

**DESCRIPTION OF PROPOSALS IN S. 2498,
THE “TAX SHELTER TRANSPARENCY ACT”**

Scheduled for a Markup
By the
SENATE COMMITTEE ON FINANCE
on June 13, 2002

Prepared by
the Staff of the
JOINT COMMITTEE ON TAXATION



June 11, 2002
JCX-53-02

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup on June 13, 2002, of S. 2498, the “Tax Shelter Transparency Act.” This document¹, prepared by the staff of the Joint Committee on Taxation, provides a description of S. 2498, the “Tax Shelter Transparency Act”.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of S. 2498, the “Tax Shelter Transparency Act,”* (JCX-53-02), June 11, 2002.

I. PROPOSALS RELATING TO THE TAX SHELTER TRANSPARENCY ACT

A. Penalty for Failure to Disclose Reportable Transactions (sec. 101 of the bill and new sec. 6707A of the Code)

Present Law

Regulations under section 6011 require corporate taxpayers to disclose with their tax return certain information with respect to each “reportable transaction” in which the corporate taxpayer participates.²

There are two categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to) a transaction that is specified by the Treasury as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a “listed transaction”). A corporation must disclose any listed transaction that is expected to reduce the taxpayer’s Federal income tax liability by more than \$1 million in any single taxable year or more than \$2 million in any combination of years.³

The second category of reportable transactions is transactions that are expected to reduce a taxpayer’s Federal income tax liability by more than \$5 million in any single year or \$10 million in any combination of years and that have at least two of the following characteristics: (1) the taxpayer has participated in the transaction under conditions of confidentiality; (2) the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained; (3) the promoters of the transaction have received or are expected to receive fees or other consideration with an aggregate value in excess of \$100,000, and such fees are contingent on the taxpayer’s participation; (4) the transaction results in a reported book/tax difference in excess of \$5 million in any taxable year; or (5) the transaction involves a person that the taxpayer knows or has reason to know is in a Federal income tax position that differs from that of the taxpayer (such as a tax-exempt entity or foreign person), and the taxpayer knows or has reason to know that such difference has permitted the transaction to be structured to provide the taxpayer with a more favorable Federal income tax treatment.⁴

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure may jeopardize the taxpayer’s ability to claim that any

² Temp. Treas. Reg. sec. 1.6011-4T; Prop. Treas. Reg. sec. 1.6011-4.

³ Temp. Treas. Reg. sec. 1.6011-4T(b)(2) and -(b)(4)(i).

⁴ Temp. Treas. Reg. sec. 1.6011-4T(b)(3)(i)(A)-(E). In certain circumstances, a taxpayer can avoid disclosure with respect to the second category of reportable transactions. *See* Temp. Treas. Reg. sec. 1.6011-4T(b)(3)(ii)(A)-(E).

income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.⁵

Description of Proposal

The proposal would create a new penalty for any person who fails to include with any return or statement any required information with respect to a reportable transaction. The new penalty would apply without regard to whether the transaction ultimately results in an understatement of tax and is in addition to any accuracy-related penalty that may be imposed.

The penalty for failing to disclose a reportable transaction is \$50,000. The amount is increased to \$100,000 if the failure is with respect to a listed transaction. For large entities and high net worth individuals, the penalty amount is doubled (i.e., \$100,000 for a reportable transaction and \$200,000 for a listed transaction). The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty could be rescinded only in exceptional circumstances. The authority to rescind the penalty could only be exercised by the Commissioner or a high-level designee within the Office of Tax Shelter Analysis -- the penalty could not be rescinded by a revenue agent, an appeals officer, or other IRS personnel. The decision to rescind a penalty would have to be accompanied by a record describing the facts and reasons for the action. There would be no taxpayer right to appeal a refusal to rescind a penalty. The IRS also would be required to prepare an annual report to Congress summarizing the application of the disclosure penalties.

