2009 Information Reporting Program Adivsory Committee Public Report Burden Reduction Subgroup

Issues Covered in this Section

A. Supplemental W-4, Employee's Withholding Allowance Certificate, Instructions for Non-resident Aliens

Recommendations

IRPAC recommends that IRS create online Form W-4 instructions for non-resident aliens, in the form of a Notice, which can be provided separately to individuals to enable them to complete the Form W-4 more accurately. IRPAC drafted a sample Notice for IRS consideration that was submitted to the Large and Mid-size Business (LMSB) operating division for technical review and further discussion as required within the Service.

Discussion

The standard Form W-4 and instructions are not sufficient in explaining the necessary detailed points that must be considered whenever a non-resident alien must complete the form. Although there is reference to other publications, these may not be made readily available, at the time of completing the Form W-4, causing inaccurate withholding.

IRPAC believes that making the essential information available in one document, rather than subsequent references to multiple publications, will help reduce the burden to a vast majority of non-resident aliens and employers in understanding and administering the withholding requirements. IRPAC drafted supplemental W-4 instructions for non-resident aliens for IRS consideration. The supplemental instructions are comprehensive except that persons requiring information on non-service related scholarships and fellowships, which require more detailed explanations, will still be referred to existing publications.

IRS will benefit from the supplemental instructions by receiving more correct withholding from the source of income rather than delayed collection of the proper federal withholding at the time the non-resident alien files their appropriate personal income tax return. In some cases, the collection of such taxes may be further delayed or impossible to collect once the non-resident alien has returned to their home country, thus adding to the continuously growing tax gap.

IRPAC has been working on the non-resident alien W-4 issue for some time. IRPAC's 2008 Public Report included this issue with a recommendation to create a new Form W-4 NR. However, after many meetings with IRS staff, it was concluded that this was not the best alternative. Therefore, IRPAC carried the issue over into the 2009 sessions.

IRS agrees that the current Form W-4 and instructions do not provide adequate guidance for non-resident alien employees. IRPAC met with representatives from IRS LMSB in April 2009. All IRS personnel were supportive of the W-4 supplemental instructions for non-resident aliens. However, the difficulties IRS would encounter to add the supplemental instructions to the current W-4 instructions was made apparent to IRPAC members. IRS stated that the non-resident alien W-4 supplement could be released as a Notice and posted on IRS.gov. This would require only minor changes to the W-4 instructions, e.g. references to the notice containing the supplemental instructions. IRPAC agreed that release of a Notice was a viable solution.

IRPAC also discussed with LMSB various methods needed to educate the public upon subsequent release of the Notice. A suggestion was made to have the Small Business Self-Employed (SBSE) Stakeholder Liaison develop the communication regarding the Notice for employers.

IRS has completed a technical review of IRPAC's supplemental W-4 instructions. See Appendix B for the reviewed draft of the supplemental W-4 instructions for non-resident aliens. IRS is moving the supplemental instructions through the appropriate approval steps with the goal to deploy the Notice for tax year 2010. IRPAC will continue to work with IRS on the finalization of the Notice and supplemental W-4 instructions for non-resident aliens.

B. Form SSA-7028, Notice to Third Party of Social Security Number Assignment

Recommendations

Payee Provides Document to Payer:

1. Given the Social Security Administration's (SSA) concerns over proper consent-based disclosure forms, IRPAC recommends that IRS allow payers to accept directly from the payee any official SSA document that shows the name/taxpayer identification number (TIN) on file with SSA.
2. Alternatively, IRPAC recommends that IRS investigate whether any current IRS systems can be utilized to provide individual payees a document that, when provided to payers, is sufficient to stop backup withholding.

SSA Provides Document to Payer:

1. If a consent-based document is the only acceptable method, IRPAC recommends that IRS encourage SSA to restore issuance of Form SSA-7028 until a viable disclosure form is developed.
2. Alternatively, IRPAC recommends that IRS identify other official SSA documents that could be used in lieu of SSA-7028 and permit payers to stop backup withholding upon receipt of one of these alternatives.

Finally, IRPAC recommends that IRS consider a temporary suspension of the Form SSA-7028 requirement and instead allow payers to follow the first notice rules upon receipt of a second or subsequent notice until a permanent solution is in place.

