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In 2004, Congress enacted the American Jobs Creation Act of 2004 ("Jobs Act")[1] to address abusive tax avoidance transactions that "threaten[ed] our tax system's integrity and fairness."[2] Congress was motivated to enact this legislation based on reports by the Internal Revenue Service (IRS) revealing that over approximately a decade, several hundred thousand participants were likely engaged in abusive tax avoidance schemes, totaling approximately tens of billions of dollars of tax losses.[3]

This comprehensive reform against abusive tax shelters was expected to raise approximately $1.5 billion over a ten-year period.[4] The Jobs Act made significant changes in the reporting requirements for transactions that Congress believed were likely to be abusive, expanding the scope of these requirements and substantially increasing the penalties for non-compliance. In particular, the Jobs Act added new provisions requiring taxpayers and "material advisors" to disclose transactions now known as "reportable transactions," which include certain transactions generating large losses. The Jobs Act also required material advisors to maintain lists of individuals whom they advise with respect to these transactions.[5] The disclosure and enhanced recordkeeping requirements—along with the penalties for non-compliance—were intended to enhance the IRS's ability to review and audit abusive transactions. Furthermore, these requirements created incentives for such advisors to avoid these transactions altogether.

This article focuses on the "loss transaction" category of reportable transactions. The IRS created this category because abusive tax shelters almost invariably involve the creation of some loss.[6] The loss transaction category accounts for nearly 90% of

1. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418.

2. U.S. Gov't Accountability Office, GAO-11-493, Abusive Tax Avoidance Transactions: IRS Needs Better Data to Inform Decisions about Transactions 1 (2011) [hereinafter GAO, *Abusive Tax Avoidance Transactions*].

3. U.S. Gov't Accountability Office, GAO-04-50, Internal Revenue Service: Challenges Remain in Combating Abusive Tax Schemes 2 (2003); U.S. Gov't Accountability Office, GAO-04-104T, Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters 3 (2003).

4. Joint Comm. on Tax'n, JCX-95-03, Estimated Revenue Effects of the Chairman's Amendment in the Nature of a Substitute to H.R. 2896, at 4 (2003).

5. *See* I.R.C. §§ 6111–6112 (Westlaw 2012).

6. *See, e.g.*, United States v. Woods, 134 S. Ct. 557 (2013); Stobie Creek Invs. LLC v. United States, 608 F.3d 1366, 1369 (Fed. Cir. 2010); Coltec Indus., Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 2006); United States v. Daugerdas, 759 F. Supp. 2d 461 (S.D.N.Y. 2010); Long Term Capital Holdings, LLC v. United States, 330 F. Supp. 2d 122, 200–01 (D. Conn. 2004). An example of an abusive loss transaction is the "Son of BOSS" transaction described generally in I.R.S. Notice 2000-44, 2000-36 C.B. 255 (Sept. 5, 2000), and in *Tigers Eye Trading, LLC v. Comm'r*, 97 T.C.M. (CCH) 1622 (2009), in which a promoter formed a limited liability company (treated as a partnership for income tax purposes) to enable an investor to claim losses that substantially offset millions of dollars of long-term capital gain realized on the sale of a business interest. *Tigers Eye Trading*, 97 T.C.M. (CCH) at 4. The losses were from options in foreign currency transactions. *Id.* at 7. These losses were offset, however, by hedging transactions such that there was no actual economic loss to the taxpayer. *Id.* at 4.

the reporting by taxpayers and material advisors since 2007.[7] The General Accounting Office estimates that 227,735 loss transactions were reported between 2007 and 2009, while merely 16,067 transactions in all other categories were reported during that same period.[8] The IRS ultimately found that most of these transactions were not abusive.[9]

The loss transaction category generates the vast majority of disclosures, but these transactions are rarely abusive. The minimal value to the IRS of collecting this information does not justify the high compliance costs and onerous penalties facing taxpayers and advisors in reporting these transactions. The definition of a loss transaction should be narrowed to better capture the abusive transactions, rather than requiring taxpayers and advisors to waste time and effort on complicated disclosures, or risk strict liability penalties.

After a brief introduction to the disclosure and list maintenance rules for reportable transactions, as well as the penalties for failure to comply with these requirements, Part I of this article discusses the general definition of reportable transaction and the loss transaction category. Part II discusses reporting and recordkeeping obligations. Part III focuses on the challenges of compliance raised by loss transactions. Part IV describes the penalties for non-compliance and argues that—given the steep penalties for non-compliance and the limited value of most of the information collected—the reportable loss transaction category should be significantly revised. Part V concludes this article.

The requirements for disclosing reportable transactions are found in §§ 6111 and 6112 of the Internal Revenue Code.[10] A taxpayer who participates in a reportable transaction is required to attach an additional form to his tax return. The same form must also be filed with the Office of Tax Shelter Analysis (OTSA). Similarly, any material advisor[11] with respect to the transaction must submit a disclosure form. Material advisors must also maintain a list of all clients who participate in reportable transactions, along with specific information about the transaction and the underlying records, and advisors must provide this information upon request by the IRS.

The penalties for failing to comply with these rules may be onerous and may apply even if the IRS does not assess any additional tax after reviewing the transaction. Additionally, with respect to the penalties for failing to disclose reportable transactions, there is no reasonable cause defense—meaning that there is strict liability for any

7. GAO, *Abusive Tax Avoidance Transactions*, *supra* note 2, at 18.

8. *Id.*

9. *Id.*

10. Section 6111 requires disclosure of reportable transactions, and § 6112 requires material advisors to maintain and produce to the IRS information regarding reportable transactions. *See* I.R.C. §§ 6111(a), 6112.

11. "Material advisor" is defined as any person who "provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and . . . derives gross income in excess of the threshold amount . . . for such aid, assistance, or advice." *Id.* § 6111(b)(1)(A)(i)–(ii); *see infra* Part II.B.

failure to comply. The IRS may rescind penalties, but the decision is in the IRS's absolute discretion and not subject to judicial review.[12]

With this backdrop, one can see why the question of whether a transaction is reportable is not academic, but remains a serious concern with high stakes for taxpayers and advisors.

I. REPORTABLE TRANSACTIONS

The Jobs Act provisions regarding reportable transactions are intended to attack abusive tax avoidance transactions. There is no formal or technical definition of an abusive tax avoidance transaction, but the definition of a tax shelter is "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax."[13] There are of course "legal" tax shelters, such as § 1031 exchanges[14] or the tax-free treatment of interest from municipal bonds under § 103(a),[15] but these were not the kind of transactions that Congress was concerned about when it enacted the Jobs Act's amendments to the tax shelter reporting rules. Rather, Congress was concerned with abusive tax avoidance in which the tax benefit and the non-tax economic impact are inconsistent.[16]

A reportable transaction is broadly defined as a transaction "of a type which the Secretary determines as having a potential for tax avoidance or evasion."[17] Despite this open-ended language, Congress hoped for "a single, clear definition regarding the types of transactions that must be disclosed by taxpayers and material advisors."[18] Particularly with respect to the loss transaction category, the definition is far from singular or clear. The next section describes the five categories of reportable loss transactions, and then takes an in-depth look at the loss transaction category.

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12. I.R.C. § 6707A(d)(1)–(2) (Westlaw 2010); *see infra* Part IV.C.

13. I.R.C. § 6662(d)(2)(C)(ii)(I)–(III) (Westlaw 2010).

14. Section 1031 allows taxpayers to defer capital gains tax on the exchange of like-kind properties for business or investment purposes. *Id.* § 1031(a)(1) (Westlaw 2008). For example, an individual who wants to sell real estate and use the proceeds of the sale to purchase another property can defer tax on the gain realized on the sale of the first property until he sells the second property. This is a commonly used tax deferral technique that is specifically authorized by Congress through the enactment of § 1031. *Id.* § 1031; Treas. Reg. § 1.1031(a)-1(a)(1) (Westlaw 1991).

15. Section 103(a) provides that subject to certain exceptions, "gross income does not include interest on any State or local bond." I.R.C. § 103(a) (Westlaw 1986).

