation holds greater weight than a private letter ruling.
- Did the taxpayer request, and rely on, a private letter ruling or a determination letter?
- Does the taxpayer have contemporaneous documentation?

Reasonable Belief:

- Did the taxpayer analyze the facts and authorities? Did the taxpayer reasonably conclude 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 Service?

- Did the taxpayer reasonably rely upon the opinion of a tax advisor? (See below for inquiries relating to reliance on a tax opinion.) Did the tax advisor unambiguously conclude that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged by the Service?
- Did the corporation participate in a tax shelter lacking significant business purpose?

Are the benefits claimed by the taxpayer unreasonable compared to the benefits? What were the risks to the taxpayer? Did the taxpayer have an out-of-pocket investment?

Inquiries Relating to Reliance on Advice

When a taxpayer claims reasonable reliance on the advice of a tax advisor, always obtain a copy of the opinion(s). If the taxpayer refuses to turn over the opinion(s) on privilege or other grounds, contact your subject matter technical advisors or local Chief Counsel Attorney.

- How did the taxpayer choose the tax advisor? Did they have a long standing relationship? Did a promoter or other person with a financial interest in the transaction refer the taxpayer to the advisor?
- Does the taxpayer have a regular tax advisor? If the taxpayer did not consult with its regular tax advisor, why not?
- Did the advisor prepare the return? Why did the taxpayer use a different person to prepare the return?
- How was the compensation for the outside advice determined (e.g., time based, a flat fee, a percentage of the tax savings, etc.)? Was there a compensation arrangement, such as a referral fee or fee sharing arrangement, between the author of the opinion and the person promoting, marketing or recommending the tax shelter? Did the taxpayer have knowledge of any fee arrangement between the advisor and a promoter? Obtain a copy of the invoice to identify the source of the opinion, number of hours or other method used to determine the fee and the date the work was done.
- What are the credentials of the tax advisor? Does the tax advisor have any special knowledge or expertise relating to the transaction or the underlying industry? Did the advisor do its own research?
- Was the advice in writing? In what format, e.g., opinion letter, offering materials, e-mail, etc.? Did the taxpayer discuss the opinion or advice with the author of the advice? If not, who explained the advice, e.g., in-

house counsel? Are there any contemporaneous notes or minutes relating to these discussions?

- Is the advice dated? Are there contemporaneous documents that discuss the transaction or the advice?
- Is there an engagement letter defining the scope of the opinion or advice? Does the opinion or advice reflect the intent of the parties as outlined in the engagement letter? Obtain a copy of the engagement letter to determine any limitations or restrictions placed on the advice agreed to by the advisor and taxpayer.
- Does the opinion identify and ascertain the facts and determine which are relevant? What was the source of the documents used to ascertain the facts? Are the facts in the opinion supported by the documents provided to the advisor?
- Are pertinent facts assumed, and, if so, are the assumptions reasonable? For example, if the opinion depends on a valuation, has an independent confirmation of the valuation been made?
- Does the opinion relate the applicable law (including potentially applicable judicial doctrines such as the step transaction, business purpose, economic substance, substance over form, and sham doctrines) to the relevant facts?
- If the opinion is based upon hypothetical facts and assumptions, did the taxpayer seek independent advice based on individual circumstances?
- Was the opinion or advice marketed to several taxpayers? Were there additional marketing and/or offering materials? Obtain a copy of the marketing and/or offering materials.
- Did any of the materials contain disclaimers, disclosures or other warnings that would suggest the taxpayer should obtain outside advice based on individual circumstances?
- Does the opinion consider all material Federal tax issues? Is the opinion limited to one or more material Federal tax issue?
- 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/promoter of the product at issue or an agent of that vendor/promoter? Did the taxpayer obtain an appraisal or a valuation?

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

Did the taxpayer actually follow the advice? Did the taxpayer enter into a transaction as described in the advice, or were there material differences between the transaction described in the advice and the transaction into which the taxpayer entered?