Discussion

IRS Publication 1281, Backup Withholding for Missing and Incorrect Name/TIN(s), provides that an individual receiving a second "B" Notice must go to their local SSA office to have his or her Social Security Number (SSN) validated on Form SSA-7028 in order to stop or prevent backup withholding. However, SSA will no longer issue Form SSA-7028 for this purpose. As a result, individual taxpayers who receive a second "B" Notice have no remedy available to them to stop backup withholding. This results in excessive backup withholding and financial hardship for payees that are attempting in good faith to comply with the "B" Notice rules promulgated by the IRS, and causes unnecessary friction between the payers, which must continue withholding, and the payees.

This issue was originally brought to IRS in 2008 by IRPAC's Emerging Compliance Issues Subgroup and appeared in the 2008 Annual Report titled "Procedures for complying with Second 'B' Notices appear outdated and should be coordinated with the Social Security Administration's current policies." In addition, IRPAC submitted a letter in May 2009 recommending that this issue be included on the 2009-2010 Guidance Priority List.

Subsequently, IRPAC has learned that SSA will only issue Form SSA-7028 for its original purpose; as authorization from new SSN applicants to notify their employers directly of their SSN, for tax and wage reporting purposes, once the SSN is assigned. Form SSA-7028 was created to reduce SSA field office (FO) traffic by eliminating the need for the FO to re-contact the applicant to visit the FO when the SSA is assigned. Over time, SSA and IRS began using Form SSA-7028 for the verification and disclosure of SSNs for other purposes.

SSA's Office of Privacy and Disclosure (OPD) has recommended that all "inappropriate" use of the Form SSA-7028 be discontinued. Per OPD, although the SSA-7028 requires the individual's signature, it is not a proper consent document for the purpose of disclosure in accordance with SSA regulations and Program Operations Manual System. Therefore, OPD also recommended that the current Form SSA-7028 be revised to unequivocally state that the form's only use is to notify employers of SSNs upon assignment and that any wording on the form, or in its instructions, that would imply that the Form SSA-7028 could be used for consent–based disclosures be deleted.

IRPAC has emphasized to IRS the urgent need to expedite release of instructions for payers with options for handling second "B" Notices. IRS CP-2100 Notices are being mailed to payers who are instructed to inform payees that a Form SSA-7028 is required to prevent/stop backup withholding. Without a change to the current procedures there is no way for individuals to resolve second "B" Notices.

IRPAC will continue its meetings with IRS Chief Counsel and SSA in an effort to reach a workable solution. Ideally, backup withholding could be discontinued when a payee provides the payer with any official SSA documentation. Alternatively, IRS should work with SSA on the development of a viable consent-based solution. In either case, IRPAC recommends that the IRS temporarily suspend the Form SSA-7028 requirement and allow payers to follow first "B" Notice rules until a permanent solution is found.

C. <u>Support Misclassified Employee Relief under Section 530 of the Revenue Act of 1978</u>

Recommendations

IRPAC recommends additional training and outreach relative to Section 530 of the Revenue Act of 1978 (Section 530 Relief). IRS internal training should include an emphasis of the following four requirements of the current IRS policy and existing law:

1. Section 530 should be considered as the first step in any case involving worker classification;
2. The agent must explore the applicability of Section 530 even if the business does not raise the issue;
3. The agent is required to provide IRS Publication 1976, Do You Qualify for Relief Under Section 530, at the beginning of the employment tax exam; and
4. The legislative history of the statute makes it clear that Congress intended that "reasonable basis" be liberally interpreted in favor of taxpayers.

Further, IRPAC encourages IRS to expand Section 530 information and training efforts outside of the examination process. For example:

1. IRS Publication 1976, can be emphasized at future IRS tax forums;
2. IRS and State participation in agency training programs provides an excellent avenue for open discussion with employers and practitioners on ways to help employers manage Section 530 issues; and
3. IRS can make employers and practitioners more aware of the issues involved in Section 530 Relief before an audit occurs through communications in employer trade journals or IRS.gov.

Discussion

Section 530 is a safe harbor provision that prevents the IRS from retroactively reclassifying "independent contractors" as employees and subjecting the principal to federal employment taxes, penalties, and interest for such misclassification. However, although agents are following the rules, application of Section 530 Relief is difficult and fact-intensive, and agents may not always be clear on how to apply it to a given set of facts. Practitioners and employers also find the Section 530 Relief process to be difficult, and are therefore concerned that the evaluation of whether the facts satisfy the Section 530 requirements may not always proceed as it should.

The need for Section 530 has not diminished over the last 30 years, as there is no less confusion or difficulty in determining a worker's status than there was in 1978. In fact, the determination has become even harder because of the IRS' inability to provide guidance on worker classification issues. Thus, compliance with Section 530 is even more important today than it has ever been.