16. In addition to the reportable transaction disclosure rules and penalties, Congress has attacked abusive tax shelters by creating a penalty that applies to transactions that lack economic substance, *id.* § 6662(i)(1), eliminating the reduction of the understatement for purposes of assessing substantial penalties if the understatement was related to a tax shelter, *id.* § 6662(d)(2)(C), creating an accuracy-related penalty for understatements related to reportable transactions, *id.* § 6662A (Westlaw 2010), and eliminating accountant-client privilege for written communications relating to tax shelters, *id.* § 7525(b) (Westlaw 2004).

17. *Id.* § 6707A(c)(1); *see id.* § 6111(b)(2) (Westlaw 2005).

18. H.R. Rep. No. 108-393, at 176 (2003).

A. The Five General Categories of Reportable Transactions

The Treasury Regulations ("Regulations" or "Treas. Reg.") provide the specific definition of reportable transaction, which includes five types of transactions: (1) listed transactions; (2) confidential transactions; (3) transactions with contractual protection; (4) transactions of interest; and (5) loss transactions.

The first type of reportable transaction, the "listed transaction," is any transaction that is the same as or substantially similar to a transaction that the IRS has identified as a "tax avoidance transaction" in a published guidance.[19] A transaction is "substantially similar" to a listed transaction if it "is expected to obtain the same or similar types of tax consequences and [] is either factually similar or based on the same or similar tax strategy."[20] The term "substantially similar" is "broadly construed in favor of disclosure."[21] The Regulations provide examples of taxpayer participation in listed transactions and transactions that are substantially similar to listed transactions.[22]

The second type of reportable transaction, the "confidential transaction," is any transaction "offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a minimum fee."[23] Conditions of confidentiality exist if the agreement with the advisor limits the taxpayer's ability to disclose "the tax treatment or tax structure of the transaction."[24] The term "tax structure" is defined as "any fact that may be relevant to understanding the purported or claimed Federal income tax treatment of the transaction."[25] A transaction will be considered confidential even though the taxpayer may not be legally bound to abide by the conditions of confidentiality.[26] To be classified as a confidential transaction, the taxpayer must have paid the advisor a minimum fee: at least $250,000 for a corporate taxpayer, a partnership, or a trust in which all of the owners or beneficiaries are corporations (looking through any partners or beneficiaries that are themselves

19. Treas. Reg. § 1.6011-4(b)(2) (Westlaw 2010); *see* I.R.C. § 6707A(c)(2). For transactions entered into on or after November 14, 2011, the definition of "listed transaction" includes transactions involving tax on generation skipping transfers. Treas. Reg. § 26.6011-4(b) (Westlaw 2011) (as amended by T.D. 9556, 2011-51 I.R.B. 862). Other forms of published guidance may include Revenue Procedures or Revenue Rulings.

20. Treas. Reg. § 1.6011-4(c)(4); *see, e.g.*, Repetto v. Comm'r, 103 T.C.M. (CCH) 1895, 16 (2012) (finding the transaction at issue to be substantially similar to a listed transaction known as an "Abusive Roth IRA Transaction," which is described in I.R.S. Notice 2004-8, 2004-4 I.R.B. 333 (2004)); Alpha I, LP v. United States, 93 Fed. Cl. 280, 321 (2010) (finding the transaction at issue was substantially similar to the listed transaction known as "Son of BOSS").

21. Treas. Reg. § 1.6011-4(c)(4). The tax court has rejected the argument that the "substantially similar" standard is unconstitutionally vague. *See, e.g.*, *Repetto*, 103 T.C.M. (CCH) at 16–17.

22. Treas. Reg. § 1.6011-4(c)(3)(ii)–(c)(4); I.R.S. Notice 2009-59, 2009-31 I.R.B. 170 (providing a list of listed transactions).

23. Treas. Reg. § 1.6011-4(b)(3)(i).

24. *Id.* § 1.6011-4(b)(3)(ii).

25. *Id.* § 1.6011-4(c)(9).

26. *Id.* § 1.6011-4(b)(3)(ii).

partnerships or trusts), or $50,000 for all other transactions.[27] The minimum fee includes all fees for a tax strategy or any advice (whether tax advice or not), or for implementation of the transaction.[28]

The third type of reportable transaction, the "transaction with contractual protection," is any transaction for which "a taxpayer or related party . . . has the right to a full or partial refund of fees . . . if all or part of the intended tax consequences . . . are not sustained."[29] A transaction with contractual protection includes those with fees that are "contingent on the taxpayer's realization of tax benefits from the transaction."[30] For example, in *Alpha I, LP v. United States*, the fee to a promoter of a "Son of BOSS" transaction[31] was 25% of the amount the taxpayers would have paid in tax had they not entered into the transaction. For purposes of contractual protection, the relevant fees are those paid to a person who makes or provides a statement to the taxpayer or related party as to the potential tax consequences of a transaction.[32]

The fourth type of reportable transaction, the "transaction of interest," is defined as "the same or substantially similar to one of the types of transactions that the IRS has identified by notice, regulation, or other form of published guidance as a transaction of interest."[33] "A transaction of interest is a transaction that the IRS and Treasury Department believe has a potential for tax avoidance or evasion, but for which the IRS and Treasury Department lack enough information to [make such a determination]."[34]

The fifth type of reportable transaction is the "loss transaction," which is discussed in the next section.

B. Reportable Loss Transactions

A loss that is deductible under § 165[35] and exceeds certain minimum thresholds[36] is a reportable transaction.[37] To determine if a taxpayer claiming a loss as a result of a transaction meets the threshold amounts over a combination of taxable years, losses

27. *Id.* § 1.6011-4(b)(3)(iii).

28. *Id.* § 1.6011-4(b)(3)(iv).

29. *Id.* § 1.6011-4(b)(4)(i); *see* I.R.C. § 267(b) (Westlaw 2010) (defining related party).

30. Treas. Reg. § 1.6011-4(b)(4)(i).

31. 93 Fed. Cl. 280, 318–20 (2010). In *Alpha I, LP*, the taxpayers used the short sale of U.S. Treasury notes to generate substantial artificial losses to eliminate their capital gain. *Id.* Son of BOSS transactions are listed transactions and are described in I.R.S. Notice 2000-44, 2000-36 I.R.B. 255.

32. Treas. Reg. § 1.6011-4(b)(4)(ii).

33. *Id.* § 1.6011-4(b)(6).

34. Prop. Treas. Reg. § 1.6011-4, 71 Fed. Reg. 64488-01, 64488 (Nov. 2, 2006). This category of reportable transaction applies to transactions entered into on or after November 2, 2006. Treas. Reg. § 1.6011-4(b)(5).

35. In general, § 165(a) allows deductions for "any loss sustained during the taxable year that is not compensated by insurance or otherwise." I.R.C. § 165(a) (Westlaw 2010).

36. These thresholds are:

> (A) $10 million in any single taxable year or $20 million in any combination of taxable years for corporations;

claimed in the taxable year that the transaction was entered into are combined with the five succeeding taxable years.[38] If the loss transaction subsequently exceeds the threshold amount, the transaction should be disclosed in the next return.[39]

The full amount of a § 165 loss is taken into account for the year in which the loss was sustained, regardless of whether all or some of the loss is part of a net operating loss under § 172,[40] or a net capital loss under § 1212[41] carried back to another year.[42] Likewise, in calculating the § 165 loss for reporting, any portion of the loss attributable to a capital loss carryback or carryover from another year will not be included.[43]

C. The "Angel List" of Loss Transactions

Certain transactions included in the IRS's published guidance that otherwise meet the definition of a reportable transaction may be excluded from the disclosure.[44] Because the loss transaction category is so broad, the IRS tried to narrow it by issuing Revenue Procedures that exclude certain transactions from the definition of a loss transaction. These Revenue Procedures are known as the "Angel List," and are intended to cover transactions that the IRS believes are unlikely to be abusive.[45] A loss transaction on the Angel List may nevertheless be reportable if it meets the criteria for

> (B) $10 million in any single taxable year or $20 million in any combination of taxable years for partnerships that have only corporations as partners (looking through any partners that are themselves partnerships), whether or not any losses flow through to one or more partners; or
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> (C) $2 million in any single taxable year or $4 million in any combination of taxable years for all other partnerships, whether or not any losses flow through to one or more partners;
>
> (D) $2 million in any single taxable year or $4 million in any combination of taxable years for individuals, S corporations, or trusts, whether or not any losses flow through to one or more shareholders or beneficiaries; or
>
> (E) $50,000 in any single taxable year for individuals or trusts, whether or not the loss flows through from an S corporation or partnership, if the loss arises with respect to a section 988 transaction (as defined in section 988(c)(1) relating to foreign currency transactions).