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Exhibit 1 – Policy Statement 20-1 (formerly P–1–18)

Effective Date: June 29, 2004

- (1.) **Penalties enhance voluntary compliance:** The Internal Revenue Service has a responsibility to collect the proper amount of tax revenue in the most efficient manner. Penalties provide the Service with an important tool to achieve that goal because they enhance voluntary compliance by taxpayers. In order to make the most efficient use of penalties, the Service will design, administer, and evaluate penalty programs based on how those programs can most efficiently encourage voluntary compliance.
- (2.) Penalties encourage voluntary compliance by: (1) demonstrating the fairness of the tax system to compliant taxpayers; and (2) increasing the cost of noncompliance
- (3.) In order to effectively use penalties to encourage compliant conduct, examiners and their managers must consider the applicability of penalties in each case, and fully develop the penalty issue when the initial consideration indicates that penalties should apply. That is, examiners and their managers must consider the elements of each potentially applicable penalty and then fully develop the facts to support the application of the penalty, or to establish that the penalty does not apply, when the initial consideration indicates that penalties should apply. Full development of the penalty issue is important for Appeals to sustain a penalty and for Counsel to successfully defend that penalty in litigation.
- (4.) Abusive transactions, frivolous returns, and other abusive taxpayer conduct undermine the fairness and integrity of the federal tax system and undercut voluntary compliance. Thus, it is particularly important in those cases for examiners and their managers to consider the potential applicability of penalties, and to develop fully the facts to either support the application of the penalty or to demonstrate that penalties should not apply. Consistent development and proper application of the accuracy-related and fraud penalties in abusive transaction cases will help curb this activity by imposing tangible economic consequences on taxpayers who engage in those transactions. In addition, consistent development and proper application of the promoter and preparer penalties in abusive transaction cases will help curb this activity by providing an economic deterrent for promoting abusive transactions and preparing returns claiming tax benefits from abusive transactions. An abusive transaction is one where a significant purpose of the transaction is the avoidance or

evasion of Federal tax.

- (5.) Special Rule for Listed Transactions. The Service will fully develop accuracy-related or fraud penalties in all cases where an underpayment of tax is attributable to a listed transaction. For purposes of this Policy Statement, a listed transaction is a transaction the Service has identified as a listed transaction pursuant to the regulations under § 6011 of the Code.
- (6.) In limited circumstances where doing so will promote sound and efficient tax administration, the Service may approve a reduction of otherwise applicable penalties or penalty waiver for a group or class of taxpayers as part of a Service-wide resolution strategy to encourage efficient and prompt resolution of cases of noncompliant taxpayers.
- (7.) In considering the application of penalties to a particular case, all Service functions must develop procedures that will promote:
 - a. Consistency in the application of penalties compared to similar cases;
 - b. Unbiased analysis of the facts in each case; and
 - c. The proper application of the law to the facts of the case.
- (8.) The Service will demonstrate the fairness of the tax system to all taxpayers by:
 - a. Providing every taxpayer against whom the Service proposes to assess penalties with a reasonable opportunity to provide evidence that the penalty should not apply;
 - b. Giving full and fair consideration to evidence in favor of not imposing the penalty, even after the Service's initial consideration supports imposition of a penalty; and
 - c. Determining penalties when a full and fair consideration of the facts and the law support doing so.

This means that penalties are not a “bargaining point” in resolving the taxpayer’s other tax adjustments. Rather, the imposition of penalties in appropriate cases serves as an incentive for taxpayers to avoid careless or overly aggressive tax reporting positions.

- (9.) The Service will continue to develop, monitor, and revise programs to help taxpayers voluntarily comply with the law and avoid penalties.
- (10.) To promote consistent development, consideration, and application of penalties, the Service prescribes guidelines in a Penalty Handbook that all operating divisions and functions will follow. The Office of Penalty and Interest Administration must review and approve changes to the Penalty Handbook for consistency with Service Policy before making recommended

changes.

- (10.) The Service collects statistical and demographic information to evaluate penalties and penalty administration, and to determine the effectiveness of penalties in promoting voluntary compliance. The Service continually evaluates the impact of the penalty program on compliance and recommends changes when the Internal Revenue Code or penalty administration does not effectively promote voluntary compliance.
- (11.) Approved: Mark E. Matthews, Deputy Commissioner for Services and Enforcement

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Exhibit 2 – LMSB Commissioner Memorandum dated 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-20-1) 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).

