SBCA LAUDS CONGRESSIONAL LEADERS & THE IRS FOR PROTECTING AMERICA'S SMALL BUSINESSES AND ENCOURAGES EFFORTS TO ENACT CORRECTIVE SECTION 6707A LISTED TRANSACTION PENALTY LEGISLATION

The Small Business Council of America lauds Congressional leaders for taking courageous, bipartisan and bicameral action to protect America's small businesses from the unintended consequences of a 2004 law aimed at stopping abuses by major corporations. The action by the Congressmen came in a June 12, 2009 letter to IRS Commissioner Douglas Shulman. The signers were Senators Max Baucus (D-Mont.) and Charles Grassley (R-Iowa) and Representatives John Lewis (D-Ga.) and Charles Boustany, Jr. (R-La). On July 6, 2009 IRS Commissioner Shulman responded by stating that the IRS will suspend collection efforts and enforcement action in cases where the tax benefits resulting from the listed transactions are less than $100,000 for individuals and $200,000 for other taxpayers until September 30, 2009, giving Congress time to enact legislation modifying Internal Revenue Code section 6707A .

The Small Business Council of America (SBCA) is the only national nonprofit organization whose sole purpose is to represent the interests of privately and family-owned business in federal income and estate tax, health care, pension and other employee benefit matters. The primary goal of the SBCA is to support legislation that creates important economic incentives and to oppose burdensome laws and proposals that negatively affect America's small businesses and their owners.

The SBCA has pledged its encouragement, support and assistance in working with Congress to assure America's small businesses and their owners of more just and reasonable application of the federal tax laws.

To that end the SBCA has prepared this position paper to foster and encourage the legislative initiatives that are presently being discussed in Congress.

BRIEF BACKGROUND

Section 6707A of the Internal Revenue Code ("section 6707A") was enacted in the American Jobs Creation Act of 2004 to shut down multi-million-dollar abusive tax shelter transactions by imposing a strict liability penalty on taxpayers unless they disclosed the transactions to the IRS. Section 6707A imposes a penalty of $100,000 per individual and $200,000 per entity for each failure to make special annual disclosure with their tax returns of Form 8886 (Reportable

Transaction Disclosure Statement) with respect to a transaction that the Treasury Department characterizes as a "listed transaction" or "substantially similar" to a listed transaction.

Under the law of unintended consequences, the IRS determined that certain retirement and welfare benefit plans that had been adopted by small businesses for their employees were abusive and deemed them "listed transactions" subject to taxpayer disclosure to avoid the penalty. The alleged tax benefits received from many of those retirement and welfare benefit plans were relatively small -- in the thousands of dollars, not the millions. Accordingly, the imposition of section 6707A penalties on small businesses and their owners were disproportionate to the tax benefit received when compared to the tax benefit realized by major corporations. Indeed, the failure to disclose penalties of 6707A apply even if the tax benefit is allowed upon audit or the taxpayer can demonstrate “reasonable cause” for the failure to make timely disclosure.

The SBCA has endorsed S765 and HR2143 which have been introduced to provide needed relief to small business.

The section 6707A penalty is in addition to a 30% accuracy related penalty imposed on the tax understatement relating to listed transactions under Section 6662A. The Section 6707A penalty under the current statute does not relate to the understatement of tax from the transaction. Accordingly, the combination of the sections 6662A and 6707A penalties can substantially exceed 100% of the understatement of tax resulting from a listed transaction.

The 6707A penalty applies regardless of the amount of understatement of tax, even if there are no additional taxes due after IRS examination, and even though the taxpayer can demonstrate “reasonable cause” for the failure to make timely disclosure. In other words, a transaction is reportable even though it is compliant with the tax law.

Existing section 6707A denies the Commissioner of Internal Revenue any discretion to abate the listed transaction penalty even though the taxpayer can demonstrate that disclosure was intended or that the taxpayer did not know that the taxpayer had entered into a listed transaction, and the taxpayer's advisors did not advise the taxpayer of the need to disclose the listed transaction or the taxpayer can demonstrate “reasonable cause” for the failure to make timely disclosure. Furthermore, unlike all other adverse determinations made by the Internal Revenue Service, existing Section 6707A does not grant a taxpayer due process of law because judicial review in the Tax Court is not allowed.

NATIONAL TAXPAYER ADVOCATE 2008 ANNUAL REPORT TO CONGRESS

The National Taxpayer Advocate 2008 Annual Report to Congress, at page 421, states:

> "Notwithstanding the underlying congressional intent in enacting Section 6707A, the statute as written can impose unconscionable hardship on taxpayers. Even the penalty for proven cases of civil fraud is capped at 75 percent of the tax underpayment. Yet this statute allows penalties of up to $300,000 per year to be

imposed on taxpayers with no underpayment of tax and no knowledge that they entered into transactions that the IRS has 'listed'. It is rare that a tax provision is found to violate the United States Constitution, but we believe that the imposition of such a large penalty on a taxpayer who entered into a transaction that produced little or even no tax savings and without regard to the taxpayer's knowledge or intent raises significant constitutional concerns, including possible violation of the Eighth Amendment's prohibition against excessive government fines and due process protections."