A public entity that is subject to a penalty for failing to disclose a listed transaction (or is subject to an accuracy-related penalty for a nondisclosed listed transaction or a nondisclosed reportable transaction with a significant tax avoidance purpose⁶) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission ("SEC") (for such period as the Secretary shall specify). The proposal would treat any failure to disclose a transaction in reports to the SEC as a failure to disclose a listed transaction.

The proposal would define a "listed transaction" and a "reportable transaction" by reference to the definition given to these terms in Treasury regulations under section 6011. A "large entity" would be defined as any entity with gross receipts in excess of \$10 million in the year of the transaction or in the preceding year. A "high net worth individual" would be defined as any individual whose net worth exceeds \$2 million, based on the fair market value of the individual's assets and liabilities immediately before entering into the transaction.

⁵ Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith.

⁶ This category of transactions is described in greater detail below in connection with the proposal to modify the accuracy-related penalty to tax shelters.

Effective Date

The proposal would be effective for returns and statements the due date for which is after the date of enactment.

B. Modifications to the Accuracy-Related Penalties for Listed Transactions and Reportable Transactions Having a Significant Tax Avoidance Purpose (sec. 102 of the bill and secs. 6662 and 6664 of the Code)

Present Law

The accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (\$10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.⁷ The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.⁸

Special rules apply with respect to tax shelters.⁹ For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The understatement penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was “reasonable cause” for the underpayment and that the taxpayer acted in good faith.¹⁰ The relevant regulations provide that reasonable cause exists where the taxpayer “reasonably relies in good faith on an opinion based on a professional tax advisor’s analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged” by the IRS.¹¹

Description of Proposal

The proposal would modify the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new set of rules that would apply to listed transactions and

⁷ Sec. 6662.

⁸ Sec. 6662(d)(2)(B).

⁹ Sec. 6662(d)(2)(C).

¹⁰ Sec. 6664(c).

¹¹ Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

reportable transactions with a significant tax avoidance purpose.¹² The rate of the penalty and the defenses that would be available to avoid the penalty would vary depending on the type of transaction and on whether the transaction was adequately disclosed.

Under the proposal, a 20-percent penalty would apply to any understatement attributable to a listed transaction or a reportable transaction with a significant purpose of tax avoidance. The only exception to the penalty would be the reasonable cause and good faith exception of section 6664(c). Under the proposal, the reasonable cause exception would apply only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed treatment, and the taxpayer reasonably believed that the claimed treatment was more likely than not the proper treatment.

If the taxpayer does not adequately disclose the transaction, the reasonable cause and good faith exception would not be available, and a higher penalty rate would apply. If the understatement is attributable to an undisclosed listed transaction, the penalty rate would be increased to 30 percent. For understatements attributable to an undisclosed reportable transaction with a significant tax avoidance purpose, the penalty rate would be increased to 25 percent. Rules are provided that would coordinate the interaction of this penalty with the understatement penalty and the fraud penalty.

Reportable transactions that are not listed transactions and do not have a significant purpose of tax avoidance would be subject to the general rules regarding substantial understatements.

The calculation of any penalty arising from a listed or reportable transaction with a tax avoidance purpose would be based on the amount of the understatement attributable to the transaction (without regard to other items on the tax return). Thus, the amount of the understatement would be determined as the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item.¹³

The proposal would clarify what constitutes "reasonable belief," and would provide that a reasonable belief will exist with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised. The proposal also sets forth certain criteria regarding the quality of the legal opinion being relied upon, as well as the independence of the advisor who is providing the legal opinion, in establishing whether a

¹² The terms "reportable transaction" and "listed transaction" have the same meanings as previously described in connection with the disclosure provision.

¹³ For this purpose, any reduction in a loss would be treated as an increase in taxable income.

taxpayer had a reasonable belief that the tax treatment was more likely than not the correct treatment.

Effective Date

The proposal would be effective for taxable years ending after the date of enactment.

