Tax Controversy Corner

By Megan L. Brackney

Reporting Loss Transactions for Partnerships

The reporting requirements for loss transactions can be confusing, particularly when dealing with passthrough entities, where individual partners or members may have different reporting requirements and the reporting of the individual partners or members may be different than that of the entity. Since the penalties for failure to properly report these transactions are severe for both the taxpayers and the advisors, it is important that these rules be applied with precision. This column discusses the loss category of reportable transactions, the IRS's guidance for partnerships and partners reporting losses and the penalties for failure to disclose as required by Treasury Regulations.

The Definition of a Reportable Loss Transaction

The Internal Revenue Code ("the Code") broadly defines "reportable transaction" as any transaction that is of a type that the Secretary determines as having a potential for tax avoidance or tax evasion under regulations prescribed under Code Sec. 6011.[1] Transactions that fall into the loss transactions category are reported at an overwhelmingly higher rate than other categories of reportable transactions. In 2009, of the 90,157 reports that were filed with the Office of Tax Shelter Analysis, 88,167 were loss transactions, most of which were determined not to be abusive.[2] A "loss transaction" is any transaction resulting in a loss that is deductible under Code Sec. 165 and exceeds certain minimum thresholds.[3] In general, Code Sec. 165 allows taxpayers to deduct losses incurred in a trade or business, or for individuals, in transactions

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entered into for profit, not compensated by insurance or otherwise. A loss transaction is a reportable transaction if it results in the taxpayer claiming a loss of: (i) for corporations, at least $10 million in any single tax year, or $20 million in any combination of tax years; (ii) for individuals, partnerships, S corporations or trusts, $2 million in any single tax year, or $4 million in any combination of tax years; or (iii) $50,000 in a single tax year for losses to individuals or trusts relating to certain foreign currency transactions under Code Sec. 988.[4]

In determining whether losses meet the threshold amounts over a combination of tax years, losses claimed in the tax year that the transaction is entered into and the five succeeding tax years are combined.[5] If the loss transaction subsequently exceeds the threshold amount, the transaction should be disclosed in the next return.[6] The full amount of the loss is taken into account for the year in which the loss was sustained, regardless of whether all or part of the loss is part of a net operating loss under Code Sec. 172 or a net capital loss under Code Sec. 1212 carried back to another year. Likewise, the threshold amount does not include any portion of a loss attributable to a capital loss carryback or carryover from another year.[7] Some examples of loss transactions include a loss resulting from a sale or exchange of a partnership interest under Code Sec. 741 and a loss resulting from a Code Sec. 988 foreign currency transaction. The loss category of reportable transactions also includes any transaction that is "substantially similar" to the definition of a "loss transaction," meaning that it includes any transaction that is expected to have the same or similar types of tax consequences and is either factually similar or based on the same or similar tax strategy.[8]

A transaction that meets the loss transaction criteria is not a reportable transaction if the Commissioner has stated in published guidance that the transaction is not subject to the reporting requirements.[9] The Commissioner has issued guidance excluding certain transactions from the "loss transaction" category in two Revenue Procedures. These Revenue Procedures, Rev. Proc. 2013-11 and Rev. Proc. 2004-66, are the so-called "Angel Lists" describing loss transactions that technically meet the definition of a reportable transaction but are exempt from disclosure because they are unlikely to be abusive.

Reporting Requirements for Loss Transactions

Both the taxpayer and any "material advisor" with respect to a reportable transaction are required to disclose the transaction. First, the taxpayer is required to file Form 8886, *Reportable Transaction Disclosure Statement*, for each reportable transaction in which the taxpayer has participated.[10] This form is due with the taxpayer's tax return that reflects the taxpayer's participation in a reportable transaction.[11] The Form 8886 must include the expected tax treatment and all potential tax benefits expected to result from the transaction, describe any tax result protection (as defined in Reg. §301.6111-3(c)(12)) and describe the transaction in sufficient detail for the IRS to be able to understand the tax structure of the transaction and identify all of the parties involved. An incomplete Form 8886 is not considered a complete disclosure, and the taxpayer will be treated as not having complied with the disclosure requirements.[12] The taxpayer must at the same time send the Form 8886 to the Office of Tax Shelter Analysis ("OTSA"). The OTSA serves as a clearinghouse of information relating to tax shelter activity. The OTSA, among other things, reviews all disclosures by advisors, promoters and taxpayers for the purposes of identifying potentially improper tax shelter transactions, identifying taxpayers who have participated in such transactions and assessing the overall extent of tax shelter activity.[13]

> Because of the significant potential penalties, the reporting of loss transactions, even those that are not abusive but are simply a result of the taxpayer's normal course of business, must be carefully considered by the practitioner.