While the worker classification issue does not seem to go away, for most businesses it has been on the "back burner" for over a decade. In 1996, IRS recognized that the relevance of the common law factors varies depending on the nature of the business and may change over the years as the business environment changes. Therefore, after seeking input from the public, IRS revised training for its revenue agents with the issuance of Training Document 3320-102. The stated goal of the training materials was "to ensure that IRS examiners properly classify workers as independent contractors or employees in a manner that is impartial and reflective of current law." Examiners were encouraged to consider the entire relationship between a business and a service provider and to understand that as long as the rules were followed, businesses could legitimately use independent contractors. Additionally, examiners were reminded that it was Congressional intent that certain relief provisions of Section 530 be construed liberally in favor of taxpayers.

During the same time period the IRS launched the Classification Settlement Program (CSP) which provides a standard settlement agreement for instances in which the examiners determine that certain workers are misclassified (IRS Fact Sheet FS-1996-05). The settlement offer, which is still in place, is quite favorable. In most cases, if a business agrees to begin treating the workers in question as employees prospectively, a tax assessment is made for only one year (rather than for all years of the examination). Moreover, the tax rate used for this assessment, assuming the misclassification was not a matter of intentional disregard, is a rate that is much less than the usual federal income tax withholding and FICA rates (IRC §3509). The program was developed around Section 530 and the amount of relief provided under the CSP depends on the strength of the business' Section 530 argument.

This effort most likely helped IRS with its backlog of highly contentious worker classification cases. With the IRS' very public effort to increase taxpayers' confidence that examiners were unbiased in their determinations and ease the administration of the issue, many businesses enjoyed a "quiet period" because the practical result was that agents seemed to lose interest in the issue. Likewise for businesses, there was very little motivation to make any self-corrections. The ”deal” was better if the IRS found the error and made a CSP assessment as a result of an examination.

In the IRS's efforts to close the tax gap, employee misclassification is resurrected as a key issue. The IRS is not alone in this desired pursuit of misclassified workers and in fact may be reacting to some encouragement from Congress and certainly many States. Senate appropriators voted on July 12, 2007, to urge the IRS to provide increased enforcement in industries where the misclassification of employees as independent contractors is widespread.

The IRS Chief of Employment Tax stated at an American Bar Association Section of Taxation meeting that worker classification cases would be a major focus in 2008. Since that time, the IRS has announced that it entered into memorandums of understanding with nearly 30 states to share data and collaboratively approach this and other employment tax issues (News Release IR-2007-184, IRS and States to Share Employment Tax Examination Results). Further, IRS hosted a webcast to discuss the importance of properly classifying workers, and published new Form 8919, Uncollected Social Security and Medicare Tax on Wages. This form is used by workers who believe they have been misclassified as independent contractors to calculate and report the employee share of uncollected Social Security and Medicare taxes due on their compensation.

One of the legislative recommendations made by National Taxpayer Advocate Nina Olson in her 2008 Annual Report to Congress was to replace Section 530 with a provision applicable to both employment taxes and income taxes, and require related IRS guidance to include specific industry focus. In addition, her recommendation includes directing the IRS to develop an electronic tool that employers would be entitled to use and rely on to determine worker classification; allowing both employers and employees to request classification determinations and seek recourse in the U.S. Tax Court; and directing the IRS to conduct public outreach and education campaigns to increase awareness of the rules and consequences associated with worker classification. In the report, the National Taxpayer Advocate recognized and stated, "depending on the terms of the relationship between a business and a worker... many workers should be classified as independent contractors."

IRPAC supports this strategy, but notes that until a fair replacement of the current Section 530 relief is enacted, Section 530 relief is the only legislatively supported recourse an employer has where the employer has misclassified a worker. It is noted that in most cases even today, the initial misclassification is unintentional. Moreover, independent contractor classification is still the standard for many positions across many different industries, and service users in those industries are not likely to independently question this determination. The very conditions that caused the enactment of Section 530 relief still carry meaning today.

Training and Outreach

Since misclassification of employees is a serious matter to any employer, communication and education on the issues are very important. We note that for the present, such information and training efforts may not get to taxpayers outside of the examination process. As employers learn the elements of employee classification and application of Section 530 Relief, employment practices almost always improve. The IRS is encouraged to find ways to better inform the public of these points well before the audit stage.

IRPAC suggests that IRS Publication 1976 be emphasized in the upcoming IRS Nationwide Tax Forums and in press releases targeted to wider employer audiences, such as in local newspapers or employer trade journals, to make employers and the practitioners more aware of the issues involved in Section 530 Relief before an audit occurs.

