Temporary Rules Under Section 6662A and Sections 6662 and 6664, as Amended

Notice 2005–12

The purpose of this notice is to alert taxpayers to the recent enactment of section 6662A and amendments to sections 6662 and 6664 of the Internal Revenue Code, provide interim guidance relating to these provisions and invite comments from the public regarding the rules and standards relating to section 6662A and sections 6662 and 6664, as amended.

BACKGROUND

The American Jobs Creation Act of 2004, Pub. L. No. 108–357, 118 Stat. 1418 (the Act), was enacted on October 22, 2004. Section 812 of the Act added section 6662A, which provides a new penalty for understatements with respect to reportable transactions. Section 812 also added section 6664(d), which provides a defense to the penalty under section 6662A if the taxpayer acted with reasonable cause and in good faith. Sections 812 and 819 of the Act amended section 6662(d) to modify the accuracy-related penalty under section 6662(d) for substantial understatements of income tax.

(1) *Section 6662A, Imposition of Accuracy-Related Penalty on Understatements with Respect to Reportable Transactions.*

Section 812 of the Act added section 6662A to the Code, which provides that a 20-percent accuracy-related penalty may be imposed on any reportable transaction understatement. Under section 6662A, a "reportable transaction understatement" means the sum of (1) the product of (A) the amount of the increase (if any) in taxable income which results from a difference between the proper tax treatment of an item to which section 6662A applies and the taxpayer's treatment of such item (as shown on the taxpayer's return of tax), and (B) the highest rate of tax imposed by section 1 (section 11 in the case of a corporation), and (2) the amount of the decrease (if any) in the aggregate amount of credits determined under subtitle A which results from a difference between the taxpayer's treatment of an item to which section 6662A applies (as shown on the taxpayer's return of tax) and the proper tax treatment of such item.

The penalty provided by section 6662A applies only (1) to listed transactions and (2) to reportable transactions (other than a listed transaction) if a significant purpose of the transaction is the avoidance or evasion of Federal income tax. In addition, a higher 30-percent penalty applies to a reportable transaction understatement if a taxpayer does not adequately disclose, in accordance with regulations prescribed under section 6011, the relevant facts affecting the tax treatment of the item giving rise to the reportable transaction understatement. The reasonable cause and good faith defense is not available with respect to the 30-percent penalty. *See* I.R.C. §§ 6662A(c) and 6664(d)(2)(A).

Section 6662A(e)(3) sets forth a special rule for amended returns. The tax treatment on an amendment or supplement to a return is not taken into account in determining the amount of a reportable transaction understatement if the amendment or supplement is filed after the earlier of (1) the date the taxpayer is first contacted by the IRS regarding an examination of the return or (2) any other date specified by the Secretary.

(2) *Section 6662, Imposition of Accuracy-Related Penalty on Underpayments.*

Section 6662(d) imposes a 20-percent accuracy-related penalty for any substantial understatement of income tax. Under section 6662(d)(1)(B), as amended, in the case of a corporation (other than an S corporation or a personal holding company), there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the lesser of (1) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or (2) $10,000,000. In the case of all other taxpayers, an understatement is substantial if it exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000.

Under section 6662(d)(2), an understatement is the excess of (i) the amount of tax required to be shown on the return for the taxable year over (ii) the amount of tax imposed which is shown on the return, reduced by any rebate. This excess is determined without regard to items to which section 6662A applies. The reportable transaction understatement, however, is added to the understatement calculated under section 6662(d)(2) for purposes of determining whether an understatement is substantial under section 6662(d)(1). Under section 6662A(e)(1)(B), in the case of an understatement, the addition to tax under section 6662(a) applies only to the excess of the amount of the substantial understatement over the aggregate amount of the reportable transaction understatements. Accordingly, the accuracy-related penalty attributable to substantial understatement of income tax does not apply to an understatement on which the section 6662A penalty is imposed.

Section 6662A does not apply to any portion of an understatement on which the section 6663 fraud penalty or the section 6662(h) accuracy-related penalty for a gross valuation misstatement is imposed. Section 6662(e) (substantial valuation misstatement) does not apply to any portion of an understatement on which a penalty under section 6662A is imposed.

Under section 6662(d)(2), as amended, the understatement with respect to any item attributable to a tax shelter item, including tax shelter items of taxpayers other than corporations, will not be reduced even if the taxpayer has substantial authority and a reasonable belief that the tax treatment of an item attributable to a tax shelter item was more likely than not the proper treatment. The taxpayer may, however, demonstrate reasonable cause and good faith under section 6664(c).