"Material advisors" are also required to disclose reportable transactions. The statutory definition of "material advisor" is extremely broad, covering any person:

> (i) who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and

(ii) who 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.[14]

A person provides "material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any transaction" if the person makes or provides a tax statement.[15] A "tax statement" is defined as "any statement, oral or written, that relates to a tax aspect of a transaction that causes the transaction to be a reportable transaction." [16] A statement relates to a tax aspect of a loss transaction if the statement concerns an item that gives rise to the reportable loss transaction.[17]

The "threshold amount" of gross income referenced above is $50,000 in the case of a reportable transaction where "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. In addition to fees actually received, fees that the material advisor expects to receive in the future are included in the amount of gross income derived.[18] The determination of whether "substantially all of the tax benefits" from a transaction are provided to natural persons is based on the facts and circumstances, but it will be presumed to be the case if 70 percent or more of the tax benefits from a reportable transaction are provided to natural persons.[19] In determining the amount of gross income a person derives in exchange for material aid, assistance or advice, all fees for services related to advice, analysis and implementation of the transaction are taken into account.[20]

The material advisor reports the transaction by filing a Form 8918, *Material Advisor Disclosure Statement* with 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.[21] After receipt of the Form 8918, the IRS will issue to the material advisor a reportable transaction number, and the material advisor must provide such number to all taxpayers and other material advisors within 60 days of the date the number is mailed by the IRS.[22] If there are multiple material advisors with respect to a transaction, they are permitted to enter into a designation agreement whereby one material advisor handles the disclosure.[23] However, a designation agreement does not relieve the other material advisors of their disclosure obligations if the designated material advisor fails to timely disclose the transaction.[24]

On or before the date the disclosure is due, the material advisor or taxpayer may submit a request to the IRS for a ruling as to whether a transaction must be disclosed. The request must fully disclose all of the relevant facts relating to the transaction. The potential obligation of the taxpayer to disclose the transaction will not be suspended during the period that the request is pending.[25] A taxpayer or material advisor who is uncertain as to whether a transaction must be disclosed may disclose the transaction with a banner stating "Protective Disclosure" at the top of Form 8886 even if the taxpayer has requested a ruling.[26]

When Partnerships and Partners Must Disclose Loss Transactions

There may be circumstances where the partnership is required to report a loss transaction and the partners are not required to report that same transaction. In CCA 201045022, the IRS provided guidance in the form of examples illustrating when particular parties have disclosure obligations with respect to loss transactions.

In the first example, the taxpayer is a partnership with two corporate partners, each having a 50-percent interest, with all items of income, gain, loss, deduction and credit also allocated 50 percent to each partner. The partnership enters into four unrelated transactions, none of which is a Code Sec. 988 (foreign currency) transaction. These transactions are not a series of steps carried out as part of a plan, and thus are not aggregated in determining whether the threshold amount is exceeded.

The first, second and fourth transactions in the first example demonstrate the basic application of the reportable transaction rules. The first two transactions are not reportable by any party because one transaction is on the "Angel List," and the other transaction was below the threshold amount for all parties. The fourth transaction generated a $30 million loss, and because $15 million in losses flow through to each of the partners, the threshold amount has been exceeded for all parties, and the partnership and both partners have to report the transaction.

The third transaction illustrates a more complicated scenario in which a transaction is reportable for one party, but not the other. In this transaction, the partnership claims a $12 million loss, which exceeds the threshold amount for a reportable transaction for this partnership. Each of the two corporate partners claims a $6 million loss. The partner's reported losses do not meet the threshold for corporations of $10 million, and thus the transaction is not a reportable transaction with respect to the partners. Accordingly, in this situation, the partnership, but not the partners, has a reporting obligation with respect to the exact same transaction.

The next example in the CCA is more complex, in that the partners have different interests, and consequently potentially different reporting requirements with respect to the same transaction. The partnership in this example has two individual partners, A and B. A has a 90-percent interest and B has a 10-percent interest in the partnership, and their allocation of the items of income, gain, loss, deduction and credit are based on their interests in the partnership. The partnership enters into a loss transaction generating a $3 million loss. For the partnership, the transaction exceeds the reporting threshold of $2 million, and thus the partnership will have to report the transaction. Based on his 90-percent interest, Partner A claims a $2.7 million loss, and based on her 10-percent interest, Partner B claims a $300,000 loss. Thus, Partner A, along with the partnership, will have to disclose the transaction, while Partner B will not.

Although at times simplistic, the examples in the CCA should alert tax advisors for passthrough entities as to the need to analyze each loss transaction from the perspective of the partnership and from the perspective of each partner. As is explained below, even if a transaction is not abusive or there is no tax adjustment, both the taxpayers and any material advisors to the transaction may be subject to steep penalties for failure to report the transaction properly.