In addition, the IRS currently holds agency training programs jointly with many states as part of SBSE outreach where Publication1976 can also be publicized. Since these forums are conducted as open two-way sessions, it will give the IRS opportunity to hear employer and practitioner thoughts on other ways to help employers manage these difficult issues in these difficult times.

In the event of legislative changes or replacements to Section 530 Relief, recognized as a real possibility, education and training should continue to include discussion of some form of relief for employers that helps to balance fairness in ways that Section 530 Relief currently offers.

In an Audit Context

It is important to note that many practitioners have shared with IRPAC that agents are generally well informed about Section 530 Relief and are doing their job regarding the relief process. Also, many told IRPAC that as practitioners, they found Section 530 Relief very hard to apply to facts themselves. The complexity of Section 530 Relief is ripe for miscommunications and misunderstandings between an agent and the audited employer.

A statement of denial of Section 530 Relief in the IRC §7436 letter, Notice of Determination of Worker Misclassification, without explanation raises questions for some practitioners on whether their arguments for the application of Section 530 Relief have been understood by agents in complying with the requirements. IRPAC is aware that practitioners have expressed concern that although agents are following the rules, application of Section 530 Relief is difficult and fact-intensive and agents may not always be clear on how to apply it to a given set of facts. Practitioners and employers also find the Section 530 Relief process to be difficult, and are therefore concerned that the evaluation of whether the facts satisfy the Section 530 requirements may not always proceed as it should.

To avoid miscommunication, it is important for the IRS to inform employers about Section 530 Relief. IRPAC recommends that IRS Publication 1976 be provided to employers as early in an audit stage as feasible whenever the agent knows that the misclassification issue could arise. Although we understand that Publication 1976 is being provided in audits, it is not clear that it is always being provided upfront.
Agents are being trained on the technicalities of Section 530 Relief and do understand their responsibilities whether in an LMSB or SBSE audit context. IRPAC believes that in addition, it is important for IRS leadership to emphasize that relief under Section 530 Relief is a legal right if the taxpayer satisfies the requirements and all the facts must be fully considered in applying Section 530 Relief. Such emphasis can help to ensure proper resolution of the difficult legal issue in examination.

Employee misclassification is so embroiled in interpretation and industry practice, that clear cut results are extremely rare. Section 530 Relief was enacted to assist taxpayers because of the challenges involved in determining proper worker classification. Where issues arise, employee misclassification matters should be handled with fairness and consistency.

In addition, a white paper by the National Association of Tax Reporting and Payroll Management explains the history and intent behind the application of Section 530 Relief, points out the current concerns and concludes with recommended solutions to the audit concerns.

D. E-Services – Expansion of Services

Recommendations

IRPAC recommends that IRS expand access to e-Service incentive products to include business entities and their affiliated companies that e-file on their own behalf (e.g. consolidated 1120) and entities who file information returns on their own without a “Reporting Agent” relationship. Currently, a person/entity needs to meet certain requirements to have full access to e-Services products.

IRPAC also asked IRS to investigate the feasibility of being able to submit a Power of Attorney (POA) electronically with the filing of the tax return.

Discussion

E-Services is a suite of web-based products that allow tax professionals and payers to conduct business with the IRS electronically. E-Services offer the following incentive products:

1. Disclosure Authorization (DA): allows eligible users to complete authorization forms, view and modify existing forms, and receive acknowledgement of accepted submissions immediately, all online.
2. Electronic Account Resolution (EAR): allows eligible users to expedite closure on clients’ account problems by electronically sending/receiving account related inquiries.
3. Transcript Delivery System (TDS): allows eligible users to request and receive account transcripts, wage and income documents, tax return transcripts, and verification of non-filing letters.

Tax Professionals who are active participants in the IRS e-file program and e-file five or more accepted individual or business returns in a season are eligible to use all of these incentive products.

Circular 230 Practitioners who qualify as attorneys, Certified Public Accountants, or Enrolled Agents have unlimited access to all of these incentive products whether they e-file their client returns or not.

Reporting Agents, who are accepted participants in IRS e-file, are provided access to TDS and EAR incentive products. A Reporting Agent is an accounting service, franchiser, bank, or other person who complies with Revenue Procedure 2007-38 and is authorized to sign a Form 940/941/944 for a taxpayer.

