LISTED TRANSACTIONS

STATUS

Issued Resolved. The Small Business Jobs Act, Public Law 111-240, revises section 6707A of the Internal Revenue Code to make the penalty for failing to disclose a reportable transaction proportionate to the underlying tax savings. The penalty for failure to disclose reportable transactions to the IRS is set at 75 percent of the tax benefit received. Reportable transactions are defined as investments in transactions that the IRS has identified as listed tax shelters or that have characteristics of tax shelters, including large losses or confidentiality agreements. The minimum penalty under the new law is $10,000 for corporations and $5,000 for individuals, and the maximum penalty is $200,000 for corporations and $100,000 for individuals

ISSUE

In its never ending quest to close tax shelters, Congress passed Section 6707A of the Internal Revenue Code in 2004, imposing a penalty of $100,000 per individual and $200,000 per entity for each failure to make special disclosures with respect to a transaction that the Treasury Department characterizes as a “listed transaction” or “substantially similar” to a listed transaction. Basically, “listed transactions” are those the IRS views as designed for tax avoidance purposes and the idea was that if taxpayers had to disclose that they were utilizing the tax shelter device they would be less likely to use them.

The significant feature of the 2004 law was a “no mercy” rule. The IRS has taken the view it has no discretion in assessing the penalty - it must do so in all cases. This means the penalty applies without regard to whether the small business or the small business owners have knowledge that the type of transaction has been “listed.” The penalty applies even if the small business and/or the small business owners derived no tax benefit from the transaction! The penalty also applies even if, on audit, the IRS accepts the derived tax benefit. You failed to disclose the transaction on the IRS list of those to be disclosed – penalty assessed – end of story.

Most small businesses probably would not seek to engage in a tax avoidance transaction and it highly unlike they have heard of the “listed transactions” rule. However, it is not out of the realm of possibility. And some have. And the penalties assessed have been as described.

What kind of transactions might small businesses trip over that are considered “listed transactions?” How about:

- Adopting a certain type of defined benefit plan which called a 412(i) plan - this is a defined benefit plan funded with insurance products. Not all 412(i) plans are listed transactions but many are.
- Insurance funded welfare plans. They were sold primarily as a vehicle for owners to be covered by insurance benefits and provided for discriminatory benefits between the owners and non-owners of the business.
- Roth-IRA transactions - small business owners were told that they could run their businesses through a Roth IRA.

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Taxpayer Advocate Nina Olson highlighted the problem in her 2008 annual report. Among the observations she noted was how quickly the penalties can add up: “Thus, an individual who does business through a wholly owned S corporation may enter into a ten-year transaction that he does not believe is improper and that produces little or no tax savings – only to end up owing a penalty of $3 million (i.e., a penalty of $200,000 on the S corporation and a penalty of $100,000 on the individual taxpayer for each of the ten years.”