(3) *Section 6664, Definitions and Special Rules.*

The accuracy-related penalty under section 6662A does not apply with respect to any portion of a reportable transaction understatement if, pursuant to section 6664(d), it is shown that there was reasonable cause and the taxpayer acted in good faith with respect to that portion of the understatement. A taxpayer does not have reasonable cause and did not act in good faith unless (1) the relevant facts affecting the tax treatment of the item are adequately disclosed in accordance with regulations prescribed under section 6011; (2) there is or was substantial authority; and (3) the taxpayer reasonably believed that its treatment of the item was more likely than not the proper tax treatment. A taxpayer is treated as having a reasonable belief only if the belief is based on the facts and the law that exist at the time the return is filed and the belief relates solely to the taxpayer's chances of success on the merits of the tax treatment of the issue.

An opinion of a tax advisor may not be relied upon to establish the reasonable belief of the taxpayer if the advisor or the opinion is disqualified. A tax advisor is disqualified if the tax advisor (1) is a material advisor under section 6111, as amended, and participates in the organization, management, promotion, or sale of the transaction or is related to any person who so participates; (2) is compensated directly or indirectly by a material advisor with respect to the transaction; (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained; or (4) has any other disqualifying financial interest with respect to the transaction as identified by the Secretary.

An opinion is disqualified if the opinion (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events); (2) unreason-

ably relies on representations, statements, findings or agreements of the taxpayer or any other person; (3) does not identify and consider all relevant facts; or (4) fails to meet any other requirement as the Secretary may prescribe.

INTERIM PROVISIONS

The Treasury Department and the IRS intend to issue regulations implementing the requirements of section 6662A and sections 6662 and 6664, as amended. Section 812 of the Act, which added section 6662A and amended sections 6662 and 6664 is effective for taxable years ending after October 22, 2004. Section 819 of the Act, which separately amended section 6662, is effective for taxable years beginning after October 22, 2004. The Treasury Department and the IRS provide the following interim rules to implement the requirements of sections 6662, 6662A and 6664. These interim rules will apply until further guidance is issued.

(1) *Adequate disclosure in accordance with section 6011*

As noted above, the 30-percent penalty provided by section 6662A applies to a reportable transaction understatement if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment of the item under section 6011. A taxpayer has adequately disclosed the facts for purposes of section 6662A, and section 6664(d)(2)(A), if the taxpayer has filed a disclosure statement in the form and manner prescribed by Treas. Reg. § 1.6011–4(d) or the taxpayer has been deemed to have satisfied its disclosure obligations under Rev. Proc. 2004–45, 2004–31 I.R.B. 140 (August 2, 2004), as applicable, or any other published guidance prescribing the form and manner of disclosure under section 6011.

(2) *Special rule for amended returns*

For purposes of determining the amount of any reportable transaction understatement, the IRS will not take into account an amendment or supplement to a return filed after the dates specified in Treas. Reg. § 1.6664–2(c)(3) and Notice 2004–38, 2004–21 I.R.B. 949 (May 24, 2004), or any amendments thereto, which are the dates after which a taxpayer may not file a "qualified amended return."

(3) *Disqualified tax advisor*

As stated above, a taxpayer may not rely on the opinion of a disqualified tax advisor to establish reasonable belief under section 6664(d). A disqualified tax advisor is any advisor who (a) is a material advisor (under section 6111, as amended) and who participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates, (b) has a disqualified compensation arrangement, or (c) has a disqualifying financial interest identified by the Secretary.

A material advisor is defined in Treas. Reg. § 301.6112–1. In addition, the existing rules under Treas. Reg. § 301.6112–1(c)(2), (c)(3) and (d) (without regard to the provisions relating to a transaction required to be registered under former section 6111), including the minimum fee amounts for listed transactions under Treas. Reg. § 301.6112–1(c)(3)(ii), shall apply. *See* Notice 2004–80, 2004–50 I.R.B. 963 (December 13, 2004). The definition of material advisor, and the rules described here, will apply for purposes of section 6662A until the IRS issues further guidance.

(a) *Organization, Management, Promotion or Sale*

A material advisor participates in the "organization" of a transaction if the advisor:

(1) devises, creates, investigates or initiates the transaction or tax strategy;

(2) devises the business or financial plans for the transaction or tax strategy;

(3) carries out those plans through negotiations or transactions with others; or

(4) performs acts relating to the development or establishment of the transaction.

The performance of an act relating to the development or establishment of a transaction includes preparing documents that (A) establish the structure used in connection with the transaction, *e.g.*, a partnership agreement or articles of incorporation, (B) describe the transaction for use in the promotion or sale of the transaction, *e.g.*, an offering memorandum, tax opinion, prospectus, or other document describing the transaction, or (C) register the transaction with any federal, state or local government body.

