

Notice of Proposed Rulemaking

Establishing Defenses to the Imposition of the Accuracy-Related Penalty

REG-126016-01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that limit the defenses available to the imposition of the accuracy-related penalty when taxpayers fail to disclose reportable transactions or fail to disclose that they have taken a position on a return based upon a regulation being invalid. By limiting a taxpayer's ability to use an opinion or advice from a tax professional as a basis for a defense, the proposed regulations are intended to promote the disclosure of reportable transactions and positions by taxpayers that conflict with regulations issued by the Secretary. The proposed regulations also clarify the existing regulations with respect to the facts and circumstances that the IRS will consider in determining whether a taxpayer acted with reasonable cause and in good faith in relying on an opinion or advice.

DATES: Written or electrically generated comments and requests for a public hearing must be received by March 31, 2003.

ADDRESSES: Send submissions to CC:IT&A:RU (REG-126016-01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:IT&A:RU (REG-126016-01), Courier's Desk, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at: www.irs.gov/reg.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jamie G. Bernstein or Heather L. Dostaler at (202) 622-4940; concerning

submissions of comments and requests for a public hearing, Ms. LaNita Van Dyke of the Regulations Unit at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed regulations amending the regulations promulgated pursuant to sections 6662 and 6664, relating to the accuracy-related penalty. Section 6662 provides for the imposition of an accuracy-related penalty for underpayments of tax, including underpayments due to negligence or disregard of rules or regulations and understatements that are *substantial* within the meaning of the statute. Taxpayers, however, can avoid the accuracy-related penalty if they can establish, among other things, that there was reasonable cause for the underpayment and that they acted in good faith within the meaning of section 6664(c).

Temporary regulations issued under section 6011 require taxpayers to disclose *reportable transactions* on their returns within the meaning of those temporary regulations. Treas. Reg. § 1.6011-4T. Reportable transactions may be abusive tax avoidance transactions. The early identification of potentially abusive tax avoidance transactions is a high priority for the IRS and Treasury. On October 22, 2002, the IRS and Treasury published proposed and temporary regulations that significantly revise the definition of certain types of reportable transactions. See Tax Shelter Disclosure Statements, (T.D. 9017, 2002-45 I.R.B. 815 [67 FR 64799] and REG-103735-00, 2002-45 I.R.B. 832 [67 FR 64840]) (October 22, 2002) (to be codified in 26 CFR parts 1, 20, 25, 31, 53, 54, 56, and 301). The proposed amendments to the disclosure rules under section 6011 generally will apply to transactions entered into on or after January 1, 2003.

The IRS and Treasury believe that taxpayers have improperly relied on opinions or advice issued by tax advisors to establish reasonable cause and good faith as a basis for avoiding the accuracy-related penalty, even when the opinion or advice relates to a reportable transaction that the taxpayer should have, but did not, disclose pursuant to § 1.6011-4T. The IRS and

Treasury also believe that taxpayers have improperly relied upon opinions or advice that a regulation is invalid without disclosing on their returns their position that the regulation is invalid.

Accordingly, the IRS and Treasury have concluded that the regulations under sections 6662 and 6664 should be amended and clarified so that (1) a taxpayer who takes a position that a regulation is invalid cannot rely on an opinion or advice to satisfy the reasonable cause and good faith exception under section 6664(c) with respect to any underpayment attributable to such position if the position was not disclosed on a return; and (2) a taxpayer who engages in a reportable transaction cannot rely on an opinion or advice to satisfy the reasonable cause and good faith exception under section 6664(c) with respect to any underpayment attributable to the transaction if the transaction was not disclosed pursuant to the regulations promulgated under section 6011. Further, a taxpayer who engages in a reportable transaction cannot rely on the realistic possibility standard under section 6662 to avoid the accuracy-related penalty for negligence or disregard of rules or regulations if the position regarding the reportable transaction is contrary to a revenue ruling or notice.

Explanation of Provisions

These proposed regulations amend 26 CFR part 1 relating to the defenses available to the imposition of the accuracy-related penalty under section 6662(b)(1) (underpayments of tax attributable to negligence or disregard of rules or regulations) and the general exception to the accuracy-related penalty under section 6664(c).

