



Memorandum

Date: January 26, 2005
To: ECI
From: Bryan Cave LLP
Re: Amendments to Tax Shelter Penalty Provisions

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Introduction

By memorandum dated March 16, 2004, we outlined the provisions of Rev. Rul. 2004-20, 2004-10 IRB 546 (2/13/04) (“Rev. Rul. 2004-20”), and discussed alternatives available to employers that adopted a Section 412(i) plan (“412(i) plan”) as described in the Ruling regarding the employer’s compliance with the disclosure statement requirements under Treas. Reg. § 1.6011-4(a) and Form 8886. One of those alternatives included filing the disclosure statement with respect to the 412(i) plan as required under Treas. Reg. § 1.6011-4(a) on Form 8886. Another alternative included filing an amended return and reversing any deduction attributable to excess coverage under the 412(i) plan prior to the time a disclosure statement would otherwise have been required to be filed. We indicated that such an employer would have a reasonable position that it did not participate in a listed transaction and, therefore, would not be subject to the reporting requirements under Treas. Reg. § 1.6011-4. Finally, we indicated if the employer established the 412(i) plan in 2003, and never took an excess deduction as described in Rev. Rul. 2004-20, the employer should not be deemed to have engaged in a listed transaction subject to the reporting requirements under Treas. Reg. § 1.6011-4. With respect to each alternative, the memorandum correctly states, as of the date of the memorandum (March 16, 2004), that “[t]here are no specific monetary penalties if an employer does not file Form 8886 when required to do so.” However, due to a recent change in the law, with respect to tax returns and statements due after October 22, 2004, substantial penalties now apply if an employer does not file Form 8886 when required to do so.

This memorandum summarizes the alternatives available to an employer as discussed in the March 16, 2004 memorandum, and re-emphasizes some arguments available to the Internal Revenue Service (the “IRS”) regarding the employers’ potential obligation to file Form 8886 as required under Treas. Reg. § 1.6011-4 with respect to the second and third alternatives discussed above. This memorandum also outlines the penalties that may be imposed if an employer fails to meet its obligations. Each employer, however, should consult independent tax counsel to determine its specific filing and disclosure obligations. There are numerous ambiguities regarding the effect of the new law. Given the substantial penalties that may be imposed, however, each employer should have an analysis done regarding the potential application of the law to its particular circumstances.

Discussion

Alternative 1. Plans Established in 2003. No Excess Deduction Taken

A. Our Analysis

As provided in the March 16, 2004 memorandum, in light of Rev. Rul. 2004-3, it is clear that deducting contributions attributable to the cost of excess coverage is a listed transaction, so all employers should limit the deduction on their 2003 returns (and any future returns) for contributions to their 412(i) plan to those which are not attributable to excess coverage. For that reason, in the case of a 412(i) plan established in 2003, the employer would not take any deduction described in Rev. Rul. 2004-20, and, thus, would not engage in a listed transaction. While the employer would have to continue making nondeductible contributions in the future to properly fund the 412(i) plan, there is nothing in Rev. Rul. 2004-20 indicating that it would engage in a listed transaction as a result. The employer would, however, be subject to a penalty tax equal to 10% of the amount of the nondeductible contributions which would continue to be assessed each year until the amount in question can be deducted. Code Section 4972(a).

B. IRS Arguments

As stated in Footnote 2 of the March 16, 2004 memorandum, it is possible that the IRS could take the position that a listed transaction occurs if an employer deducts contributions used to pay any premiums on a life insurance policy providing excess coverage, even to the extent those premiums are not attributable to the cost of excess coverage. The applicable provision in Rev. Rul. 2004-20 states that there is a listed transaction if “the employer *has deducted amounts* used to pay premiums on a life insurance contract for a participant with a death benefit under the contract that exceeds the participant’s death benefit under the plan by more than \$100,000.” (emphasis added). This language is not explicitly limited to deductions attributable to the cost of excess coverage. The memorandum went on to provide, however, since the tax avoidance transaction identified by the IRS in Rev. Rul. 2004-20 is the deduction of contributions for excess coverage, *the better position* is that a listed transaction does not occur if the employer only deducts contributions attributable to the portion of the death benefit that does not constitute excess coverage. Although we believe the IRS position that any deduction used to pay premiums on a life insurance policy providing excess coverage constitutes a listed transaction is strained, the significant penalty provisions of Section 6707A, discussed below, should be carefully considered and weighed against the likelihood such a position could nonetheless be upheld by a court.