Treas. Reg. § 1.6011-4(b)(5)(i)(A)–(E); *see* I.R.C. § 988(c)(1) (Westlaw 1999).

37. Treas. Reg. § 1.6011-4(b)(5).

38. *Id.* § 1.6011-4(b)(5)(ii).

39. *Id.* § 1.6011-4(e)(2)(ii).

40. Section 172 contains the rules for carrying those losses back and forward to offset income in profitable years. I.R.C. § 172 (Westlaw 2009); *see* Treas. Reg. § 1.165-1 (Westlaw 1977). Net operating loss is a negative profit for tax purposes, i.e., the company's deductions exceed its taxable income. *See* I.R.C. § 172.

41. *See* I.R.C. § 1212 (Westlaw 2010). Section 1212 allows for capital losses in one tax year to be applied against capital gains in other tax years. *See id.* § 1212(a)(1).

42. Treas. Reg. § 1.6011-4(b)(5)(iii).

43. *Id.* § 1.6011-4(b)(5)(iii)(a).

44. *Id.* § 1.6011-4(b)(8)(i).

45. Rev. Proc. 2013-11, 2013-2 I.R.B. 269. This Revenue Procedure, which became effective on December 6, 2012, generally applies to transactions entered into on or after January 1, 2003, and applies to losses

another category of reportable transactions, such as a confidential transaction or a transaction with contractual protection.[46] Other transactions excluded by the Angel List include losses from the sale or exchange of an asset with qualifying basis and several other types of losses. These transactions are discussed in detail below.

1. Losses from the Sale or Exchange of an Asset with Qualifying Basis

Revenue Procedure ("Rev. Proc.") 2013-11 states that a § 165 loss from the sale or exchange of an asset with a "qualifying basis" is not considered a reportable loss transaction.[47] A taxpayer is considered to have qualifying basis in an asset under one of several tests.

The first and most simple test for qualifying basis is that the loss is equal to, and "determined solely by reference to, the amount (including any option premium) paid in cash by the taxpayer for the asset and for any improvements to the asset"—tangible or intangible.[48] Rev. Proc. 2013-11 explains that, for the purposes of determining whether an asset has qualifying basis if an amount is included as compensation income under § 83,[49] such amount will be treated as "an amount paid in cash by the taxpayer for an asset if the amount is included in the taxpayer's basis in the asset."[50]

With respect to debt instruments,[51] the Rev. Proc. provides that an amount paid in cash will not be disregarded for the purposes of determining whether a taxpayer has qualifying basis in an asset "merely because the taxpayer issued a debt instrument to obtain the cash."[52] The Rev. Proc. further provides, however, that "if the taxpayer has issued a debt instrument to the person (or a related party as described in § 267(b) or § 707(b)) who sold or transferred the asset to the taxpayer, . . . the taxpayer will be treated as having paid cash for the asset or the improvement."[53] According to the Rev. Proc., the taxpayer will be treated as having paid cash only if "the debt instrument is secured by the asset and all amounts due under the debt instrument have been paid in cash no later than the time of the sale or exchange of the asset . . . for which the loss is claimed."[54]

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by certain banks with respect to § 988 transactions recognized on or after December 6, 2012. Rev. Proc. 2013-11, § 6. Rev. Proc. 2013-11 superseded the prior version, Rev. Proc. 2004-66, 2004-50 I.R.B. 966.

46. Rev. Proc. 2013-11, § 1.

47. *Id.* § 4.02.

48. *Id.* § 4.02(2)(a).

49. I.R.C. § 83 (Westlaw 2004) (governing property transferred in connection with performance of services).

50. Rev. Proc. 2013-11, § 4.02(3).

51. A debt instrument is a written promise to repay a debt and includes bonds, notes, certificates of deposits, and commercial paper. *See* I.R.C. § 1275(a)(1) (Westlaw 2000); BLACK'S LAW DICTIONARY (9th ed. 2009).

52. Rev. Proc. 2013-11, § 4.02(4).

53. *Id.*

54. *Id.* If the asset is traded on an established securities market, the amounts due under the debt instrument must be paid by the settlement date. *Id.* The same rule applies when the taxpayer "assumed a debt instrument (or took an asset subject to a debt instrument) issued by the person (or related party . . .) who

The second test for qualifying basis qualifies the taxpayer's loss under § 358 if certain circumstances have been fulfilled.[55] Section 358 determines the basis for certain stock transactions for various corporate reorganizations and controlled corporations.[56] Section 358 provides that the basis of the property deemed "to be received without the recognition of gain or loss is the same as that of the property exchanged, decreased and increased by specified items" in exchanges occurring pursuant to corporate reorganization plans, distributions of stocks and securities of controlled corporations, and transfers to controlled corporations.[57] Rev. Proc. 2013-11 states that when § 358 determines basis because the property was received in an "exchange to which §§ 354, 355, or 361 applies"[58] and the taxpayer's basis in the property exchanged in the transaction is qualifying, the property will have qualified basis.[59]

Third, an asset acquired from a decedent (such as through inheritance) will have qualifying basis under § 1014.[60]

Fourth, an asset that is acquired by gift or transfer in trust, when the basis of the asset is determined under § 1015, likewise will have qualifying basis.[61] However, if an asset was a gift or a transfer in trust, in order for that asset to have qualifying basis, the donor's basis in the asset must have been qualifying.[62]

Fifth, an asset required by an exchange for property held for productive use or investment will have qualifying basis if the basis is determined under § 1031(d),[63] so long as the taxpayer's basis in the property exchanged for the asset in the § 1031 exchange had qualifying basis.[64] In addition, any debt interest issued or assumed by the taxpayer in connection with the § 1031 transaction is treated as a payment in

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sold or transferred the asset to the taxpayer, or issued a debt instrument in exchange for improvements to an asset." *Id.*; *see* I.R.C. §§ 267, 707(b) (Westlaw 2010).

55. Rev. Proc. 2013-11, § 4.02(2)(b); *see* I.R.C. § 358 (Westlaw 2002).

56. 3 Mertens Law of Federal Income Taxation § 21:47 (Dan Sheaffer ed., Oct. 2014); I.R.C. § 358(f).

57. 3 Mertens Law of Federal Income Taxation, *supra* note 56, § 21:47; I.R.C. § 358(a)(1).

58. Rev. Proc. 2013-11, § 4.02(2)(b). Section 354(a) provides that "[n]o gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization." I.R.C. § 354(a)(1) (Westlaw 1998). Section 355(a) allows a corporation to make a tax-free distribution to its shareholders of stock and securities in one or more controlled subsidiaries such that neither the distributing corporation nor its shareholders recognize gain or loss on the distribution. *Id.* § 355(a) (Westlaw 2007). Section 361(a) provides that "[n]o gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization." *Id.* § 361(a) (Westlaw 2005).

59. Rev. Proc. 2013-11, § 4.02(2)(b).

60. *Id.* § 4.02(2)(c); *see* I.R.C. § 1014 (Westlaw 2010).

61. Rev. Proc. 2013-11, § 4.02(2)(d); *see* I.R.C. § 1015 (Westlaw 1984).

62. Rev. Proc. 2013-11, § 4.02(2)(d).

63. Section 1031(d) governs the exchange of property held for productive use or investment. *See* I.R.C. § 1031(d) (Westlaw 2008).