Under these proposed regulations, the adequate disclosure exception to the accuracy-related penalty for underpayments of tax attributable to negligence or disregard of rules or regulations (see § 1.6662-3(a)) will not apply to underpayments relating to a reportable transaction unless the reportable transaction also is disclosed under § 1.6011-4T. In addition, if a position relates to a revenue ruling or notice (other than a notice of proposed rulemaking), a taxpayer may not rely upon the fact that the posi-

tion has a realistic possibility of being sustained on the merits as a defense to the penalty imposed under section 6662(b)(1). The taxpayer instead would be required to satisfy the adequate disclosure exception under § 1.6662-3(c)(1), including the disclosure of the reportable transaction under § 1.6011-4T.

The proposed regulations also clarify and modify the standards for, and limits on, the use of opinions and advice to satisfy the reasonable cause and good faith exception under section 6664(c) as a defense to the imposition of the accuracy-related penalty under section 6662. The proposed regulations, for instance, clarify that a taxpayer's education, sophistication and business experience will be relevant in determining whether the taxpayer's reliance on the opinion or advice was reasonable and made in good faith. The IRS currently takes these facts and circumstances into account in determining whether a taxpayer has satisfied the reasonable cause and good faith exception under section 6664(c).

These proposed regulations amend § 1.6664-4(c) to specify when a taxpayer cannot rely upon an opinion or advice to satisfy the reasonable cause and good faith exception. Taxpayers who do not disclose positions based upon a regulation being invalid (see § 1.6662-3(c)(2)) cannot use an opinion or advice concerning the invalidity of the regulation as a basis for satisfying the reasonable cause and good faith exception under section 6664(c). Similarly, the proposed regulations prohibit taxpayers from using an opinion or advice as a basis for satisfying the reasonable cause and good faith exception under section 6664(c) with respect to a reportable transaction that the taxpayer did not disclose in accordance with § 1.6011-4T.

Under these proposed regulations, a taxpayer, in order to properly disclose a transaction, may be required to file with the taxpayer's return more than one disclosure form for the same transaction in order to satisfy the requirements in the regulations under sections 6662 and 6664 (as modified by these proposed regulations), and section 6011. The IRS and Treasury may consider permitting taxpayers to use a single disclosure document to satisfy those regulations, provided that all required information is provided by the taxpayer and provided that the taxpayer files a copy of the document with the Office of

Tax Shelter Analysis as required under § 1.6011-4T (or as may be otherwise provided in any successor regulations).

Proposed Effective Date

These regulations are proposed to apply to returns filed after December 30, 2002, with respect to transactions entered into on or after January 1, 2003, to coincide with the temporary regulations relating to disclosure, promulgated under section 6011 and applicable for transactions entered into on or after January 1, 2003. The IRS, however, cautions taxpayers and tax practitioners that it will rigorously apply the existing facts and circumstances standard under § 1.6664-4(c) regarding a taxpayer's reasonable reliance in good faith on advice from a tax professional, as well as the other provisions of the regulations under sections 6662 and 6664, including § 1.6664-4(c) relating to special rules for the substantial understatement penalty attributable to tax shelter items of a corporation. In addition to the modifications contained in these proposed regulations, and regardless of when a transaction was entered into, the IRS, in appropriate circumstances, may consider a taxpayer's failure to disclose a reportable transaction or failure to disclose a position that a regulation is invalid as a factor in determining whether the taxpayer has satisfied the reasonable cause and good faith exception under section 6664(c) to the accuracy-related penalty.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Jamie G. Bernstein and Heather L. Dostaler of the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1 — INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.6662-3 is amended by:

1. Revising paragraph (a).
2. Revising the last sentence of paragraph (b)(2).
3. Revising the first sentence of paragraph (c)(1).

The revisions read as follows:

§ 1.6662-3 Negligence or disregard of rules or regulations.