Currently, the e-Services products are designed for third party filers of tax return information. Business entities filing returns on their own behalf are excluded from using the e-Services incentive products unless they meet the Circular 230 practitioner definition. Also, IRS suggests that any taxpayer who uses a third party to transmit returns or other information to the IRS retain active addresses with the IRS and stay on top of the third party's actions since the taxpayer retains primary liability for them. The inability of the business entity to have direct access to e-Services also precludes this necessary monitoring. Many of these entities currently place phone calls to IRS contacts who then manually research issues and provide available information to the entities. IRPAC believes that the expansion of access to e-Services products will eliminate many of the phone calls and manual processes.

Expansion of e-Service incentive products was included in the list of Electronic Tax Administration (ETA) e-Services Enhancement Recommendations, that IRPAC provided at IRS request.

IRS is handling a tremendous amount of its investigations by correspondence (1099 matching audits, correspondence audits, etc). In order for a representative to properly respond to this correspondence, a POA (or other taxpayer authorization) is required. If the POA is already on file with the IRS by being electronically filed with the return in question, it would reduce the burden of having to get another POA signed and returned to the representative. This would allow a more timely response to most notices since taxpayers typically send these notices to the tax return preparer for response to the IRS. If the IRS would expand the authority already granted to the tax return preparer, by checking the box on the tax return, the preparer could deal with the IRS regarding all issues for that particular return. No additional POA would be required, greatly reducing burden.

IRS' Wage and Investment (W&I) operating division presented the issue of expanded access to e-Services to the directors of Electronic Products and Services Support (EPSS) and ETA. This issue is on the ETA list of potential e-Service changes. Final decision on any changes rests with ETA. Initial discussions look favorable that this additional access will be granted. IRS W&I investigated the possibility of submitting the POA electronically with the filing of the return. IRS determined that this cannot be done at this time because of the signature requirements on the POA.

E. <u>Form 1098, Mortgage Interest Statement</u>

Recommendations

SBSE requested feedback from IRPAC on a proposal to require financial institutions to report the amount of deductible mortgage interest on Form 1098. However, this calculation requires information that recipient/lenders do not have. IRPAC recommends that an alternative solution is to modify the instructions for Form 1098 and/or Reg. 1.6050H-2 to require the recipient/lender to report the address of the mortgaged property, the principal amount of the loan, and the amount of real estate taxes paid during the year. These changes should only be required for new loans and sufficient time should be provided for implementation (e.g. 18 months after the effective date). IRS should encourage the recipient/lender to provide this information on all loans if it is readily available in their processing systems.

Discussion

Form 1098 is issued by recipients/lenders to payers of mortgage interest to report the amount of interest received by the recipient/lender during the calendar year. This amount is not necessarily the tax deductible amount for home mortgage interest. The amount allowed as a deduction involves an extremely complicated calculation following significant accumulation of information. Specifically, deductible home mortgage interest is limited to the interest on up to $1 million of home acquisition indebtedness and $100,000 of home equity debt secured by the payer's principal residence and no more than one other residence. Form 1098 currently does not provide all of the information to the payer/borrower to accurately determine the allowable deduction. Recipients/lenders are currently required to provide only the amount of interest received, points paid on purchase, refund of overpaid interest, and mortgage insurance premiums. The form contains an optional box that the lender may use to report real estate taxes, mortgaged property address, insurance, or other information.

SBSE requested feedback from IRPAC on a proposal to require financial institutions to report on Form 1098 the amount of mortgage interest deductible when the amount of indebtedness exceeds $1,000,000 for home mortgages or $100,000 for home equity loans. The calculation of deductible interest is complicated and requires information that recipients/lenders do not have in their records, such as the amount of loans the payer/borrower holds with other financial institutions. Consequently, IRPAC believes the responsibility for calculation of the amount of deductible mortgage interest must remain with the payer/borrower.

In June 2009, the Burden Reduction subgroup met with representatives of SBSE to discuss alternatives that could be implemented by the lenders and that would provide useful information to the IRS. As a result of the discussion, IRPAC designed a survey and circulated it to various financial institutions. The results of this survey indicated that all of the respondents could provide the address of the mortgaged property, the amount of real estate taxes paid by the institution, and the principal balance at the beginning or end of the year on new loans, if given at least 18 months to implement changes to their reporting systems. None of the respondents could provide information regarding the use of the funds borrowed, whether or not the loan had been refinanced, or any other information that they were not currently providing.