"In practice, the requirement that this penalty be imposed without regard to culpability may have the effect of bankrupting middle class families who had no intention of entering into a tax shelter - an outcome that has dismayed even hardened IRS enforcement personnel."

SBCA LEGISLATIVE RECOMMENDATIONS

The SBCA urges Congress to enact relief legislation that (1) provides an equitable penalty that is based on (and proportional to) the understatement of tax resulting from the Listed Transaction; (2) establishes a de minimis dollar amount of tax understatement before the penalty would apply; (3) affords judicial review to taxpayers by granting the Tax Court jurisdiction to determine whether or not a transaction is a listed transaction or one that is "substantially similar" to a listed transaction; (4) allows taxpayers who want to comply with the required disclosures and avoid the penalty for not filing the Form 8886 but missed the filing deadline to be able to file Form 8886 with the IRS, to comply by filing an amended tax return so long as the taxpayer has not had prior notice from the IRS of an examination of such return or notice that the IRS has begun an examination regarding such transaction of a material advisor or a promoter; and (5) grants to the Commissioner discretion to abate the penalty when the taxpayer can demonstrate substantial compliance with the disclosure requirements, a completed Global Settlement Initiative (Announcement 2005-80), or for owners or employees who were either not aware of or did not benefit from the Listed Transaction.

1. **PROPORTIONALITY TO TAX UNDERSTATEMENT – NOT PERMITTED TAX BENEFIT:** The SBCA understands that Congress intends to amend IRC Section 6707A to provide that the amount of penalty be proportional to the "tax benefit" realized by the taxpayer. SBCA further understands the Congress has been considering a penalty of 75% or less of such tax benefit.

   The SBCA further understands that Congress' use of the term "tax benefit" means the "reportable transaction understatement" as that term is defined in section 6662A(b). Accordingly, this Paper will use the term "tax understatement" to assure clarity. S765 introduced by Senator Ben Nelson (Nebraska) makes this very clear by imposing the section 6707A penalty as a percentage of the section 6662A(a) tax understatement penalty.

   The SBCA urges Congress to refer to "reportable transaction understatement" as

defined in section 6662A(b) or to the section 6662A(a) penalty in the corrective legislation as the measurement for the penalty. This assures taxpayers that the penalty can only be proposed once the IRS has completed its examination of a taxpayer's return and the questionable transaction.

SBCA is also concerned that the section 6707A penalty tax, when added to the existing 30% accuracy related penalty under section 6662A, can create an aggregate penalty far more than 100% of the reportable transaction on the tax understatement while taxpayers who commit civil tax fraud only pay a total 75% of the tax understatement.

- **The combined Listed Transaction penalties should be significantly less than the Civil Fraud Penalty:** Under the Internal Revenue Code, a taxpayer who willfully acts to evade tax and thereby commits civil fraud is penalized at 75% of the tax evaded (or tax understated).

  Our tax code and policy should not deem a taxpayer who acts on the advice trusted advisors, however misguided, to be the moral equivalent (or worse) than a person who is proven to have committed tax fraud.

- **SBCA recommends a 20% Listed Transaction penalty.** A 20% penalty of the tax understatement when added to the existing 30% accuracy related penalty under section 6662A would equal a combined penalty of 50% of the tax understatement. SBCA believes that the 20% penalty would be more in line with Congress' intentions.

  For example, a major corporate taxpayer that enters into a multi-million dollar listed transaction and fails to disclose and is assessed a $2,000,000 tax understatement due to the denial of the tax benefits by the IRS would be assessed a combined penalty of $1,000,000 ($400,000 Listed Transaction penalty plus $600,000 accuracy related penalty). A small business that invests in a listed transaction and fails to disclose and realizes a $75,000 tax understatement due to the denial of the tax benefits by the IRS would be assessed a combined penalty of $37,500 ($15,000 Listed Transaction penalty plus $22,500 accuracy related penalty).

  And, if the tax benefit to a small business was only $6,000, the combined penalty would be $3,000 as compared to at least $201,800 under current law ($200,000 section 6707A penalty and $1,800 section 6222A penalty). In such case, however, the SBCA believes that there should be no penalty. See, DE MINIMIS TAX UNDERSTATEMENT below.

- **SBCA would support a Listed Transaction penalty ceiling of $200,000 on major corporate transactions, provided that there is a substantially lower ceiling on small businesses and their owners of $25,000 and $10,000 for**

pass-through entities. We understand that there have been discussions of maintaining the existing $200,000 ceiling on the Listed Transaction penalty, notwithstanding the multi-million dollar amounts of questionable transactions engaged in by major corporations.