(a) *In general.* If any portion of an underpayment, as defined in section 6664(a) and § 1.6664-2, of any income tax imposed under subtitle A of the Internal Revenue Code that is required to be shown on a return is attributable to negligence or disregard of rules or regulations, there is added to the tax an amount equal to 20 percent of such portion. The penalty for disre-

garding rules or regulations does not apply, however, if the requirements of paragraph (c)(1) of this section are satisfied and the position in question is adequately disclosed as provided in paragraph (c)(2) of this section (and, if the position relates to a reportable transaction as defined in § 1.6011-4T(b), the transaction is disclosed in accordance with § 1.6011-4T), or to the extent that the reasonable cause and good faith exception to this penalty set forth in § 1.6664-4 applies. In addition, if a position with respect to an item (other than with respect to a reportable transaction, as defined in § 1.6011-4T(b)) is contrary to a revenue ruling or notice (other than a notice of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter), this penalty does not apply if the position has a realistic possibility of being sustained on its merits. See § 1.6694-2(b) of the income tax return preparer penalty regulations for a description of the realistic possibility standard.

(b) * * *

(2) * * * Nevertheless, a taxpayer who takes a position (other than with respect to a reportable transaction, as defined in § 1.6011-4T(b)) contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits.

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(c) * * * (1) * * * No penalty under section 6662(b)(1) may be imposed on any portion of an underpayment that is attributable to a position contrary to a rule or regulation if the position is disclosed in accordance with the rules of paragraph (c)(2) of this section (and, if the position relates to a reportable transaction as defined in § 1.6011-4T(b), the transaction is disclosed in accordance with § 1.6011-4T) and, in case of a position contrary to a regulation, the position represents a good faith challenge to the validity of the regulation.

Par. 3. Section 1.6664-0 is amended by:

1. Adding an entry for § 1.6664-4(c)(1)(iii).

2. Redesignating the entries for § 1.6664-4(c)(2) and (c)(3) as § 1.6664-4(c)(3) and (c)(4), respectively.

3. Adding a new entry for § 1.6664-4(c)(2).

The additions read as follows:

§ 1.6664-0 Table of contents.

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§ 1.6664-4 Reasonable cause and good faith exception to section 6662 penalties.

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(c) * * *

(1) * * *

(iii) Reliance on the invalidity of a regulation.

(2) Opinions or advice relating to reportable transactions.

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Par. 4. Section 1.6664-4 is amended by:

1. Revising paragraph (c)(1) introductory text.

2. Revising the last sentence of paragraph (c)(1)(i).

3. Adding paragraph (c)(1)(iii).

4. Redesignating paragraphs (c)(2) and (c)(3) as paragraphs (c)(3) and (c)(4), respectively.

5. Adding a new paragraph (c)(2).

The revision and additions read as follows:

§ 1.6664-4 Reasonable cause and good faith exception to section 6662 penalties.

(c) *Reliance on opinion or advice* — (1) *Facts and circumstances; minimum requirements.* All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. For example, the taxpayer's education, sophistication and business experience will be relevant in determining whether the taxpayer's reliance on the advice was reasonable and made in good faith. In no event will a taxpayer be considered to have reasonably relied in good faith on advice (including an opinion) unless the requirements of this paragraph (c)(1) are satisfied and the advice is not disqualified under paragraph (c)(2) of this section. The fact that these requirements are satisfied, however, will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a professional tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or reasonably should

have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

(i) * * * In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.

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(iii) *Reliance on the invalidity of a regulation.* 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 § 1.6662-3(c)(2), including the disclosure of the position that the regulation in question is invalid, and, if the position relates to a reportable transaction as defined in § 1.6011-4T(b), the transaction is disclosed in accordance with § 1.6011-4T.

(2) *Opinions or advice relating to reportable transactions.* Taxpayers may not reasonably rely on an opinion or advice of a tax advisor if the opinion or advice is disqualified under this paragraph. An opinion or advice is disqualified if it relates to the appropriate tax treatment of a reportable transaction, as defined in § 1.6011-4T(b), and the taxpayer does not disclose the transaction in accordance with § 1.6011-4T.

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David A. Mader,
Assistant Deputy Commissioner
of Internal Revenue.

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