A recent GAO Report (GAO-09-769, Home Mortgage Interest Deduction: Despite Challenges Presented by Complex Tax Rules, IRS Could Enhance Enforcement and Guidance) recommended that Form 1098 be revised to require third party lenders to provide information on mortgage balances at the beginning and end of the current year or the average balance, the address of the secured property, an indicator of loan refinancing in the current year, and an indicator of whether the mortgage relates to an acquisition loan or a home equity loan, to assist the IRS with the detection of noncompliance in the home mortgage area. The report included a sample of a revised 1098 including this information and made suggestions for modifying the instructions, training examiners and educating the public on the mortgage interest limits.

Based on the discussions with SBSE, the lender survey, and the GAO Report, IRPAC recommends, as an alternative to SBSE's proposal, that recipients/lenders be required to provide the address of the mortgaged property, the principal balance of the loan at the end of the year, and the amount of real estate taxes paid by the institution during the year. This information would aid IRS in screening returns for audit and detecting noncompliance by identifying those taxpayers who have outstanding home loans cumulatively in excess of $1 million, taxpayers who have second or third mortgage loans on the same property (often indicative of home equity loans), and taxpayers claiming deductions for home mortgage interest on more than two residences. This information could help with detection of underreported income if, for instance, a taxpayer owns several homes, some of them may be rental property. This information would also benefit tax practitioners and taxpayers to more easily and accurately determine the deductible home mortgage interest amount thus fostering compliance.

IRC §6050H authorizes the Treasury Secretary to prescribe the form and required information to be reported regarding home mortgage interest. Treas. Reg. 1.6050H-2(a)(2)(vi) dictates the reporting of any information required by Form 1098 or its instructions, thus these recommendations are within IRS' authority to change.

F. Form 8886, Reportable Transaction Disclosure Statement

Recommendations

1. The Commissioner should exercise his discretion under IRC §6707A and 6011 to change the reporting requirements for partners, shareholders and beneficiaries of pass-through entities that appropriately file Form 8886 at the entity level.
2. IRS should clarify that the reporting requirements under §6011 will terminate for the corporate participants in the Lease-in/Lease-out (LILO) and Sale-in/Sale-out (LILO/SILO) Settlement Initiative after the year of actual or deemed termination of the tax shelter related transactions. Further, IRS should consider adding a provision to all closing agreements or settlements related to reportable transactions that specifies the reporting obligation, if any, for that transaction in subsequent years.

Discussion

IRC §6707A, enacted in 2004, imposes a severe penalty on the failure to disclose the details of reportable transactions on a properly filed IRS Form 8886 as required by §6011. For tax shelters, designated by the IRS as “listed” transactions, this is a mandatory penalty without exceptions for reasonable cause or good faith, is not required to be proportional to the tax benefits derived from the transaction, and has been criticized as “unconscionable” and “unconstitutional” by the Taxpayer Advocate. Both IRPAC in its 2008 Report, and The Taxpayer Advocate, in her 2008 Annual Report to Congress, identified this issue as burdensome.

Penalty: The total penalty for any transaction depends upon the type of transaction, the type of entity or entities involved, and the duration of the transaction.

“Listed transactions” and transactions “the same as, or substantially similar” to listed transactions carry a penalty of $100,000 for a natural person (individual) and $200,000 for any others (corporations, partnerships, or trusts), for each taxable year of the transaction. If a pass-through entity is involved in a listed transaction, all of the beneficial owners, shareholders and partners, must also report the transaction, resulting in a “stacking effect.” Thus, if a partnership with two partners participated in a transaction substantially similar to a listed transaction for a three-year period, and the partnership and its partners failed to file the required 8886 forms, the mandatory penalty would be $1,200,000 ($200,000/year for the partnership, and $100,000 for each of the two partners, for three reporting periods). Currently, this penalty imposes strict liability regardless of the taxpayer’s knowledge or intent, cannot be challenged in court, there is no statute of limitations on assessment, and the IRS may not rescind any penalties related to listed transactions. However, in June 2009, in a letter to IRS, several prominent legislators criticized the severity of the penalties that are disproportionate to the tax benefits received, especially for small businesses inadvertently involved in listed transactions, and committed to remedial legislation to correct the inequities. In response, IRS Commissioner Shulman agreed to suspend collection enforcement action through September 30, 2009 for penalties assessed on cases where the annual tax benefit from the transaction is less than $100,000 for individuals or $200,000 for other taxpayers per year. Subsequently, Commissioner Shulman extended the suspension of collection enforcement actions through December 31, 2009 to allow the Congress time to address this issue.