SBCA believes that the policy behind the annual ceiling was that the taxpayer was already subject to the 30% accuracy related penalty of section 6662A. Accordingly, in the spirit of proportionality, SBCA recommends that the ceiling of the Listed Transaction penalty for small business be $25,000 and $10,000 for pass-through entities that received no tax benefit, as described in more detail below, unless the tax understatement is de minimis as described below.

2. **DE MINIMIS TAX UNDERSTATEMENT OF $15,000 – NO PENALTY:** The section 6707A Listed Transaction penalty was intended to punish major corporate taxpayers who engaged in multi-million dollar tax motivated transactions which lacked economic substance and business purpose, The SBCA recognizes the importance of reporting requirements under section 6011 as a means for the IRS to conduct fact finding and discover tax abusive transactions.

   The SBCA believes that a questionable pension or welfare plan established by a small business which produces a de minimis tax understatement (defined as a tax understatement not in excess of $15,000) was not intended to be the kind of Listed Transaction that Congress intended to punish. Accordingly, the SBCA proposes that any Listed Transaction that produces a de minimis tax understatement ($15,000 or less) should be excepted from the section 6707A Listed Transaction penalty.

3. **PENALTY ON PASS-THROUGH ENTITIES LIMITED TO $10,000:** Pass-through entities, including S Corporations, partnerships and LLCs and LLPs (taxed as partnerships) do not derive any tax benefit from an alleged Listed Transaction because they do not incur a tax liability. Only the shareholders or partners or members can have a tax understatement due to the denial of tax benefits by the IRS for a Listed Transaction. Existing section 6707A provisions imposes a penalty of $200,000 at the entity level and $100,000 at the individual level. The IRS has applied this provision to impose a $200,000 penalty on pass-through entities in addition to the $100,000 penalty on each shareholder or partner.

   The SBCA understands that the entity that engages in an alleged Listed Transaction should be responsible for its actions, and therefore, should be subject to the penalty. Congress also understands the unfair penalty application to pass-through entities since the Listed Transaction penalty is also applied at the individual shareholder, partner or member level.

   Accordingly, in consideration of this inequitable result, the SBCA would endorse Congress' proposal to limit the Section 6707A penalty on pass-through entities to

$10,000 while applying the amended proportional penalty at the individual shareholder, partner or member level.

4. **CONSTITUTIONAL DUE PROCESS – RIGHT OF JUDICIAL REVIEW:** The U. S. voluntary tax system is unique and admired throughout the world. One of its most important tenets is the right of each taxpayer to judicial review of an adverse determination of tax issues by the Internal Revenue Service. Taxpayers have the right to file a lawsuit with the United States Tax Court and to receive an impartial adjudication of the tax controversy without first having to pay the assessed tax.

   This basic right is not available to taxpayers who are deemed to have engaged in an alleged Listed Transaction unless they pay the penalty and sue for refund. However, when the Listed Transaction penalty ranges from $200,000 to in excess of one million dollars on small businesses and their owners, the requirement of a taxpayer to pay the penalty and sue for at best a refund places a "chilling effect" on the taxpayer's constitutional right of due process of law under the Fifth and Eighth Amendments.

   Accordingly, the SBCA urges Congress to grant taxpayers subject to the Listed Transaction penalty the non-payment right of Tax Court review of an IRS determination that a transaction is a "Listed Transaction" or that it is "substantially similar". The phrase "substantially similar to a list transaction" is inherently vague. To assure a taxpayer of due process, a taxpayer should have fair and timely notice of any transaction that might result in a section 6707A penalty.

   The SBCA believes that judicial review is needed to cure these constitutional concerns and to provide a check and balance on the IRS' broad discretion to determine what is a listed transaction, and more importantly, what is "substantially similar" which makes the substantially similar transaction a listed transaction.

   The SBCA also urges Congress to consider requiring listed transactions to be designated either by Treasury Regulation where there is notice and an opportunity for public comment, or a requirement that upon designation of a transaction as a listed transaction, the characteristics of that transaction which would make another transaction substantially similar to it be stated and more importantly limited to the tax avoidance aspects of the listed transactions.

5. **COMMISSIONER DISCRETION:** Commissioner Shulman in his letter dated July 6, 2009 to Representative John Lewis (Georgia) stated that "…I am concerned that because the current statute applies uniformly without exceptions and without regard to the amount of tax in question, some taxpayers are caught in a penalty regime that the legislation did not intend." This statement along with Commissioner Shulman's previous comments before the House Ways and Means Subcommittee on Oversight, demonstrate the IRS's need and desire for discretion in applying the Listed Transaction penalty.