[Exhibit 1 / Table of Contents / Exhibit 3](#)

[Internal Revenue Code Search / Internal Revenue Manual Search / Treasury Regulations Search](#)

Exhibit 3 – LMSB Commissioner Memorandum dated July 10, 2003



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

July 10, 2003

Large and Mid-Size
Business Division

MEMORANDUM FOR LARGE AND MID-SIZE BUSINESS DIVISION
EXECUTIVES, MANAGERS AND AGENTS

FROM: Deborah M. Nolan /s/
Commissioner, Large and Mid-Size Business Division

It has come to my attention that there may be some confusion regarding the application of penalties in cases where taxpayers disclosed their participation in abusive tax avoidance transactions under the Announcement 2002-2 Disclosure Initiative. As a result, I am taking this opportunity to reiterate our penalty policy in these cases.

Under the Disclosure Initiative, the IRS is committed to waiving the accuracy related penalty under § 6662(b) for that section of an underpayment attributable to the disclosed item and due to one or more of the following: (i) negligence or disregard of rules or regulations; (ii) any substantial understatement of income tax; (iii) any substantial or gross valuation misstatement, except for any underpayment attributable to a net § 482 transfer price adjustment; and (iv) any substantial overstatement of pension liabilities.

Disclosure under Announcement 2002-2 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. However, the IRS will waive the accuracy related penalty under §6662(b) for all cases that otherwise qualifies under the terms of Announcement 2002-2. As a result, examiners should not develop the accuracy related penalty in cases where the taxpayer filed and was considered qualified under the terms of Announcement 2002-2. This determination should be confirmed by the team manager and no further approval is required. This applies for all years for which the taxpayer voluntarily disclosed and was considered eligible under the terms of Announcement 2002-2.

With respect to cases not qualifying for treatment under the Disclosure Initiative, we will continue our policy of mandatory penalty consideration. 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 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.

In cases involving potentially abusive tax shelters, examiners should identify and evaluate the facts regarding the shelter, then 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.

Please follow these guidelines in your examination. If you have any questions, please call John Risacher, Acting Manager, and Office of Tax Shelter Analysis at (202) 283-8386 or Kathy K. Petronchak, Acting Director, PFTG at (202) 283-8463.

[Exhibit 2 / Table of Contents / Exhibit 4](#)

[Internal Revenue Code Search / Internal Revenue Manual Search / Treasury Regulations Search](#)

Exhibit 4 – LMSB-SB/SE Memorandum dated August 21, 2003



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

August 21, 2003

Large and Mid-Size
Business Division

MEMORANDUM FOR LMSB AND SB/SE EXECUTIVES, MANAGERS AND AGENTS

FROM: Deborah M. Nolan /s/
Commissioner, Large and Mid-Size Business Division

Dale F. Hart /s/
Commissioner, Small Business/Self Employed Division

SUBJECT: Coordination of Listed Transactions

The Internal Revenue Service has alerted taxpayers to transactions that are potentially abusive and identified these transactions as "listed transactions." Listed transactions must be disclosed by taxpayers pursuant to Treasury Regulations § 1.6011-4. Organizers, sellers and material advisors must maintain and furnish certain investor information under Treas. Reg. § 301.6112-1. Organizers, managers and sellers (also referred to as "promoters") may be required to register certain listed transactions under Temp. Treas. Reg. § 301.6111-1 T and Treas. Reg. § 301.6111-2.

In order to ensure consistency and uniformity in issue development for each listed transaction, this guidance is provided to field examiners and their managers. There are two scenarios to consider:

1. The transaction is a listed transaction.
2. The transaction is new and the facts need to be developed to determine if it should be listed.

Each type of transaction is described below.

Listed Transaction

When a listed transaction is identified during an examination, the issue will be raised and developed. Examiners should contact the Technical Advisor, identified Coordinator or Issue Management Team handling the issue. The examiner should provide the name of the taxpayer, taxable period(s) involved, type of listed transaction, and the name of the promoter, if known. LMSB examiners should include the names of the Team Manager and Team coordinator and their telephone numbers. SB/SE examiners should include the name of their Group Manager and their telephone number. The initial contact may be via e-mail (utilizing secure messaging), fax, or telephone. The most recent summary of the listed transactions can be found on the LMSB website at <http://lmsb.irs.gov/hq/pftq/otsa/downloads/Listed%20Transactions/Contact%20List.doc>.