Failure to report other Reportable Transactions that are not Listed Transactions carries a penalty of $10,000 for individuals and $50,000 for corporations and partnerships, for each transaction and each taxable period involved. IRS may rescind a penalty for transactions other than listed transactions if “rescinding the penalty would promote compliance with the requirements of this title and effective tax administration.” Recent regulatory guidance allows IRS to rescind the penalties for transactions that are not listed transactions if the penalty is disproportionate to the tax benefit received and there was reasonable cause for the failure to disclose. Absent from the non-exclusive list of factors that would support rescission of the penalties, was any reference to the failure of a partner or shareholder to report a transaction that was timely and appropriately reported by the pass-through entity and included all elements related to the individual partners or shareholders.

The §6707A penalties are in addition to any other penalty, such as substantial understatement or negligence.

Listed Transactions: The term "listed transaction" means a reportable transaction, which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of §6011. Generally listed transactions are transactions considered abusive tax shelters.

Reportable Transaction: The term "reportable transaction" means any transaction of a type, which the Secretary determines as having a potential for tax avoidance or evasion. The currently applicable categories are:

1. Confidential transactions;
2. Transactions with contractual protections;
3. Section 165 losses; and
4. Transactions of interest, specifically identified in IRS pronouncements.

Reporting Requirements: Form 8886 must be attached to each tax return that includes a reportable transaction and for the first year of the transaction, an exact copy must be mailed directly to the IRS Office of Tax Shelter Analysis (OTSA). The transaction must be explained in detail and penalties will apply if it is not complete.

Because of the severe monetary penalties, often disproportionate to the tax benefits received or intended, many practitioners are filing "protective" Forms 8886 for transactions in the ordinary course of business, unrelated to any tax shelter scheme, but could arguably fall into one of the reportable transaction categories, such as §165 losses. Often these loss transactions and other reportable transactions occur within a partnership or S corporation and are passed through to various individuals.

The burden on taxpayers to accurately file Form 8886 and include all required disclosures, and the burden on IRS to process arguably unnecessary forms was discussed with representatives of SBSE in June 2009. SBSE confirmed that all Forms 8886 mailed directly to OTSA and most Forms 8886 filed with returns are reviewed. They also indicated that protective disclosures are processed the same as other disclosures. Further, SBSE stated that Form 8886 is an important information gathering activity to assist IRS in the detection and deterrence of tax avoidance. One reason for the requirement that each partner and shareholder disclose regardless of entity level reporting is that the individual partners or shareholders may have additional activity or varying fact patterns related to the transaction. IRPAC responded that conversely, most participants in pass-through activities not only do not extend, modify or alter the transaction but are completely unaware of the elements of any tax shelters or other transactions and would be incapable of adding any helpful information to their individually filed Forms 8886. Further, according to the instructions for partnership and S corporation returns, a pass-through entity that is required to file Form 8886 must determine if any of the partners or shareholders are required to disclose the transaction and provide those individuals with information they need to file Form 8886. Practice pass-through entities and software providers merely attach a complete copy of Form 8886 to the K-1 distributed to affected partners or shareholders.

Another reporting issue involves the recent settlement related to LILO/SILO transactions. LILO/SILO transactions are listed tax-shelter transactions under Rev. Rul. 2002-69 and Notice 2005-13, respectively, and subject to the $100,000/$200,000 reporting penalties. In October 2008, IRS offered a settlement initiative to approximately 45 corporations and two-thirds agreed to participate. The terms of the settlement required the participants to terminate the LILO/SILO activity in 2008 and report 80% of the inception to date original issue discount income (OID) related to the LILO/SILO in 2008 and report 100% of the remaining OID in subsequent years. If the participants are required to continue reporting for each year that OID is accrued, failure to file Form 8886 in those subsequent years would result in a $200,000 annual penalty. According to the settlement, the activity will be deemed terminated in 2008 notwithstanding the recognition of the OID in subsequent years. However, absent clarification to the contrary, participants will be compelled to file a complete Form 8886 each year thus burdening the participants and the IRS unnecessarily. This dilemma was discussed with SBSE representatives on June 16, 2009 and they acknowledged the need for further guidance.