64. Rev. Proc. 2013-11, § 4.02(2)(e).

cash under the Rev. Proc.[65] "[T]he taxpayer will be treated as having paid cash for the asset or improvement only if a debt instrument is secured by the asset and all amounts due under the debt instrument have been paid in cash no later than the time of the sale or exchange of the asset . . . for which the loss is claimed."[66]

Assets with adjustments to basis under § 961 (basis adjustments for stock of a subsidiary owned by another member), Treas. Reg. § 1.1502-32 (basis adjustments for stock in a controlled corporation), § 1272(d)(2) (basis adjustments for debt instruments with original issue discount), or § 1278(b)(4) (basis in bond increased when the taxpayer elected to include market discount into income annually), will be considered qualifying so long as the taxpayer's basis in the asset immediately prior to the adjustment was qualifying.[67]

In addition to having qualifying basis as described above, the asset cannot be an interest in a pass-through entity, except for interests in a real estate mortgage investment conduit (REMIC) under § 860G(a)(1).[68] The following entities are defined as pass-through entities: regulated investment companies, real estate investments trusts, S corporations, partnerships, trusts, common trust funds, passive foreign investment companies (as defined in § 1297 without regard to subsection (d), thereof), and REMICs (which as noted, can be an asset with qualifying basis).[69] These pass-through entities significantly limit the Angel List because many non-abusive loss transactions will involve a pass-through entity.[70]

For example: Fund 1 invests in another hedge fund, Fund 2, which is a partnership. If Fund 1 redeems its investment in Fund 2 for a loss of $3 million, even though Fund 1 paid cash for its investment in Fund 2 (and thus would have qualifying basis), the transaction would be reportable because Fund 2 is a pass-through entity. There is absolutely nothing abusive about this transaction. Fund 1 invested cash in Fund 2, Fund 2 did not perform well due to poor market conditions, and Fund 1, when it redeemed its interest, suffered an actual economic loss. Although the transaction involves nothing more than a run-of-the-mill § 165 loss, it is subject to reporting by the taxpayer (and any material advisor) because the property at issue is an investment in a pass-through entity.

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65. *Id.*

66. *Id.* § 4.02(4).

67. *Id.* § 4.02(2)(f)–(g); *see* I.R.C. §§ 961, 1272(d)(2), 1278(b)(4) (Westlaw 2005); Treas. Reg. § 1.1502-32 (Westlaw 2013).

68. Rev. Proc. 2013-11, § 4.02(1)(b); *see* I.R.C. §§ 1260(c)(2), 860G(a)(1) (Westlaw 2007).

69. I.R.C. § 1260(c)(2).

70. There will not be a qualifying basis if the loss is an ordinary loss under § 988. *Id.* § 988 (Westlaw 1999). Generally, § 988 provides that gains or losses on foreign currency transactions (such as acquiring a debt instrument that is issued and redeemed for U.S. dollars, but that provides an economic return that is determined by reference to the euro and market interest rates with respect to the euro) are treated as ordinary income and loss. *Id.* § 988(a)(1)(A). Rev. Proc. 2013-11 provides an exception when a bank recognizes § 988 losses, as described in §§ 581 or 582(c)(2)(A)(i) (concerning foreign banks as limited by § 582(c)(2)(C)), and the § 988 losses qualify as a sale or exchange of an asset with qualifying basis. Rev. Proc. 2013-11, § 4.02(1)(c); *see* I.R.C. §§ 581, 582(c)(2)(A)(i), 582(c)(2)(C) (Westlaw 2005).

Finally, to be non-reportable under this category of loss transactions, the asset cannot have been "separated from any portion of the income it generates."[71] Furthermore, the asset cannot ever have been "part of a straddle[72] within the meaning of § 1092(c), excluding a mixed straddle under [Treas. Reg.] § 1.1092(b)-4T."[73]

In sum, losses from the sale or exchange of an asset with qualifying basis are not subject to the reportable transaction disclosure rules for either the taxpayer or the material advisor.

2. Other Losses

The second category of losses described in the Angel List includes a wide array of loss transactions the IRS deems unlikely to be abusive because they involve actual economic loss of some kind to taxpayers.[74] The following losses under § 165 are not considered in determining whether a transaction is a reportable loss transaction as defined in Treas. Reg. § 1.6011-4(b)(5):[75]

> (1) A loss from fire, storm, shipwreck, or other casualty, or from theft . . . ;
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> (2) A loss from a compulsory or involuntary conversion [such as destruction, theft or seizure or requisition of condemnation] . . . ;
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> (3) A loss to which § 475(a) or § 1256(a) applies;
>
> (4) A loss arising from any mark-to-market treatment of an item . . . provided that the taxpayer computes its loss by using a qualifying basis . . . or a basis resulting from previously marking the item to market . . . ;
>
> (5) A loss arising from a hedging transaction described in § 1221(b), if the taxpayer properly identifies the transaction as a hedging transaction, or from a mixed straddle account under [Treas. Reg.] § 1.1092(b)-4T;
>
> (6) A loss attributable to basis increases under § 860C(d)(1) during the period of the taxpayer's ownership;
>
> (7) A loss attributable to the abandonment of depreciable tangible property that was used by the taxpayer in a trade or business and that has a qualifying basis . . . ;
>
> (8) A loss arising from the bulk sale of inventory if the basis of the inventory is determined under § 263A;

71. Rev. Proc. 2013-11, § 4.02(1)(d).

72. Section 1092(c)(1) defines "straddle" as "offsetting positions with respect to personal property," and defines "offsetting positions" as occurring when there "is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other positions with respect to personal property (whether or not of the same kind)." I.R.C. § 1092(c)(1)–(2)(A) (Westlaw 2014).

73. Rev. Proc. 2013-11, § 4.02(1)(e); *see* I.R.C. § 1092(c); Treas. Reg. § 1.1092(b)-4T (Westlaw 1985).

74. Rev. Proc. 2013-11, § 4.03.

75. *Id.* § 4.03(1)–(11).

> (9) A loss that is equal to, and is determined solely by reference to, a payment of cash by the taxpayer . . . ;
>
> (10) A loss from the sale to a person other than a related party . . . of property described in § 1221(a)(4) in a factoring transaction in the ordinary course of business; or
>
> (11) A loss arising from the disposition of an asset to the extent that the taxpayer's basis in the asset is determined [after a deemed stock purchase] . . . .

II. DISCLOSURE, RECORDKEEPING, AND LIST MAINTENANCE

The next section discusses the obligations of taxpayers and their advisors to maintain information on reportable transactions and to disclose those transactions to the IRS. For taxpayers, these obligations include filing forms with the OTSA describing the transactions and the tax benefits derived from them. Material advisors also must file certain forms, and retain and provide additional information upon request. These obligations, as well as the definition of material advisor, are discussed below.

A. The Taxpayer's Obligations

If a transaction falls into a category of reportable transactions, the taxpayer must report it by filing Form 8886—Reportable Transaction Disclosure Statement.[76] This form is due with the taxpayer's return reflecting participation in a reportable transaction.[77] At the same time, the taxpayer must send Form 8886 to the OTSA.[78] The IRS describes the OTSA as a "clearinghouse for all information relating to tax shelter activity" that comes to its attention.[79] The OTSA reviews all disclosures to identify "potentially improper tax shelter transactions" and the taxpayers who have participated in them, assessing the overall extent of tax shelter activity.[80] The taxpayer must disclose the transaction to the OTSA as required, regardless of whether the taxpayer has otherwise disclosed the transaction under other published guidance.[81] Form 8886 requires detailed and specific information, including: the type of reportable transaction, the type of entity involved, the tax benefit generated by the transaction, the amount and nature of expected tax treatment, and all individuals and entities involved in the transaction.[82]

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76. Treas. Reg. § 1.6011-4(d) (Westlaw 2010).

77. *Id.* § 1.6011-4(e)(1).