**C. Modifications to the Substantial Understatement Penalty
(sec. 103 of the bill and sec. 6662 of the Code)**

Present Law

Definition of substantial understatement

An accuracy-related penalty equal to 20 percent applies to any substantial understatement of tax. A “substantial understatement” exists if the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (\$10,000 in the case of most corporations).¹⁴

Reduction of understatement for certain positions

For purposes of a penalty that is attributable to a substantial understatement of tax, the amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.¹⁵

The Secretary is required to publish annually in the Federal Register a list of positions for which the Secretary believes there is not substantial authority and which affect a significant number of taxpayers.¹⁶

Description of Proposal

Definition of substantial understatement

The proposal would modify the definition of “substantial” for corporate taxpayers. Under the proposal, a corporate taxpayer would have a substantial understatement 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 million.

Reduction of understatement for certain positions

The proposal would elevate the standard that a taxpayer must satisfy in order to reduce the amount of an understatement for undisclosed items. With respect to the treatment of an item whose facts are not adequately disclosed, the understatement would be reduced only if the taxpayer had a reasonable belief that the tax treatment was more likely than not the proper treatment. The proposal also would authorize (but not require) the Secretary to publish a list of

¹⁴ Sec. 6662(a) and -(d)(1)(A).

¹⁵ Sec. 6662(d)(2)(B).

¹⁶ Sec. 6662(d)(2)(D).

positions for which it believes there is not substantial authority or there is no reasonable belief that the tax treatment is more likely than not the proper treatment (without regard to whether such positions affect a significant number of taxpayers).

Effective Date

The proposal is effective for taxable years beginning after date of enactment.

**D. Tax Shelter Exception to Confidentiality Privileges
Relating to Taxpayer Communications
(sec. 104 of the bill and sec. 7525 of the Code)**

Present Law

In general, a common law privilege of confidentiality exists for communications between an attorney and client with respect to the legal advice the attorney gives the client. The Code provides that, with respect to tax advice, the same common law protections of confidentiality that apply to a communication between a taxpayer and an attorney also apply to a communication between a taxpayer and a federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. This rule is inapplicable to communications regarding corporate tax shelters.

Description of Proposal

The proposal would modify the rule relating to corporate tax shelters by making it applicable to all tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt entities, or any other entity. Accordingly, communications with respect to tax shelters would not be subject to the confidentiality provision of the Code that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner.

Effective Date

The proposal would be effective with respect to communications made on or after the date of enactment.

**E. Disclosure of Reportable Transactions by Material Advisors
(secs. 201 and 202 of the bill and secs. 6111 and 6707 of the Code)**

Present Law

Registration of tax shelter arrangements

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.¹⁷ A “tax shelter” means any investment with respect to which the tax shelter ratio¹⁸ for any investor as of the close of any of the first five years ending after the investment is offered for sale may be greater than two to one and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State securities agency, or (3) a substantial investment (greater than \$250,000 and at least five investors).¹⁹

Other promoted arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of Federal income tax by a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the promoter may receive fees in excess of \$100,000 in the aggregate.²⁰

A transaction has a “significant purpose of avoiding or evading Federal income tax” if the transaction: (1) is the same as or substantially similar to a “listed transaction,”²¹ or (2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.²² Certain exceptions are provided with respect to the second category of transactions.²³

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows, or has reason to know that a party

¹⁷ Sec. 6111(a).

¹⁸ The tax shelter ratio is, with respect to any year, the ratio that the aggregate amount of the deductions and 350 percent of the credits, which are represented to be potentially allowable to any investor, bears to the investment base (money plus basis of assets contributed) as of the close of the tax year.

¹⁹ Sec. 6111(c).

²⁰ Sec. 6111(d).

²¹ Temp. Treas. Reg. sec. 301.6111-2T(b)(2).

²² Temp. Treas. Reg. sec. 301.6111-2T(b)(3).

²³ Temp. Treas. Reg. sec. 301.6111-2T(b)(4).

other than the potential participant claims that the transaction (or any aspect of it) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use.²⁴

Failure to register tax shelter

The penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or \$500.²⁵ However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of \$10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

Section 6707 also imposes (1) a \$100 penalty on the promoter for each failure to furnish the investor with the required tax shelter identification number, and (2) a \$250 penalty on the investor for each failure to include the tax shelter identification number on a return.