As a transaction is listed, the Technical Advisor, with the assistance of the Field Counsel Attorney assigned to the issue, will prepare a paper describing the facts of the issue, questions raised, and the best way to address the issue to ensure full development and consistency among taxpayers. Training, reference, and resource materials will also be provided. The Technical Advisor, with the assistance of the Field Counsel Attorney assigned to the issue, will develop and propose a Coordinated Issue Paper or similar document, as appropriate.

Examiners should consult with the Technical Advisor on the development of the issue. Examiners must secure the concurrence of the Technical Advisor if their examination deviates from any mandated specific audit techniques proposed for issue development or their proposal for adjustment deviates from any stated legal positions. In addition, examiners must consult with and secure the concurrence of the Technical Advisor before proposing any resolution other than full concession of the issue by the taxpayer.

The penalties under Internal Revenue Code Section 6662 must be considered for all listed transactions where there is an underpayment attributable to a listed transaction. Examiners must follow established policies. LMSB examiners should follow LMSB commissioner's Memorandum dated December 20, 2001, that directs Director of Field Operations' (DFO) approval of the decision to impose or not to impose the accuracy related penalty. If the transaction was properly disclosed under the Announcement 2002-2 Disclosure Initiative, then penalties under § 6662(b) as described in the Announcement will be waived. SB/SE examiners should follow existing penalty policies.

Transactions which may be Considered for Listing

When an examiner identifies and evaluates the facts regarding a new potentially abusive tax shelter transaction, LMSB examiners must contact LMSB Field

Counsel Attorney as well as the Office of Tax Shelter Analysis (OTSA). SB/SE examiners should send the promoter information to the Lead Development Center and contact the appropriate Technical Advisor in compliance Policy, Reporting Enforcement. OTSA and Reporting Enforcement are responsible for coordinating and assisting in the identification of tax shelters.

This directive will become effective for all listed transactions and remain in effect for each listed transaction until:

- It is superseded by a published resolution offer and the taxpayer elects to participate in the offer,
- The issue becomes a coordinated issue,
- The transaction is no longer a listed transaction, or
- An additional directive is issued for a specific listed transaction withdrawing it from this process.

If you have any LMSB questions, please contact Kathy K. Petronchak, Acting Director, PFTG, at (202) 283-8463 or Mary B. Baker, Manager, Office of Tax Shelter Analysis, at (202) 283-8386. For SB/SE questions, please contact Joseph R. Brimacombe, Deputy Director, Compliance Policy, at (202) 283 2200 or Elizabeth Cashin, Program Manager, ATAT Offshore, at (202) 283-7183.

Additional References:

1. SB/SE website with the list of Technical Advisors and Issue Management Teams

<http://abusiveshelter.web.irs.gov/AbusivePromotions/AbusiveSchemes.htm>

2. LMSB Commissioner's Memorandum dated July 10, 2003: Penalty Policy in Disclosure Initiative Cases

<http://lmsb.irs.gov/hq/pftq/otsa/downloads/Penalty%20Policy%20&%20Disclosure%20Initiative/Penalty%20Policy%20Reiteration%207-10-03%20Debbie%20Nolan.pdf>

3. LMSB Commissioner's Memorandum dated December 20, 2001: Consideration of Penalties in Listed transactions and other Abusive Tax Shelter Cases

[http://lmsb.irs.gov/hq/pftQ/otsa/downloads/Penalty%20Policy%20&%20Disclosure%20Initiative/Penalty%20Policy-Larry%20\(12-20-01\).pdf](http://lmsb.irs.gov/hq/pftQ/otsa/downloads/Penalty%20Policy%20&%20Disclosure%20Initiative/Penalty%20Policy-Larry%20(12-20-01).pdf)

4. Announcement 2002-02, Disclosure Initiative for Certain Transactions Resulting in Waiver of certain Penalties under IRC § 6662 of the Internal revenue Code