Penalties for Failure to Properly Disclose Reportable Transactions

Code Secs. 6707 and 6707A provide penalties for material advisors and taxpayers who did not properly disclose reportable transactions. From 2005–2009, the IRS assessed these penalties against a total of 430 taxpayers and 26 material advisors. Although there were few penalties assessed against material advisors, most of the penalty assessments exceeded $1 million.[27] The IRS's enforcement of these penalties continues to be a priority, making the reportable transaction rules a significant hazard for the tax practitioner.

Code Sec. 6707A contains the penalty for taxpayers who fail to disclose reportable transactions. 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).[28] The penalty cannot exceed $200,000 ($100,000 in the case of a natural person) if the taxpayer failed to disclose a listed transaction, or $50,000 ($10,000 in the case of a natural person) if the taxpayer failed to disclose any other reportable transaction.[29] In addition, the penalty cannot be less than $10,000, or $5,000 in the case of a natural person.[30] These penalties apply whether or not there is a tax deficiency.[31]

Code Sec. 6707 contains a similar penalty against material advisors of $50,000 for each failure to timely file the Form 8918 or for filing a return containing false or incomplete information.[32] If the material advisor acted intentionally, the penalty is increased to the greater of $200,000 or 75 percent of the gross income so derived.[33] As with the Code Sec. 6707A penalties, these penalties apply whether or not there is a tax deficiency.[34] Additionally, the IRS has taken the position that it may aggregate fees derived by a material advisor from each taxpayer when computing the penalty.[35]

There is no reasonable cause exception to Code Sec. 6707 or 6707A penalties. The IRS, however, has authority to rescind all or a portion of this penalty if: (i) the violation relates to a reportable transaction that is not a listed transaction; and (ii) rescission promotes compliance with the Code and effective tax administration.[36] In considering whether to rescind the penalty, the IRS will take into account all of the facts and circumstances, including whether (i) the taxpayer or material advisor corrected the failure to disclose the reportable transaction upon becoming aware of such failure; (ii) the failure was due to a reasonable mistake of fact; (iii) the failure was caused by events not under the person's control; (iv) the taxpayer or material advisor has a history of compliance with the reporting and disclosure requirements and other tax laws; (v) the taxpayer or material advisor cooperated with the IRS; and (vi) imposing the penalty would weigh against equity and good conscience. The IRS will not consider doubt as to collectability or economic hardship when evaluating a request for rescission.[37]

Further, and of great importance for tax practitioners, an assessment of penalties under Code Sec. 6707A may result in a referral to the IRS's Office of Professional Responsibility,[38] which, based on its own review of the factual circumstances, may impose additional sanctions against the practitioner, including monetary penalties, censure or suspension or disbarment from practice before the IRS.[39]

In addition to these harsh penalties for the mere failure to file the disclosure forms, if there is a "reportable transaction understatement,"[40] the taxpayer will be faced with accuracy-related penalties under Code Sec. 6662A of 30 percent of such understatement.[41] There is a limited reasonable cause exception to penalties under Code Sec. 6662A,[42] but for understatements attributable to transactions entered into after March 30, 2010, this exception does not apply to a position for which the claimed tax benefits are disallowed due to a lack of economic substance.[43] Otherwise, in order to qualify for the reasonable cause exception, the taxpayer must have (i) disclosed the relevant facts affecting the tax treatment of the item, (ii) substantial authority for the treatment and (iii) a reasonable belief that such treatment was more likely than not the proper treatment.[44]

Conclusion

Because of the significant potential penalties, the reporting of loss transactions, even those that are not abusive but are simply a result of the taxpayer's normal course of business, must be carefully considered by the practitioner. This is particularly true for tax practitioners advising passthrough entities and their partners and members, as the reporting obligations may differ between the parties, requiring the practitioner to make an individualized determination for each party.

Endnotes

1 Code Secs. 6707A(c); 6111(b)(2). In addition to certain loss transactions, Treasury has identified four other categories of "reportable transactions": listed transactions; confidential transactions; transactions with contractual protection; and transactions of interest.

2 *Abusive Tax Avoidance Transactions: IRS Needs Better Data to Inform Decisions about Transactions,* GAO-11-493, Report to Congressional Requestors by the United States Government Accountability Office (May 2011), at p. 18.

3 Reg. §1.6011-4(b)(5). A "transaction" includes all of the factual elements relevant to the tax treatment of any investment, entity, plan, or arrangement, and includes any series of steps carried out as part of a plan. CCA 201045022 (Sep. 2, 2010).