A material advisor participates in the "management" of a transaction if the material advisor is involved in the decision-making process regarding any business activity with respect to the transaction. Participation in the management of a transaction includes managing assets, directing business activity, or acting as general partner, trustee, director or officer of an entity involved in the transaction.

A material advisor participates in the "promotion or sale" of a transaction if the material advisor is involved in the marketing of the transaction or tax strategy. Marketing activities include: (1) soliciting, directly or through an agent, taxpayers to enter into a transaction or tax strategy using direct contact, mail, telephone or other means; (2) placing an advertisement for the transaction in a newspaper, magazine, or other publication or medium; or (3) instructing or advising others with respect to marketing of the transaction or tax strategy.

Consistent with the legislative history, a tax advisor, including a material advisor, will not be treated as participating in the organization, management, promotion or sale of a transaction if the tax advisor's only involvement is rendering an opinion regarding the tax consequences of the transaction. In the course of preparing a tax opinion, a tax advisor is permitted to suggest modifications to the transaction, but the tax advisor may not suggest material modifications to the transaction that assist the taxpayer in obtaining the anticipated tax benefits. Merely performing support services or ministerial functions such as typing, photocopying, or printing will not be considered participation in the organization, management, promotion or sale of a transaction.

(b) *Disqualified Compensation Arrangements*

As stated above, a disqualified tax advisor includes a tax advisor who has a disqualified compensation arrangement. A disqualified compensation arrangement includes (1) an arrangement by which the advisor is compensated directly or indirectly by a material advisor with respect

to the transaction or (2) a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained. *See* I.R.C. § 6664(d)(3)(B)(ii).

Until further guidance is issued, a tax advisor also will be treated as a disqualified tax advisor, even if not a material advisor, if the tax advisor has a referral fee or a fee-sharing arrangement by which the advisor is compensated directly or indirectly by a material advisor. In addition, an arrangement will be treated as a disqualified compensation arrangement if there is an agreement or understanding (oral or written) with a material advisor of a reportable transaction pursuant to which the tax advisor is expected to render a favorable opinion regarding the tax treatment of the transaction to any person referred by the material advisor. A tax advisor will not be treated as having a disqualified compensation arrangement if a material advisor merely recommends the tax advisor who does not have an agreement or understanding with the material advisor to render a favorable opinion regarding the tax treatment of a transaction.

In addition, a disqualified compensation arrangement includes a fee that is contingent on all or part of the intended tax benefits from the transaction being sustained, including agreements that provide that (1) a taxpayer has the right to a full or partial refund of fees if all or part of the tax consequences from the transaction are not sustained or (2) the amount of the fee is contingent on the taxpayer's realization of tax benefits from the transaction. Transactions described in Treas. Reg. § 1.6011–4(b)(4)(iii) do not give rise to a disqualified compensation arrangement.

REQUEST FOR COMMENTS

The Treasury Department and the IRS intend to issue regulations implementing section 6662A and the amendments to sections 6662 and 6664 and invite interested persons to submit comments regarding rules and standards under sections 6662, 6662A and 6664 in general and on the specific matters set forth below, including particularly item 2 under "Definition and Special Rules" regarding the extent to which a tax advisor should be permitted to suggest modifications to a transaction without becoming a "disqualified tax advisor."

Section 6662A. Imposition of Accuracy-Related Penalty on Understatements with Respect to Reportable Transactions.

1. Definition of "reportable transaction understatement";
2. Coordination of the reportable transaction understatement penalty with the substantial understatement penalty, including the methodology for calculating the excess of the aggregate reportable transaction understatement;
3. Coordination of the reportable transaction understatement penalty with the accuracy-related penalty on underpayments, including the penalty on underpayments attributable to negligence or disregard of rules or regulations, and the fraud penalty; and
4. Special rules for amended returns, including whether rules similar to the rules provided in Rev. Proc. 94–69, 1994–2 C.B. 804, should apply.

Section 6664. Definitions and Special Rules.

1. Definition of "disqualified tax advisor," including definition of "participates in the management, organization, promotion or sale of a transaction";
2. Providing suggested modifications regarding the transaction;
3. Definition of "disqualifying financial interest";
4. Additional requirements relating to "disqualified opinions."

Comments are encouraged to be submitted by February 28, 2005, to: Internal Revenue Service, CC:PA:LPD:PR (Notice 2005–12), room 5203, P.O. Box 7604, Ben Franklin Station, Washington, DC 20224. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (Notice 2005–12), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS e-mail address: *notice.comments@irscounsel.treas.gov*.

DRAFTING INFORMATION

The principal author of this notice is Heather L. Dostaler of the Office of Associate Chief Counsel (Procedure & Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this notice, contact Heather L. Dostaler at (202) 622–4940 (not a toll-free call).