<http://lmsb.irs.gov/hq/pftq/otsa/downloads/Penalty%20Policy%20&%20Disc%20Initiative/IRB%20Ann%20of%20Initiative.pdf>

[Exhibit 3 / Table of Contents / Exhibit 5](#)

[Internal Revenue Code Search / Internal Revenue Manual Search / Treasury Regulations Search](#)

Exhibit 5 – Accuracy-Related Penalty – IRC § 6662

Negligence or disregard of rules or regulations - IRC § 6662(c)

Negligence (the following applies to both individuals and corporations):

- Reasonable attempt to comply with Code
- Position is “too good to be true”
- Position has a reasonable basis
- Adequate disclosure
- Taxpayer kept adequate books and records
- Taxpayer can substantiate properly
- Reasonable cause and good faith exception under IRC § 6664(c) may apply.

Disregard of a Revenue Ruling or Notice (the following applies to both individuals and corporations):

- Careless, reckless or intentional disregard of a revenue ruling or notice
- Position satisfies the realistic possibility standard
- If the transaction is reportable, penalty applies regardless of disclosure
- Reasonable cause and good faith exception under IRC § 6664(c) may apply.

Disregard of a Regulation (the following applies to both individuals and corporations):

- Careless, reckless or intentional disregard of a regulation
- Position represents a good faith challenge to the validity of the regulation
- Taxpayer disclosed position on Form 8275-R
- Taxpayer disclosed reportable transaction on Form 8886
- Taxpayer kept adequate books and records
- Taxpayer can substantiate properly
- Adequate disclosure
- Reasonable cause and good faith exception under IRC § 6664(c) may apply.

Substantial Understatement of income tax - IRC § 6662(d)

Amount of Understatement

The following applies to an individual:

- 10% of tax required to be shown on return or \$5,000.

The following applies to a corporation:

- 10% of tax required to be shown on return or \$10,000 (for corporation other than an S corporation or personal holding company).

Reductions for items not attributable to a tax shelter (the following applies to both individuals and corporations):

- Substantial authority or
- Adequate disclosure and reasonable basis for the tax treatment
- Reasonable cause and good faith exception under IRC § 6664(c) may apply.

Reduction for items attributable to a tax shelter

The following applies to an individual:

- Substantial authority and taxpayer reasonably believed that the tax treatment was more likely than not the proper treatment
- Reasonable cause and good faith exception under IRC § 6664(c) may apply.

The following applies to a corporation:

- None
- Special rules to establish reasonable cause and good faith exception under IRC § 6664(c).

Substantial (or Gross) Valuation Misstatement under Chapter 1 and Net IRC § 482 Transfer Price Adjustment - IRC § 6662(e) (or (h)(2)(A))

Amount of Underpayment of tax

The following applies to an individual:

- Must exceed \$5,000.

The following applies to a corporation:

- Must exceed \$10,000 (for corporation other than an S corporation or personal holding company).

Substantial valuation misstatement - IRC § 6662(e) - Penalty is 20% of the underpayment of tax

Transactional Penalty (the following applies to both individuals and corporations):

- Value of any property (or adjusted basis) is 200% or more of the amount determined to be correct or
- Price for any property or services (or use of property) in connection with a transaction described in IRC § 482 is 200% or more (or 50% or less) of the amount under IRC § 482 determined to be correct.

Net IRC § 482 Transfer Price Adjustment (the following applies to both individuals and corporations):

- Net IRC § 482 transfer price adjustment exceeds the lesser of \$5,000,000 or 10% of taxpayer's gross receipts.

Gross valuation misstatement - IRC § 6662(h)(2)(A) - Penalty is 40% of the underpayment of tax

Transactional Penalty (the following applies to both individuals and corporations):

- Value of any property (or adjusted basis) is 400% or more of the amount determined to be correct or
- Price for any property or services (or use of property) in connection with a transaction described in IRC § 482 is 400% or more (or 25% or less) of the amount under IRC § 482 determined to be correct.

Net IRC § 482 Transfer Price Adjustment (the following applies to both individuals and corporations):

- Net IRC § 482 transfer price adjustment exceeds the lesser of \$20,000,000 or 20% of taxpayer's gross receipts.

