

New Rule Requiring Tax Penalties To Be Disclosed in Form 10-K

The American Jobs Creation Act of 2004 added Sections 6707A and 6662A to the Internal Revenue Code (the "Code"). Section 6011 of the Code and the regulations thereunder require a taxpayer that has participated in a reportable transaction to disclose certain information with respect to the reportable transaction to the IRS along with its tax return. A reportable transaction is a transaction that the IRS regards as likely to constitute an abusive tax avoidance transaction. The IRS has identified six categories of transactions that it deems reportable: (1) listed transactions (those identified by the IRS in published guidance as tax avoidance transactions), or transactions that are substantially similar to listed transactions; (2) transactions marketed under conditions of confidentiality; (3) transactions that have contractual protection; (4) transactions for which tax losses exceed specified amounts; (5) transactions resulting in a significant book-tax difference; and (6) transactions generating tax credits where the underlying asset is held for 45 days or less. Sections 6707A and 6662A of the Code provide for monetary penal-

ties of up to \$200,000 for failing to disclose such information along with a tax return or statement. Importantly, Section 6707A(e) of the Code requires companies, and their consolidated subsidiaries, to disclose in their Forms 10-K if they have been required to pay certain penalties. A company's failure to report the imposition of certain monetary penalties in a Form 10-K is treated as an additional failure to disclose a reportable transaction and is subject to an additional penalty as well as the obligation to report this additional penalty in a subsequent Form 10-K.

Tax Penalties Which Must Be Disclosed

The new provisions of the Code provide for various penalties resulting from a taxpayer's failure to disclose reportable transaction information along with a tax return. From a disclosure perspective, the penalties relate to listed transactions, which were implemented pursuant to Section 6707A of the Code, and the accuracy-related penalties, which were implemented pursuant to Section 6662A of the Code and which pertain to understatements of tax

resulting from listed transactions or other reportable transactions that have a significant tax avoidance purpose, are most pertinent. The following sets forth those penalties which, if imposed, must be disclosed in a company's Form 10-K:

- \$200,000 for failure to disclose a listed transaction to the IRS. This penalty can only be rescinded by the IRS if it is determined that the undisclosed transaction is not a listed transaction and the IRS Commissioner determines that rescission of the penalty promotes compliance with the requirements of the tax law and effective tax administration. Refusal by the IRS to rescind the penalty is not subject to judicial review.
- A 30% accuracy-related penalty for the portion of any reportable transaction understatement with respect to which the relevant facts affecting the tax treatment of the item were not adequately disclosed to the IRS in accordance with Section 6011 of the Code.
- A 40% accuracy-related penalty for a gross valuation misstatement, if the company would have been subject to the 30% accuracy-related penalty but for the applicability of certain exceptions.¹

- The penalty resulting from a company's failure to report any of the above three penalties in prior Form 10-K.

A company's Form 10-K disclosure of the requirement to pay one of the above penalties must include the following:

- a description of the penalty;
- the amount of the penalty;
- whether the penalty has been paid in full; and
- the Code section and subparagraph under which the penalty was determined.

Where and When Disclosure Must be Made

A company required to pay any of the above penalties must disclose the requirement to pay the penalty under "Item 3. Legal Proceedings" on the Form 10-K that relates to the fiscal year in which the IRS sends the company notice and demand for payment of the penalty. If the company pays the penalty in full prior to the IRS sending notice and demand for payment, the company must disclose the requirement to pay the penalty on the Form 10-K that relates to the fiscal year in which the penalty was paid. In the event that the company fails to disclose in its Form 10-K the requirement to pay a penalty, future Form 10-K's must disclose both the penalty and the failure to

previously disclose such penalty. This ongoing disclosure obligation continues until the company discloses its requirement to pay each of the required penalties. In addition, each failure to disclose the requirement to pay a penalty gives rise to a new, separate penalty which must be disclosed in a subsequent Form 10-K.

Endnotes

1. A company must only disclose in its Form 10-K the requirement to pay the 40% accuracy-related penalty if: (i) the company consented to the assessment of the 40% penalty without the issuance of a statutory notice of deficiency if the IRS proposed the 30% accuracy-related penalty in the alternative in a notice of pro-

posed deficiency; or (ii) the company consented to the 40% penalty or did not timely petition the Tax Court if the IRS included the 30% penalty in the alternative in a statutory notice of deficiency; or (iii) the government raised the 30% accuracy-related penalty in the alternative in any pleading in a judicial proceeding challenging the applicability of the 40% penalty and the court determined that the 30% penalty applied in the alternative; or (iv) the company acknowledged the applicability of the 30% penalty in the alternative to the 40% penalty in a written settlement agreement with the government.

For more information
please contact:

M. Ridgway Barker

Stamford
(203) 351-8032
mrbarker@kelleydrye.com

Randi-Jean G. Hedin

Stamford
(203) 351-8107
rhedin@kelleydrye.com