Description of Proposals

Disclosure of reportable transactions by material advisors

The proposal would repeal the present law rules with respect to registration of tax shelters. Instead, the proposal would require each material advisor with respect to any reportable transaction²⁶ to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe). The return must be filed on such date as prescribed by the Secretary.

The information return would include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe.

A “material advisor” means any person (1) who provides material aid, assistance, or advice with respect to promoting, selling, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income in excess of \$250,000 (\$50,000 in the case of a

²⁴ The regulations provide that the determination of whether an arrangement is offered under conditions of confidentiality is based on all the facts and circumstances surrounding the offer. If an offeree’s disclosure of the structure or tax aspects of the transaction are limited in any way by an express or implied understanding or agreement with or for the benefit of a tax shelter promoter, an offer is considered made under conditions of confidentiality, whether or not such understanding or agreement is legally binding. Treas. Reg. sec. 301.6111-2T(c)(1).

²⁵ Sec. 6707.

²⁶ A reportable transaction (which would include a listed transaction) has the same meaning as previously described in connection with the taxpayer-related provisions.

reportable transaction substantially all of the tax benefits from which are provided to natural persons) for such advice or assistance.

Penalty for failing to furnish information regarding reportable transactions

The proposal would repeal the present law penalty for failure to register tax shelters. Instead, the proposal would impose a penalty on any material advisor who fails to file an information return with respect to any reportable transaction, or who files a false or incomplete information return with the Secretary with respect to a reportable transaction. The amount of the penalty would be \$50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) \$200,000, or (2) 50 percent of the gross income of such person with respect to aid, assistance, or advice which is provided with respect to the reportable transaction before the date the return that includes the transaction is filed. Intentional disregard of the requirement to register a listed transaction increases the penalty to 75 percent of the gross income.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty could be rescinded only in exceptional circumstances. The authority to rescind the penalty could only be exercised by the Commissioner or a high-level designee within the Office of Tax Shelter Analysis -- the penalty could not be rescinded by a revenue agent, an appeals officer, or other IRS personnel. The decision to rescind a penalty would have to be accompanied by a record describing the facts and reasons for the action. There would be no right to appeal a refusal to rescind a penalty. The IRS also would be required to prepare an annual report to Congress summarizing the application of the information penalty.

The terms “reportable transaction” and “listed transaction” would have the same meaning as previously described in connection with the taxpayer-related provisions.

Effective Date

The proposal requiring disclosure of reportable transactions by material advisors would apply to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

The proposal imposing a penalty for failing to disclose reportable transactions would apply to returns the due date for which is after the date of enactment.

F. Investor Lists and Applicable Penalties
(secs. 201 and 203 of the bill and secs. 6112 and 6708 of the Code)

Present Law

Investor lists

A promoter must maintain (for a period of seven years) a list identifying each person who was sold an interest in any tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions).²⁷ Regulations under section 6112 provide that, in addition to the name, tax shelter identification number and other identifying information the promoter must include detailed information about the tax shelter (including details of the shelter and the expected tax benefits, as well as copies of any additional written material given to any participant or advisor).²⁸ A limited exception is provided for certain shelters if the total fees are less than \$25,000 or if the expected reduction in tax liabilities for any single year is less than \$1 million for corporations or \$250,000 for non-corporate taxpayers.²⁹

The Secretary is required to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.³⁰

Penalties for failing to maintain investor lists

Under section 6708, the penalty for failing to maintain the list required under section 6112 is \$50 for each name omitted from the list (with a maximum penalty of \$100,000 per year).

Description of Proposals

Investor lists

Under the proposal, each material advisor³¹ that is required to file an information return with respect to a reportable transaction³² would be required to maintain a list that (1) identifies

²⁷ Sec. 6112.

²⁸ See Temp. Treas. Reg. sec. 301.6112-1T Q&A 17.