Reasonable Cause and Good Faith Exception under IRC § 6664(c)

Transactional Penalty (the following applies to both individuals and corporations):

- Reasonable cause and good faith exception under IRC § 6664(c) may apply.

Net IRC § 482 Transfer Price Adjustment (the following applies to both individuals and corporations):

- Taxpayer not eligible for reasonable cause and good faith exception unless meets the requirements of IRC § 6662(e)(3)(B)(i), (ii) or (iii).

Substantial Overstatement (or Gross Valuation Misstatement) of Pension Liabilities IRC § 6662(f)(or (h)(2)(B))

Amount of overstatement (the following applies to both individuals and corporations):

- Substantial overstatement or pension liabilities must exceed \$1,000.

Substantial Overstatement of Pension Liabilities - IRC § 6662(f) - Penalty is 20% of the underpayment of tax (the following applies to both individuals and corporations):

- Actuarial determination of liabilities under IRC § 404(a)(1) or (2) is 200% or more of correct amount
- Reasonable cause and good faith exception under IRC § 6664(c) may apply.

Gross valuation misstatement - IRC § 6662(h)(2)(B) - Penalty is 40% of the underpayment of tax (the following applies to both individuals and corporations):

- Actuarial determination of liabilities under IRC § 404(a)(1) or (2) is 400% or more of correct amount.

Substantial Estate of Gift Tax Valuation Understatement (or Gross Valuation Misstatement) - IRC § 6662(g)(or (h)(2)(C))

Amount of understatement (the following applies to both individuals and corporations):

- Substantial estate or gift tax valuation understatement must exceed \$5,000.

Substantial Estate of Gift Tax Valuation Understatement - IRC § 6662(g) - Penalty is 20% of the underpayment of tax (the following applies to both individuals and corporations):

- Value of property claimed on any return of tax imposed by subtitle B is 50% or less of the correct amount
- Reasonable cause and good faith exception under IRC § 6664(c) may apply.

Gross valuation misstatement - IRC § 6662(h)(2)(C) - Penalty is 40% of the underpayment of tax (the following applies to both individuals and corporations):

- Value of property claimed on any return of tax imposed by subtitle B is 25% or less of the correct amount.

Reasonable Cause and Good Faith - IRC § 6664(c)

Facts and Circumstances test (the following applies to both individuals and corporations):

- Taxpayer's efforts to assess the proper tax liability
- Taxpayer's experience, knowledge, sophistication and education
- Taxpayer's reasonable reliance on a tax advisor.

*Substantial understatement of a corporation attributable to a tax shelter item
The following applies to an individual:*

- Not applicable.

The following applies to a corporation:

Facts and Circumstances test:

- Legal Justification - minimum requirements must be met
- Taxpayer's efforts to assess the proper tax liability
- Taxpayer's experience, knowledge, sophistication and education.

[Exhibit 4 / Table of Contents / Exhibit 6](#)

[Internal Revenue Code Search / Internal Revenue Manual Search / Treasury Regulations Search](#)

Exhibit 6 - Substantial Authority List

There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. Treas. Reg. § 1.6662-4(d)(3)(i). The weight accorded an authority depends on its relevance, persuasiveness and the type of document providing the authority. Treas. Reg. § 1.6662-4(d)(3)(ii).

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 there under, 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.

There also is substantial authority if the treatment of an item is supported by (1) the conclusion of a ruling or a determination letter issued to the taxpayer, (2) the conclusion of a technical advice memorandum in which the taxpayer is named, or (3) an affirmative statement in a Revenue Agent's report with respect to a prior

taxable year of the taxpayer. Such a written determination does not, however, demonstrate substantial authority 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 or if the written determination is modified or revoked after the date of issuance. See Treas. Reg. § 1.6662-4(e)(3)(iv)(A).

[Exhibit 5 / Table of Contents / Exhibit 7](#)

[Internal Revenue Code Search / Internal Revenue Manual Search / Treasury Regulations Search](#)

Exhibit 7 - 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:	Circumstances that may indicate lack of reasonable cause and good faith:
Honest misunderstanding of fact or law that is reasonable given the experience, knowledge, sophistication and education of taxpayer	Failure to disclose a position that a regulation is invalid.
An isolated computational or transcription error.	Reliance on advice of a tax advisor or appraiser who the taxpayer knows or should have known lacked sufficient expertise or lacked independence.
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.	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.
Reliance on advice of a tax advisor or appraiser who does not suffer from a conflict of interest or lack of expertise.	Claimed tax benefits are unreasonable in comparison to the taxpayer's investment in the tax shelter.
A corporation's legal justification.	Nondisclosure of a reportable transaction.
	Lack of significant business purpose.