Alternative 2. Amended Returns

A. Our Analysis

With respect to plans established prior to 2003, the employer would have filed a return on which it took a deduction attributable to excess coverage. A disclosure statement, however, would not be required to be filed until the employer’s next tax return was filed. The March 16, 2004 memorandum states that we believe that Rev. Rul. 2004-20 should not be interpreted to mean that the employer has necessarily engaged in a listed transaction simply because it previously filed a return claiming that deduction. Instead, a better interpretation is that this would constitute a listed transaction only if the employer derives a tax benefit from the transaction. Accordingly, if the

employer files amended returns for any open years and reverses any deduction attributable to excess coverage, it should not be considered to have engaged in a listed transaction since it would not have taken an impermissible deduction for any taxable for which tax could be assessed. As an employer would not have taken a deduction for contributions attributable to excess coverage for any open year at the time the disclosure statement would have to be filed, such an employer should not be considered to have engaged in a listed transaction, and it would not be required to file a disclosure statement.

B. IRS Arguments

As provided above, the plain language of the Rev. Rul. 2004-20 states a 412(i) transaction is a listed transaction if “the employer *has deducted amounts* used to pay premiums on a life insurance contract for a participant with a death benefit under the contract that exceeds the participant’s death benefit under the plan by more than \$100,000.” (emphasis added). Again, the IRS could argue this language is not explicitly limited to deductions attributable to the cost of excess coverage. In addition, with respect to an employer that has amended the original return, the IRS can argue “the employer has deducted amounts used to pay premiums” with respect to excess coverage on its original tax return. In other words, unlike the situation described in Alternative 1, where the employer never has taken a deduction with respect to excess coverage, an employer under this Alternative 2 did deduct contributions attributable to the portion of the death benefit that constitutes excess coverage on its original return. Again, we believe the employer has a reasonable argument that the transaction is not a listed transaction in light of the fact it amended its return to remove any deduction attributable to excess coverage before a disclosure statement would be required to be filed. However, in light of the potential application of the substantial penalty described below, employers in a gray area regarding the application of Section 6011 must now seriously consider the severe consequences for failure to file a required disclosure statement.

Alternative 3. File Form 8886

Our memorandum provided if an employer has taken a deduction for contributions attributable to excess coverage for any open year, and does not file an amended return to reverse that deduction, it would have to file the disclosure statement required under Treas. Reg. § 1.6011-4(a) on Form 8886. Of course, an employer in Alternatives 1 and 2, above, could also file a Form 8886 as a protective measure. An employer which engaged in the listed transaction described in Rev. Rul. 2004-20 would have to file that Form 8886 with its next return filed after February 13, 2004. That form would also have to be filed with the taxpayer’s return for each subsequent taxable year in which it engaged in the listed transaction. At the time the first Form 8886 is filed with the taxpayer’s return, a copy would also have to be filed with the Office of Tax Shelter Analysis. Treas. Reg. § 1.6011-4(e)(1).

Penalty Provisions

The American Jobs Creations Act of 2004, P.L. 108-357 (the “AJCA”), did not alter the substance of the taxpayer disclosure rules under Section 6011. However, Section 811 of the AJCA created new Code Section 6707A, which imposes penalties on taxpayers that fail to disclose reportable transactions under Section 6011 (and Treas. Reg. § 1.6011-4). For example, under Section 6707A(b)(1), an individual taxpayer faces a \$10,000 penalty for failing to disclose a reportable transaction (other than a listed transaction) and any other type of taxpayer faces a

\$50,000 penalty for failing to disclose such a transaction. Moreover, Section 6707A(b)(2) provides, in the case of a failure to disclose a listed transaction, the penalty increases to \$100,000 for an individual and \$200,000 for any other taxpayer.

Section 811 of the AJCA provides the taxpayer disclosure penalties apply to tax returns and statements due after Oct. 22, 2004. This formulation of the effective date led to considerable debate and discussion as to whether the return "due date" should be construed narrowly to include only the original return due date or expansively to include the return due date with extensions. IRS Notice 2005-11 moots these debates by providing that the new penalties will apply to all returns filed after October 22, 2004, regardless of the return due date.

In addition to this expanded interpretation of the effective date, a special rule regarding listed transactions creates a trap for the unwary. Treas. Reg. § 1.6011-4(e)(2)(i) provides if a transaction becomes a listed transaction after the filing of a taxpayer's tax return (including an amended return) reflecting either tax consequences or a tax strategy (or a tax benefit derived therefrom) and before the end of the period of limitations for the final return (whether or not already filed) reflecting the tax consequences, tax strategy, or tax benefit, then a disclosure statement (*i.e.*, Form 8886) must be filed as an attachment to the taxpayer's tax return next filed after the date the transaction is listed regardless of whether the taxpayer "participated" in the transaction in that year (*i.e.*, regardless of whether that year's return reflects tax consequences or a tax strategy described in the IRS Ruling or Notice that lists the transaction). Presumably, such a disclosure statement, if filed after Oct. 22, 2004, is subject to the Section 6707A penalty even though the taxpayer entered into the transaction and filed its tax return reflecting that transaction before Oct. 22, 2004.