4 Reg. §1.6011-4(b)(5)(i)(A)–(E).

5 Reg. §1.6011-4(b)(5)(ii).

6 Reg. §1.6011-4(e)(2)(ii).

7 Reg. §1.6011-4(b)(5)(iii).

8 Reg. §1.6011-4(c)(4).

9 Reg. §1.6011-4(b)(8)(i). The Commissioner also may make a determination by individual letter ruling that a transaction or type of transaction satisfies the reporting requirements. Reg. §§1.6011-4(b)(8)(i), 1.6011-4(f).

10 Reg. §1.6011-4(d).

11 Reg. §1.6011-4(e)(1).

12 CCA 201045022 (Sep. 2, 2010).

13 *Id.*; Announcement 2000-12, 2000-12 IRB 835.

14 Code Sec. 6111(b)(1)(A). 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. Code Sec. 6111(b)(1)(B); Reg. §301.6111-3(b)(3)(i)(A).

15 A "material advisor" does not include a person who makes a tax statement solely in that person's capacity as an employee, shareholder, partner, or agent of another person. Reg. §301.6111-3(b)(2)(iii)(A).

16 Reg. §301.6111-3(b)(2)(ii)(A).

17 Reg. §301.6111–3(b)(2)(ii)(D).

18 Reg. §§301.6111-3(c)(3); 301.6112-1(c)(2); CCA 201021021 (Apr. 2010).

19 Reg. §301.6111-3(b)(3)(i)(D).

20 Reg. §301.6111-3(b)(3)(ii).

21 Code Sec. 6111(a); Reg. §301.6111-3(d) and (e); Notice 2007-85, 2007-45 IRB 965.

22 Reg. §301.6111-3(d)(2).

23 Reg. §301.6111-3(f).

24 *Id.*

25 Reg. §§301.6111-3(h); 301.6011-4(f).

26 Reg. §1.6011-4(f)(2).

27 *Abusive Tax Avoidance Transactions: IRS Needs Better Data to Inform Decisions about Transactions,* GAO-11-493, Report to Congressional Requestors by the United States Government Accountability Office (May 2011), at p. 26.

28 Code Sec. 6707A(b)(1), as amended by the Small Business Jobs Act of 2010 (P.L. 111-240). Prior to the 2010 amendment, the penalty for failure to disclose a nonlisted reportable transaction was $10,000 for a natural person and $50,000 in any other case, and if the transaction was listed, the penalty was $100,000 for a natural person and $200,000 in any other case. Because the 2010 amendment applies to any Code Sec. 6707A penalty assessed after December 31, 2006, the IRS may revise previously-assessed penalties. However, any such revised penalties will not be assessed until the IRS has developed new centralized processing procedures. See Memorandum from Cheryl Claybough (Jan. 19, 2011), LB&I-20-0211-001.

29 Code Sec. 6707A(b)(2).

30 Code Sec. 6707A(b)(3).

31 Code Sec. 6707A(a).

32 Code Sec. 6707(a) and (b)(1). The penalty is increased if the reportable transaction is a listed transaction, in which case the penalty is the greater of $200,000 or half of the gross income derived by the material advisor with respect to the given aid, assistance, or advice provided with respect to such transaction before the date the return is to be filed. Code Sec. 6067(b)(2).

33 Code Sec. 6067(b)(2) (flush language).

34 Code Sec. 6707(a).

35 CCA 201021021 (Apr. 28, 2010).

36 The same standards for rescission apply to both Code Sec. 6707 and 6707A penalties. Code Sec. 6707(c); Code Sec. § 6707A(d)(1); Rev. Proc. 2007-21, 2007-9 IRB 613.

37 Rev. Proc. 2007-21, 2007-1 CB 613.

38 IRM 4.11.55.4.2.2.2 (April 20, 2010).

39 31 CFR §§10.50-10.52.

40 The "reportable transaction understatement" is the sum of: (1) the product of (a) the amount of the increase in taxable income which results from a difference between the proper tax treatment of an item to which Code Sec. 6662A applies and the taxpayer's treatment of such item, and (b) the highest rate of tax imposed by Code Sec. 1 (Code Sec. 11 for corporations); and (2) the amount of the decrease in the aggregate amount of

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tax credits which results from a difference between the taxpayer's treatment of an item to which Code Sec. 6662A applies and the proper tax treatment of such item. Code Sec. 6662A(b)(1).

41 The normal penalty rate of 20 percent in Code Sec. 6662A is increased to 30 percent if the taxpayer failed to properly report the transaction. See Code Sec. 6662A(a), (b)(2), (c).

42 Code Sec. 6664(d)(1).

43 Code Sec. 6664(d)(2), Act Sec. 1409 of the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152).

44 Code Sec. 6664(d)(3).