The SBCA supports Commissioner Shulman's efforts to be granted some discretion in the application of the penalty. However, the SBCA understands that Congress does not intend to consider "reasonable cause" as a means of abatement of the Listed Transaction penalty.

The SBCA continues to believe that a reasonable cause exception is eminently appropriate. However, if Congress is unwilling to take that approach, the SBCA would propose that at least the following discretion be granted to the Commissioner which is consistent with Commissioner Shulman's statements:

A. **Limited Discretion to Fully Waive or Reduce:** The Commissioner should be granted by statute limited discretion to waive or reduce the section 6707A (listed transaction) penalty in cases where:

- **The taxpayer demonstrates substantial compliance with the Section 6011 reporting requirements.** The SBCA is aware of many cases in which the penalty has been imposed where the disclosure Form 8886 (Reportable Transaction Disclosure Statement) (1) was filed but was incomplete; (2) was filed with the taxpayer's return, but not with the Office of Tax Shelter Analysis for the first year of the transaction; (3) was filed with the entity return, but not with the shareholder or partner return or vice versa; (4) was completely prepared but inadvertently not attached to the taxpayer's return. In such cases, the taxpayer has demonstrated intent to report, but failed to fully comply with all technical requirements.

- **The Taxpayer entered into the Global Settlement Initiative:** The SBCA is also aware of cases in which the 6707A penalty has been imposed after taxpayers voluntarily entered the IRS Global Settlement Initiative (Announcement 2005-80) on the published promise that all tax, interest and penalty liability would be settled by treating the alleged transaction as if it had never occurred and paying all taxes and interest and a 5% understatement accuracy penalty. In such cases, the taxpayer came forward in reliance on IRS representations that subsequently turned out to be inaccurate.

- **The Taxpayer is a Shareholder, Partner or Member not active in the Business or a Non-owner Employee:** The SBCA is also aware that with respect to pass-through entities with several shareholders, partners or members, each shareholder, partner or member has had the section 6707A penalty imposed on them. This has occurred even if the shareholder, partner or member was not active in the business and was not an active participant in (or even aware of) the transaction. It has even been imposed on minor children!

- **The Listed Transaction only benefited the Taxpayer's Non-Owner Employees:** The SBCA is also aware of at least one case in which the business owner established a plan which only benefited his employees and not himself.

B. **Timely Disclosure by filing Form 8886 with an Amended Return prior to IRS Notification of Taxpayer or Material Advisor Examination should be allowed and be effective to avoid the Listed Transaction Penalty:** Section 6011 provides for the filing of returns according to forms and regulations prescribed by the Secretary of the Treasury. Section 6011 is silent on "listed transaction" disclosures other than for tax-exempt entities. The proscribed disclosure return to be filed is Form 8886 (Reportable Transaction Disclosure Statement). The IRS currently takes the position that the failure to file Form 8886 with a timely filed tax return is fatal and cannot be later corrected by a taxpayer. Furthermore, when the IRS announces a new Listed Transaction, the taxpayer is given only 90 days from the date of the announcement to file Form 8886 with the Office of Tax Sheltered Analysis to report all prior tax years in which the taxpayer derived a tax benefit from the transaction. If the taxpayer fails to learn a transaction was listed until after the 90-day period expires, there is no way for the taxpayer to timely file and avoid the section 6707A penalty.

There are many taxpayers who want to comply with the reporting requirement, but if they are informed after the time proscribed by the IRS, the filing will be considered late and will subject them to the Listed Transaction penalty. Accordingly, these taxpayers are afraid to voluntarily comply with the reporting since it is their belief that to do so is the equivalent of a tax death sentence. Furthermore, the IRS' current position provides no incentive for them to come into filing compliance – they are already subject to the maximum non-waivable 6707A penalty regardless of whether they then file.

The SBCA believes that discouraging voluntary compliance by filing an amended return with the threat of a death sentence penalty is inconsistent with proper tax policy and administration. In all other matters under the tax law, taxpayers are encouraged and have the right to voluntarily correct a mistake by filing an amended tax return without the threat of a mandated penalty.

Accordingly, the SBCA urges Congress to allow taxpayers to file Form 8886 on an amended return, provided they do so before the earlier of the receipt of notice of examination from the IRS or notice to a material advisor or promoter of examination or filing of a John Doe summons. The SBCA believes that this right presents the IRS with ample time to complete an examination of the taxpayer's return and will increase the amount of voluntary reporting and will thereby increase compliance. An amended return would extend the statute of

limitations to the later of 3 years from the filing of the tax return or 2 years from the date of the amended return.

The Small Business Council of America (SBCA) is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, virtually all of which provide health insurance and retirement plans. The SBCA is proud to have many of the country's leading small business tax, healthcare and employee benefit advisors as members of its Board and Advisory Boards.

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