Pursuant to Rev. Rul. 2004-20, certain 412(i) plans became listed transactions on February 13, 2004. Therefore, if Treas. Reg. § 1.6011-4(e)(2)(i) applies to the transaction, each employer must file a disclosure statement (Form 8886) under Section 6111 with the employer's return next filed after February 13, 2004. If such employer's next tax return is filed after October 22, 2004, the penalties under Section 6707A would likely apply to such return.¹

Example: An employer that participated in a Section 412(i) plan is a fiscal year employer with a tax year ending July 31. The employer adopted the 412(i) plan in February 2002 and its tax return for the year ending July 31, 2002, filed on November 15, 2002, reflected an excess deduction. The employer timely filed its tax return for the year ending July 31, 2003, on November 15, 2003, reflecting an excess deduction. The Section 412(i) plan becomes a listed transaction on February 13, 2004 because it is substantially similar to the plan described in Rev. Rul. 2004-20. On April 1, 2004, the employer amended its 2002 and 2003 tax returns to remove the excess deduction.

¹ Note, it is unclear whether the penalty provisions of Section 6707A apply to employers who filed a tax return after February 13, 2004 and before October 22, 2004, but failed to include a required disclosure statement under Treas. Reg. § 1.6011-4 with such return. Arguably, the rules applicable before the enactment of the AJCA apply. However, in light of the uncertainty regarding the application of Section 6707A, and the significant amount of penalties that may be imposed, each employer should seek advice from independent tax counsel regarding the application of Section 6707A to its particular circumstances.

If the IRS successfully maintains that the 412(i) plan was a listed transaction, even though the employer amended its return to remove the excess deduction, then Treas. Reg. § 1.6011-4(e)(2)(i) requires the employer to file a disclosure statement as an attachment to the employer's tax return next filed after February 13, 2004. That return is the tax return for the year ending July 31, 2004, which is due November 15, 2004. Since the employer's tax return will be filed after October 22, 2004, the provisions of Section 6707A, as amended by the AJCA, apply to the employer.

Again, in light of the significant strict liability-type penalty for listed transactions, an employer in a gray area regarding the application of Section 6011 must seriously consider the severe consequences for failure to file the disclosure statement.² For this reason, and the fact there are numerous ambiguities regarding the interaction and application of Sections 6011 and 6707A, we recommend each employer seek independent tax counsel regarding the potential application of Section 6011 and Section 6707A to its particular circumstances.

It is also interesting to note, although unlikely to apply to any of ECI's clients, that in addition to imposing monetary penalties under Sections 6707A and 6662A for return positions regarding reportable transactions, Section 6707(e) also requires companies that must file periodic reports under Section 13 or Section 15(d) of the Securities and Exchange Act of 1934 (or to be consolidated with another entity in such reports) to disclose payment of certain penalties in its SEC reports, including the Section 6707A penalty for failing to disclose a listed transaction. This disclosure requirement applies even if the penalty amount is immaterial to a company's financial statements. A company must disclose these penalties on the earlier of the date it pays the penalty or the date it exhausts its administrative and judicial remedies concerning the penalty. Section 6707A(e) treats a failure to disclose one of these penalties in SEC reports as a failure to disclose a listed transaction on a tax return under Code Section 6707(b)(2).

In addition, Section 814 of the AJCA amended Section 6501(c)(10) to provide the statute of limitations for a taxpayer that has failed to disclose a listed transaction as required under Code Section 6011 will remain open until one year after the earlier of the date the taxpayer discloses the transaction or the date a material adviser informs the IRS of the transaction with respect to a request under Code Section 6112 to furnish its list of clients who engaged in reportable transactions. This rule keeps the statute of limitations open only for tax liabilities related to the listed transaction. This provision applies to taxable years with respect to which the period for assessing a deficiency did not expire before the date of enactment, October 22, 2004. Therefore,

² Note, this penalty provision is different than many other penalty provisions in the Code. First, it is not tied to understatements or underpayments of tax liability. In other words, it applies if a taxpayer fails to disclose a reportable transaction even if the IRS does not question the tax treatment of the transaction or the tax treatment is ultimately sustained by the courts. Second, the IRS may not waive the penalty for reasonable cause. Third, where Code Section 6707A(d)(1) gives the IRS Commissioner limited authority to rescind all or portion of the penalty, that authority does not extend to the penalty for failing to disclose a listed transaction; such a penalty is a strict liability penalty. Moreover, Code Section 6707A(d)(1)(B) provides the Commissioner is only permitted to exercise its rescission authority regarding failures to disclose non-listed reportable transactions if rescission would "promote compliance" with the Code and "effective tax administration." The Commissioner may be reluctant to rescind the Code Section 6707A penalty even when the penalty is applied for failing to disclose routine transactions because the Commissioner must submit an annual report to Congress explaining the reasons for any rescissions. Fourth, pursuant to Code Section 6707A(d)(2), a taxpayer may not seek judicial review of the denial of a rescission request.

not only may the Section 6707A failure to disclose penalty apply to a taxpayer when it fails to disclose a transaction once the IRS lists that transaction, but also the statute of limitations on the tax returns reflecting that transaction, if open on the date the IRS lists the transaction, will remain open.