78. *Id.*

79. I.R.S. Announcement 2000-12, 2000-12 I.R.B. 835.

80. *Id.*

81. Treas. Reg. § 1.6011-4(e)(3).

82. *See* U.S. Dep't of the Treasury Internal Revenue Serv., I.R.S. Form 8886: Reportable Transaction Disclosure Statement (Mar. 2011), *available at* http://www.irs.gov/pub/irs-pdf/f8886.pdf [hereinafter I.R.S. Form 8886].

In addition to disclosing reportable transactions, the Regulations require a taxpayer to retain a copy of all documents and other records in connection with the disclosed transaction.[83] A taxpayer must retain these records until the applicable statute of limitations to the final taxable year for which disclosure was required expires.[84] Documents covered under this section include: marketing materials; written analyses; correspondence and agreements between the taxpayer and any advisor, lender, or other party to the transaction; and "documents discussing, referring to, or demonstrating the purported or claimed tax benefits arising from the reportable transaction . . . ; and documents, if any, referring to the business purposes for the reportable transaction."[85]

B. The Material Advisor's Obligations

Material advisors also have significant filing and record maintenance obligations.[86] The definition of material advisor is extremely broad, covering any person who: (1) provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction; and (2) directly or indirectly derives gross income in excess of the threshold amount (or such other amount as may be prescribed by the Secretary) for such aid, assistance, or advice.[87]

The threshold amount of gross income referenced above is $50,000 for a reportable transaction when substantially all of the tax benefits are provided to natural persons (looking through any partnerships, S corporations, or trusts), and $250,000 for all other transactions.[88] With respect to listed transactions and transactions of interest, the threshold amounts are reduced from $50,000 to $10,000, and from $250,000 to $100,000.[89] The threshold amounts are lower for listed transactions and transactions of interest in order to increase the number of reported transactions.

Determining whether substantially all of the tax benefits from a transaction are provided to natural persons is based on the facts and circumstances, but it is presumed to be substantially all of the tax benefits "if 70 percent or more of the tax benefits from a reportable transaction are provided to natural persons (looking through any partnerships, S corporations, or trusts)."[90] To determine the amount of gross income a person derives in

83. Treas. Reg. § 1.6011-4(g).

84. *Id.* This requirement supplements the record-keeping requirements imposed by § 6001. *Id.*; *see* I.R.C. § 6001 (Westlaw 1982). Section 6501 contains the various statutes of limitations for assessment of tax. *See id.* § 6501 (Westlaw 2010).

85. Treas. Reg. § 1.6011-4(g).

86. I.R.C. § 6111 (Westlaw 2005).

87. *Id.* § 6111(b)(1).

88. *Id.* § 6111(b)(1)(B); Treas. Reg. § 301.6111-3(b)(3)(i)(A) (Westlaw 2011).

89. Treas. Reg. § 301.6111-3(b)(3)(i)(B).

90. *Id.* § 301.6111-3(b)(3)(i)(D).

exchange for material aid, assistance, or advice, all fees for services related to advice, analysis, and implementation of the transaction are taken into account.[91]

The Regulations define the term "transaction" to include "all of the factual elements relevant to the expected tax treatment of any investment, entity, plan or arrangement, and includes any series of steps carried out as part of a plan."[92] An advisor provides material aid, assistance, or advice if he makes or provides a tax statement[93] to or for the benefit of a taxpayer or other material advisor who is required to: (1) disclose a listed transaction or transaction of interest, or would have been required to do so had the transaction "become a listed transaction or a transaction of interest" within the applicable limitations period; or (2) disclose the transaction because it is a confidential transaction, a transaction with contractual protection, or a loss transaction.[94]

There are some important exceptions to the definition of material advisor. Generally, "a person who makes a tax statement solely in that person's capacity as an employee, shareholder, partner, or agent of another person" is not a material advisor.[95] However, such person may be treated as a material advisor if he or she "forms or avails of an entity" to avoid the reporting and disclosure requirements of §§ 6111 or 6112, or the penalty provisions of §§ 6707 or 6708.[96] Other exceptions to the definition of material advisor include an advisor who proffers advice after the first tax return is filed with the IRS that reflects the tax benefits of the reportable transaction, so long as it is not anticipated that the taxpayer will file a supplemental or amended return reflecting additional tax benefits.[97]

Material advisors must file a disclosure statement with the OTSA on Form 8918—Material Advisor Disclosure Statement.[98] This requires reporting of substantially the same information reported on Form 8886.[99] Form 8918 "must be

91. *Id.* § 301.6111-3(b)(3)(ii). "[F]ees derived from separate transactions may not be aggregated for purposes of determining whether an advisor meets the threshold amount under section 6111." I.R.S. Chief Couns. Mem. 2010-21-021 (May 28, 2010), *available at* http://www.irs.gov/pub//irs-wd/1021021.pdf.

92. Treas. Reg. § 301.6111-3(b)(1).

93. *Id.* § 301.6111-3(b). A tax statement is defined as "any statement (including another person's statement), oral or written, that relates to a tax aspect of a transaction that causes the transaction to be a reportable transaction." *Id.* § 301.6111-3(b)(2)(ii)(A). The Regulations further provide specific guidance as to whether a statement is a tax statement with respect to confidential transactions, transactions with contractual protection, and loss transactions. *Id.* § 301.6111-3(b)(2)(ii)(B)–(D). A tax statement "includes tax result protection that insures some or all of the tax benefits of a reportable transaction." *Id.* § 301.6111-3(b)(2)(ii)(A).

94. *Id.* § 301.6111-3(b)(2)(i)(A)–(B); *see id.* § 1.6011-4(b)(3) (Westlaw 2010).

95. *Id.* § 301.6111-3(b)(2)(iii)(A).

96. *Id.*

97. *Id.* § 301.6111-3(b)(2)(iii)(B). Also, statements contained in publicly available documents filed with the U.S. Securities and Exchange Commission no later than the close of the transaction are not considered to be tax statements. *Id.* § 301.6111-3(b)(2)(iii)(C).

98. *Id.* § 301.6111-3(d)(1).

99. *Compare* U.S. Dep't of the Treasury Internal Revenue Serv., I.R.S. Form 8918: Material Advisor Disclosure Statement (rev. Dec. 2011), *available at* http://www.irs.gov/pub/irs-pdf/f8918.pdf, *with* I.R.S. Form 8886, *supra* note 82.

filed with the OTSA by the last day of the month that follows the end of the calendar quarter in which the advisor became a material advisor with respect to the reportable transaction or in which the circumstances necessitating an amended disclosure statement occur."[100] Because of confusion as to when an advisor becomes a material advisor, the IRS offered the following guidance:

> [A] material advisor will be treated as becoming a material advisor under § 6111 when all of the following events have occurred: (1) the material advisor makes a tax statement, (2) the material advisor receives (or expects to receive) the minimum fees, and (3) the transaction is entered into by the taxpayer.[101]

After receiving Form 8918, the IRS will issue the material advisor a reportable transaction number, which must be forwarded to all taxpayers and other material advisors at the time the transaction is entered into or, "if the transaction is entered into prior to the material advisor receiving the reportable transaction number, within 60 days from the date the reportable transaction number is mailed to the material advisor."[102] If there are multiple material advisors with respect to a transaction, they may enter into a designation agreement whereby one material advisor handles the disclosure.[103] The benefit of a designation agreement is that it reduces the compliance costs because only one disclosure is made. This is particularly beneficial in a transaction with multiple parties and material advisors. The downside of entering into a designation agreement, however, is that the agreement does not relieve the other material advisors of their disclosure obligations if the designated material advisor fails to timely disclose the transaction.[104]

The Jobs Act amended § 6112 to require each material advisor with respect to a reportable transaction to prepare and maintain a list of clients who participated in the reportable transaction and furnish such list upon written request of the IRS.[105] The list must identify each person to whom, or for whose benefit, the material advisor has made or provided a tax statement,[106] as well as other information.[107]

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100. Treas. Reg. § 301.6111-3(e); I.R.S. Notice 2007-85, 2007-2 I.R.B. 965.