²⁹ See Temp. Treas. Reg. sec. 301-6112-1T Q&A 8.

³⁰ Sec. 6112(c)(2).

³¹ The term “material advisor” has the same meaning as when used in connection with the requirement to file an information return under section 6111.

³² The term “reportable transaction” has the same meaning as previously described in connection with the taxpayer-related provisions.

each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the proposal would authorize the Secretary (but not require) to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.

Penalty for failing to maintain investor lists

The proposal would modify the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a person who is required to maintain an investor list and who fails to make the list available upon request by the Secretary within 20 business days after the request would be subject to a \$10,000 per day penalty. Thus, this penalty could apply when a person has failed to maintain a list, has maintained an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty could be waived if the failure to make the list available is due to reasonable cause.

Effective Date

The proposal requiring disclosure of reportable transactions by material advisors would apply to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

The proposal imposing a penalty for failing to maintain investor lists would apply to requests made after the date of enactment.

**G. Actions to Enjoin Conduct with Respect to Tax Shelters
(sec. 204 of the bill and sec. 7408 of the Code)**

Present Law

The Code authorizes civil actions to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.³³

Description of Proposal

The proposal would expand this rule so that injunctions may also be sought with respect to the requirements of the reporting of tax shelters³⁴ and of the keeping of lists of investors by the organizers and sellers of potentially abusive tax shelters.³⁵

Effective Date

The proposal would be effective on the day after the date of enactment.

³³ Code sec. 7408.

³⁴ Code sec. 6707, as amended by other provisions of this proposal.

³⁵ Code sec. 6708, as amended by other provisions of this proposal.

**H. Understatement of Taxpayer's Liability by Income Tax Return Preparer
(sec. 211 of the bill and sec. 6694 of the Code)**

Present Law

An income tax return preparer who prepares a return with respect to which there is an understatement of tax that is due to a position for which there was not a realistic possibility of being sustained on its merits and the position was not disclosed (or was frivolous) is liable for a penalty of \$250, provided that the preparer knew or reasonably should have known of the position. An income tax return preparer who prepares a return and engages in specified willful or reckless conduct with respect to preparing that return is liable for a penalty of \$1,000.

Description of Proposal

The proposal would alter the standards of conduct that must be met to avoid imposition of the first penalty. The proposal would replace the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment in the position was more likely than not the proper treatment. The proposal also would replace the not frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position.

In addition, the proposal would increase the amount of these penalties. The penalty relating to not having a reasonable belief that the tax treatment was more likely than not the proper tax treatment would be increased from \$250 to \$1,000. The penalty relating to willful or reckless conduct would be increased from \$1,000 to \$5,000.

Effective Date

The proposal would be effective for documents prepared after the date of enactment.

**I. Penalty on Failure to Report
Interests in Foreign Financial Accounts
(sec. 212 of the bill)**

Present Law

The Secretary of the Treasury must require citizens, residents, or persons doing business in the United States to keep records and file reports when that person makes a transaction or maintains an account with a foreign financial entity.³⁶ In general, individuals must fulfill this requirement by answering questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B of the IRS Form 1040. Taxpayers who answer “yes” in response to the question regarding foreign accounts must then file Treasury Department Form TD F 90-22.1. This form must be filed with the Department of the Treasury, and not as part of the tax return with the IRS.

The Secretary of the Treasury may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of \$100,000; the minimum amount of the penalty is \$25,000.³⁷ In addition, any person who willfully violates this reporting requirement is subject to a criminal penalty. The criminal penalty is a fine of not more than \$250,000 or imprisonment for not more than five years (or both); if the violation is part of a pattern of illegal activity, the maximum amount of the fine is increased to \$500,000 and the maximum length of imprisonment is increased to 10 years.³⁸

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.³⁹ This report, which was statutorily required,⁴⁰ studies methods for improving compliance with these reporting requirements. It makes several administrative recommendations, but no legislative recommendations. A further report is required to be submitted by the Secretary of the Treasury to the Congress by October 26, 2002.