Exhibit 8 - Excerpt from Treas. Reg. § 1.6664(f) – 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 (f)(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 (f)(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 (f)(2)(i)(A) of this section and the belief requirement of paragraph (f)(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.)

(ii) *Legal justification defined.* For purposes of this paragraph (f), *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 (f)(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 (f)(2) of this section are satisfied.

HISTORY: T.D. 8790, 63 FR 66433, 66435, Dec. 2, 1998; amend T.D. 9109, 68 FR 75126, Dec. 30, 2003.

[Exhibit 7 / Table of Contents / Exhibit 9](#)

[Internal Revenue Code Search / Internal Revenue Manual Search / Treasury Regulations Search](#)

Exhibit 9 - 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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[Internal Revenue Code Search / Internal Revenue Manual Search / Treasury Regulations Search](#)

Exhibit 10 – Commissioner Memorandum

dated December 29, 2003

MEMORANDUM FOR:

COMMISSIONER, LARGE & MID-SIZE BUSINESS DIVISION

COMMISSIONER, SMALL BUSINESS/SELF EMPLOYED DIVISION

FROM:

Mark W. Everson
Commissioner of Internal Revenue

SUBJECT:

Penalty Policy Statement of the Internal Revenue Service

The following new penalty policy statement is being issued in conjunction with the issuance of new final regulations under sections 6662 and 6664 and proposed revisions to the Rules of Practice before the Service (Circular 230). Please ensure that your employees are provided with a copy of this statement and implement its provisions immediately.

Promoters of abusive tax shelters have encouraged or arranged for taxpayers to obtain tax opinions regarding the tax shelters from tax advisors with a financial interest in the promotion of the tax shelters or a preexisting referral agreement with the promoter. Tax advisors having a financial interest or a referral agreement relating to a tax shelter are not disinterested or independent tax advisors concerning the merits of the tax shelter.

In some cases, taxpayers do not know of the tax advisor's financial interest or referral agreement. In other cases, taxpayers know or have reason to know of the financial interest or referral agreement, but disregard that interest to obtain a favorable opinion concerning the merits of the tax shelter. In either case, taxpayers seek to rely on the tax advisor's opinion to avoid imposition of the accuracy-related penalty under section 6662.

On December 29, 2003, Treasury and the Service issued proposed revisions to Circular 230 governing tax shelter opinions that address this lack of independence. The proposed rules mandate the disclosure of a tax advisor's referral agreement or financial interest in the promotion of tax shelters. The proposed rules also require that a marketed tax shelter opinion expressly state that taxpayers should seek advice on their individual circumstances from their own tax advisors. These disclosures will provide taxpayers with critical

information to evaluate the quality and reliability of the advice they receive and put taxpayers on notice that they should seek independent tax advice.

Taxpayers may not rely on the advice of a tax advisor who has a financial arrangement or a referral agreement with a tax shelter promoter. The tax advisor's independent judgment is compromised by these arrangements and agreements. Accordingly, the Service will question the reasonableness and good faith of taxpayers who know or have reason to know that the tax advisor is not independent. The Service will not accept reliance on an opinion from a non-independent tax advisor as proof of reasonable cause and good faith on the part of the taxpayer.

The Service will scrutinize opinions from tax advisors who have financial interests in the tax shelter promotions as part of its broader effort to combat abusive tax shelters. The Service will impose appropriate penalties on taxpayers who rely on opinions from non-independent advisors regarding the merits of tax shelters. Accordingly, taxpayers should not rely on claims from tax advisors, who are not independent, that their opinions provide protection from accuracy-related penalties.

cc: Deputy Commissioner for Services and Enforcement
Acting Chief Counsel

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[Internal Revenue Code Search / Internal Revenue Manual Search / Treasury Regulations Search](#)