101. I.R.S. Notice 2005-22, 2005-1 C.B. 756.

102. Treas. Reg. § 301.6111-3(d)(2).

103. *Id.* § 301.6111-3(f).

104. *Id.*

105. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (amending I.R.C. § 6112 (Westlaw 2005)); Treas. Reg. § 301.6112-1(a) (Westlaw 2011).

106. Treas. Reg. § 301.6112-1(b)(2).

107. *Id.* § 301.6112-1(b)(3)(i)(A)–(F). The response must include:

> (A) The name of each reportable transaction, the citation to the published guidance number identifying the transaction if the transaction is a listed transaction or a transaction of interest, and the reportable transaction number obtained under section 6111;
>
> (B) The name, address, and [taxpayer identification number] of each person required to be included on the list;
>
> (C) The date on which each person required to be included on the list entered into each reportable transaction, if known by the material advisor;

In addition to this information, the list must contain a detailed description of each reportable transaction describing the tax structure and the purported tax treatment of the transaction.[108] The material advisor must also maintain, and produce to the IRS upon request, a copy of any designation agreement and the transactional documents.[109]

The material advisor must retain the list and related documents "for seven years following the earlier of the date on which the material advisor last made a tax statement relating to the transaction, or the date the transaction was last entered into, if known."[110] The material advisor must furnish the list to the IRS within twenty days of its request.[111] Practitioners should be mindful, however, that the other material advisors are not relieved of their obligation to maintain and furnish lists if the designated advisor fails to do so.[112] A material advisor who has a claim of privilege, with respect to information required in the list, must nonetheless maintain the list.[113]

III. ADDITIONAL CHALLENGES TO PROPERLY REPORTING LOSS TRANSACTIONS

Aside from understanding the definition of a loss transaction and the Angel List exceptions, taxpayers and advisors face other challenges in reporting loss transactions. The forms themselves are complex, and require detailed and specific information. The IRS estimates that the burden on taxpayers for each Form 8886 is approximately 10 hours and 16 minutes of recordkeeping, 4 hours and 50 minutes learning about the form, and 6 hours and 25 minutes preparing, copying, assembling, and sending the form to the IRS—a total of 21 hours and 31 minutes per form.[114]

> (D) The amount invested in each reportable transaction by each person required to be included on the list, if known by the material advisor;
>
> (E) A summary or schedule of the tax treatment that each person is intended or expected to derive from participation in each reportable transaction; and
>
> (F) The name of each other material advisor to the transaction, if known by the material advisor.

Id.

108. *Id.* § 301.6112-1(b)(3)(ii). The IRS created an optional Form 13976, "Itemized Statement Component of Advisee List," to aid material advisors in maintaining lists of advisees. Rev. Proc. 2008-20, 2008-1 C.B. 980; U.S. Dep't of the Treasury Internal Revenue Serv., I.R.S. Form 13976: Itemized Statement Component of Advisee List (Apr. 2008), *available at* http://www.irs.gov/pub/irs-pdf/f13976.pdf.

109. Treas. Reg. § 301.6112-1(b)(3)(iii)(A)–(B) (requiring production of "a copy of any designation agreement . . . to which the material advisor is a party; and [c]opies of any additional written materials, including tax analyses or opinions, relating to each reportable transaction that are material to an understanding of the purported tax treatment or tax structure of the transaction that have been shown or provided to any person who acquired or may acquire an interest in the transactions, or to their representatives, tax advisors, or agents, by the material advisor or any related party or agent of the material advisor").

110. *Id.* § 301.6112-1(d); I.R.C. § 6112(b)(1)(B).

111. I.R.C. § 6708(a)(1) (Westlaw 2004); Treas. Reg. § 301.6112-1(e)(1).

112. Treas. Reg. § 301.6112-1(f).

113. *Id.* § 301.6112-1(e)(2).

114. *See* U.S. Dep't of the Treasury Internal Revenue Serv., I.R.S. Instructions to Form 8886 (Mar. 2011), *available at* http://www.irs.gov/pub/irs-pdf/i8886.pdf.

The disclosure forms are not merely onerous, they are also unforgiving. Penalties may be imposed if the taxpayer or material advisor attempts to comply but does not adequately complete the disclosure forms—despite making a good faith effort to do so. A Chief Counsel Advice (CCA)[115] provides the following example: the taxpayer is a partnership with no corporate partners that incurs a § 165 loss of $50 million on the sale of property and the loss is not excluded by the Angel List.[116] The taxpayer attaches a Form 8886, which states that the taxpayer claimed a loss in excess of the $2 million threshold, rather than stating the exact amount of the loss.[117] According to the IRS, this disclosure fails to comply with the requirements of the Regulations because the exact amount of the loss was not stated, despite the fact that the amount of the loss is presumably reported on the return to which the disclosure statement is attached.[118]

Knowing when a particular loss transaction must be disclosed may depend on whom you represent. For pass-through entities, individual partners or members may have different reporting requirements, and the reporting of the individual partners or members may be different from each other and from that of the entity.[119] For example, if a partnership claimed a $12 million loss in a transaction and each of the two corporate partners claimed a $6 million loss,[120] the loss exceeded the $2 million threshold for the partnership, but not the $10 million threshold for corporate partners. Thus, the partnership has a reporting obligation but the partners do not.[121]

Another example illustrates the potentially different reporting requirements of partners with different interests. If a partnership claimed a $3 million loss, and Partner 1 had a 90% interest and Partner 2 had a 10% interest, the partnership and Partner 1 will have to report the transaction, but Partner 2 will not.[122]

Because identifying loss transactions that are reportable can be difficult, taxpayers and advisors have the option of protectively disclosing transactions they are uncertain about in order to avoid penalties. The Regulations allow protective disclosures, which permit a taxpayer or material advisor to disclose the transaction by including a banner stating "Protective Disclosure" across the top of the disclosure form that is being filed on a protective basis.[123] A protective disclosure is not likely to save

115. CCA materials are written advice or instructions prepared by the Office of Chief Counsel and issued to field or service center employees of the IRS or Office of Chief Counsel. *See* IRM 33.1.2.2 (June 2, 2014); IRM 33.1.3.1 (July 5, 2011).

116. I.R.S. Chief Couns. Mem. 2010-45-022, at 9 (Nov. 12, 2010), *available at* http://www.irs.gov/pub/irs-wd/1045022.pdf.

117. *Id.*

118. *Id.*

119. *See* Megan L. Brackney, *Reporting Loss Transactions for Partnerships*, J. Passthrough Entities 41, 43 (Jan.–Feb. 2014), *available at* http://www.kflaw.com/siteFiles/News/2FB05F01368CEC959456ED1A69A5C871.pdf.

120. *Id.* at 43–44.

121. Treas. Reg. § 1.6011-4(b)(5)(i) (Westlaw 2010); *see* I.R.S. Chief Couns. Mem. 2010-45-022, at 6.

122. *See* I.R.S. Chief Couns. Mem. 2010-45-022, at 7–8.

123. Treas. Reg. § 1.6011-4(f)(2).

resources because it still must be a complete disclosure. The IRS will not treat a protective disclosure statement any differently than other disclosure statements and, if the requested information is not provided on the form, the disclosure will not be considered adequate if the filing is ultimately required.[124]

The CCA provides an illustration of the IRS's view on protective disclosure. In this example, the taxpayer is the top-tier of a tiered investment partnership (e.g., a "fund of funds" or "master-feeder fund") with some non-corporate partners.[125] The lower-tiered entities of the taxpayer engage in numerous transactions that result in § 165 losses exceeding $2 million.[126] The partners of the lower-tiered entities may not have the resources or ability to determine which of these transactions are reportable as to the lower-tiered partnership or its partners. In this situation, one might think that the IRS would accept the Form 8886 filed by the taxpayer (the top-tier partnership) and attach it to the returns of the lower-tiered partnerships and its partners as an adequate protective disclosure. However, in the CCA, the IRS stated that the lower-tiered entities have not complied with their disclosure obligations under these circumstances.[127]

A taxpayer or material advisor may also submit a request to the IRS for a ruling as to whether a transaction must be disclosed.[128] The request must be filed on or before the due date for the disclosure statement, and must fully disclose all of the relevant facts relating to the transaction.[129] "The potential obligation of the [taxpayer] to disclose the transaction . . . will not be suspended during the period that the ruling request is pending."[130] Thus, this procedure is of limited utility.