Description of Proposal

The proposal would add an additional civil penalty that may be imposed on any person who violates this reporting requirement (without regard to willfulness). This new civil penalty

³⁶ 31 U.S.C. 5314.

³⁷ 31 U.S.C. 5321(a)(5).

³⁸ 31 U.S.C. 5322.

³⁹ *A Report to Congress in Accordance with Sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001*, April 26, 2002.

⁴⁰ Sec. 361(b) of the USA PATRIOT Act of 2001 (Pub. L. 107-56).

would be \$5,000. The penalty could be waived if any income from the account was properly reported on the income tax return and there was reasonable cause for the failure to report.

Effective Date

The proposal would be effective with respect to failures to report occurring on or after the date of enactment.

J. Frivolous Tax Returns and Submissions
(sec. 213 of the bill and sec. 6702 of the Code)

Present Law

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of \$500 imposed by the IRS (sec. 6702). The Code also permits the Tax Court⁴¹ to impose a penalty of up to \$25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless (sec. 6673(a)).

Description of Proposal

The proposal would modify the IRS-imposed penalty by increasing the amount of the penalty to up to \$5,000 and by applying it to all taxpayers and to all types of Federal taxes.

The proposal would also modify present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration. The submissions to which this provision would apply are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the provision would permit the IRS to dismiss such requests. Second, the provision would permit the IRS to impose a penalty of up to \$5,000 for such requests, unless the taxpayer withdraws the request after being given an opportunity to do so.

The proposal would require the IRS to publish a list of positions, arguments, requests, and proposals determined to be frivolous for purposes of these provisions.

Effective Date

The proposal would be effective for submissions made and issues raised after the date on which the Secretary first prescribes the required list.

⁴¹ Because in general the Tax Court is the only pre-payment forum available to taxpayers, it deals with most of the frivolous, groundless, or dilatory arguments raised in tax cases.

**K. Regulation of Individuals Practicing Before the Department of the Treasury
(sec. 214 of the bill and sec. 330 of Title 31, United States Code)**

Present Law

The Secretary of the Treasury is authorized to regulate the practice of representatives of persons before the Department of the Treasury.⁴² The Secretary is also authorized to suspend or disbar from practice before the Department a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented). The rules promulgated by the Secretary pursuant to this provision are contained in Circular 230.

Description of Proposal

The proposal would make two modifications to expand the sanctions that the Secretary may impose pursuant to these statutory provisions. First, the proposal would expressly permit censure as a sanction. Second, the proposal would permit the imposition of a monetary penalty as a sanction. If the representative is acting on behalf of an employer or other entity, the Secretary may impose a monetary penalty on the employer or other entity if it knew, or reasonably should have known, of the conduct. This monetary penalty on the employer or other entity may be imposed in addition to any monetary penalty imposed directly on the representative. These monetary penalties are not to exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. These monetary penalties may be in addition to, or in lieu of, any suspension, disbarment, or censure.

The proposal would also confirm the present-law authority of the Secretary to impose standards applicable to written advice with respect to an entity, plan, or arrangement that is of a type that the Secretary determines as having a potential for tax avoidance or evasion.

Effective Date

The modifications to expand the sanctions that the Secretary may impose would be effective for actions taken after the date of enactment.

⁴² 31 U.S.C. 330.

**L. Penalties on Promoters of Tax Shelters
(sec. 215 of the bill and sec. 6700 of the Code)**

Present Law

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.⁴³ A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A “gross valuation overstatement” means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

The amount of the penalty is \$1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity). A penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

Description of Proposal

The proposal would modify the penalty amount to equal 50 percent of the gross income derived by the person from the activity for which the penalty is imposed. The new penalty would apply to any activity that involves a statement regarding the tax benefits of participating in a plan or arrangement if the person knows or has reason to know that such statement is false or fraudulent as to any material matter. The enhanced penalty would not apply to a gross valuation overstatement.

Effective Date

The proposal would be effective for activities after the date of enactment.

⁴³ Sec. 6700.