Accordingly, IRPAC makes two recommendations related to Reportable Transactions:

1. For reportable transactions involving pass-through entities, only the direct entity level participant in the transaction should be required to file Form 8886 provided it lists the names, addresses, identifying numbers, and potential tax benefits for each partner or shareholder. If a partner is also a partnership or S Corporation, this secondary pass-through entity should also be required to file Form 8886 identifying its indirect participants and potential tax benefits. A copy of the 8886 should be a required attachment to each K-1, confirming that the reporting requirements are met. Reg. §1.6011-4 should be amended to provide that if the direct participant is a pass-through entity and appropriately discloses the transaction on Form 8886, partners and shareholders that were indirect participants in the reportable transaction are not required to separately file Form 8886, but must attach the entity generated form to their individual tax returns. Alternatively, Reg. §1.6707A-1T should be amended to reflect that a factor to consider for rescission of penalties is whether the taxpayer was an indirect participant and the direct participant was a pass-through entity that appropriately filed Form 8886.

2. IRS should clarify that the reporting requirements of section 6011 will cease after 2008 related to the LILO/SILO listed transactions for all the corporate participants in the settlement initiative regardless of any OID recognition in subsequent years. IRS should also consider adding a provision to all closing agreements or settlements related to reportable transactions that specifies the reporting obligation, if any, for that transaction in subsequent years.

G. Comments on a moratorium on enforcement and on methods for determining personal call usage on employer-provided cell phones – Notice 2009-46

Recommendations

Moratorium

In light of the pending legislation to remove cell phones from the definition of listed property, IRPAC recommends the temporary suspension of enforcement of the listed property rules as they impact cell phone use as well as the related employee income inclusion for personal cell phone use.

Notice 2009-46, Substantiating Business Use of Employer-Provided Cell Phones, Comments

Simplified Substantiation Methods

Minimal Personal Use

1. IRPAC recommends that employers should establish a policy under which an employee who is provided a cell phone by the employer will agree to maintain and use a non-employer provided cell phone for personal use.
2. IRPAC recommends that an employer's policy include a definition of appropriate use of employer provided cell phones along the same lines as policies governing use of employer provided computers and other technology.
3. If an employer provides a cell phone with "unlimited use" or "fixed flat minute" billing and the employees' job requires at least 50% business use, the IRS should assume that the entire cost of the cell phone is business use.

Safe Harbor Substantiation

1. IRPAC believes it reasonable to allow the employer to elect to use internally developed pricing schedules or actual billings in lieu of a national pricing list. IRPAC strongly recommends the IRS avoid publishing a national rate list, which can quickly become outdated then become very unfair to administer.
2. The IRS suggested safe harbor of 75% business use/ 25% personal use is a fair resolution of a difficult determination and one that many employers will elect to follow.

Statistical Sampling Method

In IRPAC's opinion, the one method that seems allowable for documenting both listed and de-listed property is under Reg. §1.274-5T(c) which allows a sampling supported by collateral evidence. There is potential in the approach under Revenue Procedure 2004-29, however, this revenue procedure does not authorize all necessary statistical sampling components, see IRPAC comment letter, for further details. IRPAC also notes that cell phone use varies between employees even within the same industry and this will make establishing a sampling strategy difficult.

Other Topics of Interest

Employer's Written Policy

An employer's written policy should be made applicable to all employees and clearly written to explicitly provide that personal use of employer provided cell phones and related technology is prohibited by the employer. Members of IRPAC suggested specific policy inclusions.

Methods Used by Employers to Determine Fair Market Value (FMV) of Employer Provided Cell Phones

IRPAC provided examples of two methods used by some employers, small and large, to determine FMV with discussion of their limitations and benefits.

Simplified Method of Determining FMV

IRPAC believes it is reasonable to allow employers to use internally developed pricing schedules or actual billings but opposes IRS publication of a yearly schedule of pricing.

Discussion

IRPAC appreciated the opportunity to provide comments on the development of new methods for determining personal call usage on employer-provided cell phones and commends the IRS' efforts to seek comments through Notice 2009-46. This notice requests comments from the public regarding several proposals to simplify the procedures under which employers substantiate an employee's business use of employer-provided cellular telephones or other similar telecommunications equipment (e.g. Blackberry, pager, iPhones, smart phones and other 3G equipment, PDAs, GPS locators).

Notice 2009-46 suggests some means of documenting business use of cell phones that would be simpler than the current requirement for detailed logs of date, time, duration, business purpose, etc. IRPAC believes that the ideal solution, as suggested by IRS Commissioner Douglas Shulman, is for Congress to pass legislation ensuring no tax consequences to employers or employees for personal use of work-related devices such as cell phones provided by employers. Looking to an impending legislative change, IRPAC believes the best course of action for the present is a moratorium on enforcement.

IRPAC's comment letter on Notice 2009-46, dated August 31, 2009, provides detailed discussion of the recommendations summarized above.

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