Finally, if the advisor ceases his relationship with the taxpayer, it may be difficult to know whether or when to report a transaction because the advisor may not know, or be able to find out, if the taxpayer actually engaged in the transaction or whether the transaction ultimately generated a tax loss. The IRS's only response to these concerns is to state that material advisors "who cease providing services prior to the time the transaction is entered into, must make reasonable and good faith efforts to determine whether the taxpayer entered into the transaction."[131] Since acting reasonably and in good faith is not necessarily a defense to penalties, this advice is not particularly comforting to the former advisor. Similarly, the IRS does not address how a material advisor who has stopped working with a client can be expected to know whether a transaction he advised later became reportable after the relationship ended.

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124. I.R.S. Chief Couns. Mem. 2010-45-022, at 8.

125. *Id.*

126. *Id.*

127. *Id.*

128. Treas. Reg. §§ 301.6011-3(h), 301.6011-4(f)(1) (Westlaw 2010).

129. *Id.* §§ 301.6111-3(h), 301.6011-4(f)(1).

130. *Id.* §§ 301.6111-3(h), 301.6011-4(f)(1).

131. I.R.S. Notice 2005-22, 2005-1 C.B. 756.

IV. PENALTIES FOR FAILURE TO COMPLY WITH THE REPORTABLE TRANSACTION RULES

This section describes the penalties against taxpayers and material advisors who do not properly disclose their reportable transactions, as well as the procedures for assessing those penalties.

A. Penalties Against the Taxpayer for Failure to Disclose

It may be a surprise to learn that failure to comply with the disclosure rules, which are exceedingly complex and time-consuming, is subject to strict liability penalties under § 6707A.[132] Accordingly, no defense to penalties based on reasonable cause or good faith exists. These strict liability penalties may be imposed regardless of whether there is any tax liability arising from the reportable transaction because Congress believed that making the penalty independent from the underlying tax treatment would provide an additional incentive for taxpayers and advisors to comply with the Jobs Act disclosure provisions.[133]

Penalties under § 6707A are cumulative, meaning that they can be assessed in addition to any other penalties imposed.[134] If the taxpayer fails to attach Form 8886 to an original or amended return, and fails to provide a copy of the required disclosure statement to the OTSA, the taxpayer will be subject to a single § 6707A penalty.[135] But, if the taxpayer subsequently files an amended return for the same tax year, and again fails to attach Form 8886, the taxpayer will be subject to an additional penalty.[136] Moreover, persons who are required to file reports with the U.S. Securities and Exchange Commission, and are required to pay penalties for their failure to disclose a reportable transaction, must disclose those penalties to the Commission.[137] Failure to do so is treated as a separate failure to disclose a reportable transaction.[138]

For penalties assessed after December 31, 2006, the penalty for failure to disclose a reportable transaction (including a listed transaction) is "75 percent of the decrease in tax shown on the return as a result of such transaction (or which would have resulted from such transaction if such transaction were respected for Federal tax purposes)."[139]

132. I.R.C. § 6707A(a) (Westlaw 2010).

133. H.R. Rep. 108-393, at tit. III (2003).

134. I.R.C. § 6707A(f).

135. Treas. Reg. § 301.6707A-1(c)(2), Example 1 (Westlaw 2011); I.R.C. § 6707A(f).

136. *See* Treas. Reg. § 301.6707A(c)(2), Example 3; *see also* I.R.C. § 6707A(f).

137. I.R.C. § 6707A(e).

138. *Id.*; *see* Rev. Proc. 2005-51, 2005-2 C.B. 296, § 2.04, *amplified by* Rev. Proc. 2007-25, 2007-1 C.B. 761.

139. I.R.C. § 6707A(b)(1). Under § 6707A(b), as in effect prior to amendment, the maximum penalty for failure to disclose a reportable transaction was $10,000 for a natural person, and $50,000 in any other case. I.R.C. § 6707A(b)(2)(B), *amended by* Small Business Jobs Act of 2010, Pub. L. No. 111-240, 124 Stat. 2504. The maximum penalty for failure to disclose a listed transaction was $100,000 for a natural person and $200,000 in any other case. *Id.* § 6707A(b)(2)(A). Because the 2010 amendment applies to any § 6707A penalty assessed after December 31, 2006, the IRS may reassess penalties in past cases. *See* Small Business Jobs Act, § 2041(b). However, until the IRS has developed a protocol for reassessing penalties, revenue agents are not processing these reassessments until further notice. Cheryl P.

As noted, the assessment of this penalty does not require an IRS determination of a tax deficiency.[140] Rather, the IRS will compare the amount of tax that would have resulted had the transaction not taken place with the amount of tax reported on the return, and will assess a penalty of 75% of the difference.[141]

The § 6707A penalty has a ceiling and a floor. First, the penalty cannot exceed $200,000 ($100,000 in the case of a natural person) for failure to disclose a listed transaction, or $50,000 ($10,000 in the case of a natural person) for failure to disclose any other reportable transaction.[142] Second, the penalty cannot be less than $10,000 ($5,000 in the case of a natural person).[143] Accordingly, as an example, unless the IRS agrees to rescind the penalty (a process discussed below), a taxpayer partnership that has engaged in a reportable loss transaction but failed to file or send Form 8886 to the OTSA is subject to a penalty of between $10,000 and $50,000 per violation.

B. Penalties Against Material Advisors for Failure to Disclose

The penalties against material advisors are also strict liability penalties and apply whether or not there is a tax deficiency.[144] For returns due after October 22, 2004, under § 6707, a material advisor who is required to file a return under § 6111(a) with respect to a reportable transaction is subject to a penalty of $50,000 for failure to timely file such return or for filing a return containing false or incomplete information.[145] The § 6707 penalty is increased if the reportable transaction is a listed transaction, in which case the penalty is "the greater of $200,000, or 50 percent of the gross income derived by such person with respect to the given aid, assistance, or advice provided with respect to the listed transaction before the date the return is filed under section 6111."[146] If the failure or action upon which the penalty is based is intentional, the penalty increases to the greater of $200,000 or 75% of the gross income so derived.[147] Intentional (in this context) means that the material advisor knew that disclosure was required but consciously chose not to file Form 8918, or the material advisor filed the form knowing that it was false or incomplete.[148]

Claybough, *Large Business and International Division Memorandum: Amended IRS Section 6707A Penalty—Interim Procedures*, LB&I- 20-0211-001, U.S. Dep't Treasury (Jan. 19, 2011).

140. *See* I.R.C. § 6707A(a).

141. *Id.* § 6707A(b)(1).

142. *Id.* § 6707A(b)(2).

143. *Id.* § 6707A(b)(3).

144. *See id.* § 6707(a) (Westlaw 2004).

145. *Id.* § 6707(a), (b)(1)–(2); Treas. Reg. § 301.6707-1(a)(1)(i) (Westlaw 2014).

146. I.R.C. § 6707(b)(2); Treas. Reg. § 301.6707-1(a)(1)(ii). The gross income derived from providing aid, assistance, or advice includes income received before the October 22, 2004 effective date of the Jobs Act. I.R.S. Chief Couns. Mem. 2010-21-021 (May 28, 2010).

147. I.R.C. § 6707(b)(2); Treas. Reg. § 301.6707-1(a)(1)(B).

148. Treas. Reg. § 301.6707-1(b)(4).

The IRS has taken the position that it may aggregate fees derived by a material advisor from each taxpayer even though such fees may not be aggregated for purposes of determining whether an advisor meets the threshold amount under § 6111.[149] Moreover, all gross income derived with respect to a listed transaction, including all transactions substantially similar to the listed transactions—even those for which the advisor did not meet the gross income threshold—is includible in the calculation of the § 6707 penalty.[150]

C. Rescission of §§ 6707 and 6707A Penalties

There is no reasonable cause exception in §§ 6707 or 6707A,[151] which creates strict liability penalties that the IRS can impose any time there is a violation. Treasury recently issued Regulations, which provide that information on Form 8918 will not be considered false or incomplete if the material advisor completes the form to the best of his ability and acts with reasonable care.[152] This language suggests that, despite the lack of a reasonable cause defense in the statute itself, the IRS may be willing to forgo the penalty if an advisor can demonstrate reasonable cause.[153]

Nevertheless, the penalties cannot be challenged in tax court.[154] The only judicial review available is for a taxpayer or material advisor to pay the penalty and then sue for a refund in district court.[155] However, the review will be limited to whether the transaction was a reportable transaction or whether the party was a material advisor, as the IRS's decision to impose or rescind penalties is not subject to judicial review.[156]

The IRS has the authority to rescind all or a portion of the penalty if: (1) the violation relates to a reportable transaction that is not a listed transaction; and (2) rescission promotes compliance with the IRC and effective tax administration.[157] To determine whether to rescind the penalty, the IRS will consider all of the facts and circumstances, including whether: (1) the taxpayer or material advisor corrected the failure to disclose the reportable transaction upon becoming aware of such failure; (2) the failure was due to a reasonable mistake of fact; (3) the taxpayer or material advisor has a history of compliance with the reporting and disclosure requirements and other tax laws; (4) the failure was caused by events not under the person's control; (5) the taxpayer or material advisor cooperates with the IRS; and (6) imposing the penalty

149. I.R.S. Chief Couns. Mem. 2010-21-021, at 4.

150. *Id.* at 3–4.

151. I.R.C. §§ 6707(a), 6707A(a) (Westlaw 2010).

152. Treas. Reg. § 301.6707-1(b)(2)–(3).

153. *See id.*

154. Smith v. Comm'r, 133 T.C. 424 (2009).

155. I.R.S. Chief Couns. Mem. 2006-46-016 (Nov. 17, 2006); *see* IRM 4.32.2.11.7.2 (June 8, 2012).

156. I.R.C. §§ 6707(c), 6707A(d)(2).

157. *Id.* § 6707A(d)(1); Treas. Reg. § 301.6707-1(e)(1).

would outweigh equity and good conscience.[158] The IRS will not consider uncollectability or economic hardship in deciding whether to rescind penalties.[159]

The rescission request must be made "in writing within 30 days after the date the [IRS] sends notice and demand for payment of the penalty."[160] Alternatively, if the taxpayer timely pays the penalty in full (not including interest), he will have thirty days from the date of payment to request rescission.[161] The IRS's decision to rescind the penalty in whole or in part is not reviewable by any court.[162]

D. Penalties for Failure to Comply with List Maintenance Requirements

Prior to the Jobs Act, the penalty for failure to comply with the list maintenance rules was $50 for each person not properly included on a list, with a maximum penalty of $10,000 per advisor per calendar year.[163] The Jobs Act substantially increased this penalty.[164] For requests made after October 22, 2004, a material advisor who fails to comply with § 6112(a) is subject to a penalty of $10,000 for *each day* after the twentieth business day that the material advisor fails to provide the list.[165] There is no maximum penalty amount and thus, for example, if the material advisor failed to respond for thirty days after the deadline, the penalty could be $300,000. This penalty is also cumulative, meaning that it can be imposed along with any other penalty.[166] There is a reasonable cause exception to the imposition of the penalty,[167] but "a failure to maintain

158. Rev. Proc. 2007-21, § 4.04, 2007-1 C.B. 613; Treas. Reg. § 301.6707-1(e)(3)(i)–(vi).

159. Rev. Proc. 2007-21, § 4.06; Treas. Reg. § 301.6707-1(e)(5).

160. Rev. Proc. 2007-21, § 4.01.

161. *Id.*; Treas. Reg. § 301.6707-1(e)(2).

162. I.R.C. § 6707A(d)(2).

163. *Id.* § 6708(a)(1) (Westlaw 1986), *amended by* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 817, 118 Stat. 1418.

164. *See* American Jobs Creation Act of 2004, § 817.

165. I.R.C. § 6708(a)(1) (Westlaw 2004). Proposed regulations provide that the penalty will continue to accrue after the advisor has responded to the list maintenance request if the response was not made in good faith. Prop. Treas. Reg. § 301.6708-1(h), 78 Fed. Reg. 14939-01, 14941–42 (Mar. 8, 2013). The current penalty applies to a material advisor who fails to comply with a request for disclosure made after the enactment of the Jobs Act, regardless of whether that advisor was required to maintain such a list pursuant to the current or former versions of § 6112(a). I.R.S. Notice 2004-80, § 4(B), 2004-2 C.B. 963; *see* I.R.S. Tech. Adv. Mem. JCX-88-05, at 87–88 (Dec. 16, 2005).

166. I.R.C. § 6708(b).

167. *Id.* § 6708(a)(2); IRM 20.1.6.18.3 (Sept. 17, 2010); IRM 4.32.2.11.6.2(1)(D) (June 8, 2012). Proposed regulations contain guidance as to the standards for reasonable cause and identify, as the most important factor, the material advisor's good faith effort to comply with § 6112. Prop. Treas. Reg. § 301.6708-1(g). Good faith includes the material advisor's efforts to: (1) determine or assess status as a material advisor; (2) determine the information and documentation required to be maintained; (3) meet its obligations to maintain a readily-producible list; (4) make the list available to the IRS within the twenty-business day period (or any extended period); and (5) ensure that the list furnished to the IRS is accurate and complete. *Id.*

a required list [will not be considered] reasonable cause for failing to make the list available to the IRS."[168]

V. CONCLUSION AND SUGGESTIONS FOR IMPROVEMENT

The vast majority of reportable transactions that have been disclosed since the Jobs Act have been non-abusive loss transactions. This suggests that a taxpayer or material advisor could be subject to strict liability for penalties for their failure to report a transaction for which no additional tax will be assessed and which is of little or no interest to the IRS. To avoid the possibility of penalties, responsible taxpayers and advisors who seek to comply with the loss reporting rules are saddled with enormous costs and risks of compliance. The time has come for the IRS and Congress to reconsider the loss transaction category and think about ways to lessen the burden of compliance and/or penalties related to these transactions.

The IRS's continued efforts to reduce the reporting of certain transactions through the Angel Lists have been helpful—particularly with respect to the "Other Losses" category, which clearly identify eleven types of losses that are not abusive.[169] The exemption from disclosure for assets with qualifying basis is also helpful, but it could go much further and allow specified interests in pass-through entities to have qualifying basis as well. Also, it may be time to consider raising the loss thresholds so that fewer transactions are reported. The IRS should take a closer look at the reports of loss transactions that it has received so far to determine which categories of non-abusive transactions are being reported under the current regime. The IRS should then attempt to craft additional exceptions for the Angel List.

Other quick fixes exist to alleviate the burdens of compliance. For example, the IRS could relax the reporting rules so that partners can satisfy their reporting requirements by attaching the partnership's Form 8886 to their returns, as opposed to each partner filing a unique form with each return. Additionally, the IRS could allow taxpayers and material advisors to make less detailed protective disclosures. Given the serious penalties, costs of compliance, and the burden of sifting through the disclosure of non-abusive transactions, it is time for creative thinking by Treasury, the IRS, and practitioners who advise in this area to improve the procedures for reporting loss transactions.

168. Iantosca v. Benistar Admin. Servs., No. 08-11785-NMG, 2012 U.S. Dist. LEXIS 20693, at *37 (D. Mass. Feb. 17, 2012) (quoting H.R. Rep. No. 108-548(I), at n.273 (2004)).

169. Rev. Proc. 2013-11, § 4.03, 2013-2 I.R.B. 269.