

# From the Cradle to the Grave: What Remains of Interest Suspension Under Code Sec. 6404(g)?

*By Hale E. Sheppard*

Hale E. Sheppard discusses the evolution of interest and penalty suspension, the benefits that still endure and the transitional rules applicable to existing cases.

## Introduction

Not long ago the halls of Congress were filled with criticisms of one of the most feared agencies of the U.S. government: the IRS. A series of congressional hearings revealed that the IRS's mistreatment of taxpayers was widespread.<sup>1</sup> Among the troublesome practices were unnecessarily prolonging audits. Putting off an unpleasant experience such as a tax audit has a certain amount of appeal to taxpayers, but it can take a significant economic toll. This is because the interest charged by the IRS on any tax underpayment generally begins to accrue from the date on which the relevant tax return is due. Therefore, by the time an audit has been completed and any related disputes have been resolved, the taxpayer could be facing not only a large tax bill, but also serious penalties and interest. It is one thing when the taxpayer is the cause of a delayed or protracted audit; she made her own bed, so to speak. It is quite another when the IRS is the source of the problem.

In an effort to prevent the IRS from manipulating the pace of the audit to a taxpayer's detriment, Congress introduced Code Sec. 6404(g) in 1998.<sup>2</sup> This provision served to stop the accrual of interest and certain time-

sensitive penalties after 18 months. The IRS could still complete its audit and assess additional amounts after this period; it was just prohibited from slapping on interest and penalty charges to a portion of the increase. Taxpayers and tax practitioners rejoiced, but their happiness was short-lived. No sooner had this protection been put into place than Congress and the IRS began taking steps to rescind it. At this point, Code Sec. 6404(g) is essentially moribund. While this provision's demise may be imminent, it is nonetheless important for taxpayers and their representatives to understand the evolution of interest and penalty suspension, the benefits that still endure, and the transitional rules applicable to existing cases. This article addresses these topics.

## Underpayment Interest in General

An individual taxpayer generally must file her federal income tax return by April 15 each year.<sup>3</sup> She also has the duty to pay the entire tax liability at this juncture, regardless of whether she manages to file the return on time.<sup>4</sup> If she fails to pay in full, then interest and penalties begin to run on the underpayment amount.<sup>5</sup> In other words, the IRS starts charging interest as of April 15 on any tax shortfall reported by the taxpayer on her return.

Ordinarily, the IRS has three years (*i.e.*, 36 months) from the date on which a taxpayer filed her return to se-

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lect her for audit, conduct the necessary review, inform the taxpayer of the adjustments/changes that the IRS proposes to make to the return, and assess any additional taxes and penalties.<sup>6</sup> If these additional amounts are ultimately upheld by taxpayer concession, administrative agreement or court decision, then the IRS charges interest on such amounts. These interest charges do not begin to run as of the eventual date of assessment; rather, they start back on the original payment deadline for the year in question. Thus, when a taxpayer gets audited, she often must pay additional taxes and penalties, as well as sizable amounts in interest. Therefore, the accumulation of interest is a major concern, particularly in cases where the tax underpayment is large.

This concern becomes even more acute when one realizes that the IRS can exercise significant influence over the amount of interest charged by controlling when an audit begins, how quickly it is concluded, and when to issue a notice to the taxpayer describing the proposed or actual adjustments. To be certain, these timing issues are often the result of outside forces, such as the size of a revenue agent's caseload, the priorities imposed by the IRS national office, staffing shortages, etc. However, not all delays in alerting a taxpayer to her tax deficiency are attributable to such innocuous reasons. Congress made several significant changes aimed at stopping the IRS from altering an audit to a taxpayer's disadvantage, including the enactment of Code Sec. 6404(g).

### **Evolution of Interest Suspension**

#### **IRS Restructuring and Reform Act**

Congress enacted the IRS Restructuring and Reform Act (RRA) in 1998.<sup>7</sup> Among its many provisions was Code Sec. 6404(g), which contained the following interest-suspension rule:

In the case of an individual who files [an income tax return] for a taxable year on or before the due date for the return (including extensions), if the Secretary does not provide a notice to the taxpayer specifically stating the taxpayer's liability and the basis for the liability before the close of the 1-year period (18-month period in the case of taxable years beginning before January 1, 2004) beginning on the later of (i) the date on which the return is filed, or (ii) the due date of the return without regard to extensions, the Secretary shall suspend the imposition of any interest, penalty, addition to tax, or additional amount with respect to any failure relating to the

return which is computed by reference to the period of time the failure continues to exist and which is properly allocable to the suspension period.<sup>8</sup>

Like most tax provisions, the original Code Sec. 6404(g) was a mouthful. It is helpful, therefore, to break it down into digestible pieces. In the case of an individual taxpayer who filed a timely income tax return, the IRS was generally required to suspend the accrual of interest, as well as the accrual of penalties calculated on the basis of how long the taxpayer's infraction continues, if the IRS did not provide adequate notice to the taxpayer of her increased tax liability within 18 months after the original due date for filing the tax return (if the taxpayer filed her return on or before April 15) or within 18 months of the date on which the taxpayer actually filed her tax return (if the taxpayer filed her return after the original due date pursuant to a valid extension), whichever is later.<sup>9</sup> This interest-suspension benefit was supposed to get even better for taxpayers in later years. Beginning with income tax returns for 2004, interest suspension was set to commence a mere 12 months from the earlier of the filing deadline or the actual filing date.<sup>10</sup>

The halt on interest charges began the day after the 18-month notification period passed and continued until 21 days after the IRS gave the taxpayer "adequate notice" of the proposed deficiency.<sup>11</sup> In this context, the IRS determined that adequate notice consists of math error notices, under-reporter program notices, revenue agent reports, 30-day letters and statutory notices of deficiency.<sup>12</sup> Audit letters that simply identify the items under examination without reaching any conclusions, however, are deemed inadequate notice for these purposes.<sup>13</sup>

A simple example may help clarify the general interest-suspension concept under Code Sec. 6404(g)(1). Say an individual taxpayer timely files her federal income tax return for 2001 on April 15, 2002. The IRS initiates an audit of her tax return, concludes that she understated and thus underpaid the true amount due, and sends the taxpayer a 30-day letter with an accompanying revenue agent's report on April 15, 2004, explaining the amount of and the reasons for the tax increase. The taxpayer may ultimately be liable for the tax deficiency, but she would get a break on the underpayment interest charges thanks to Code Sec. 6404(g)(1). These would be suspended from October 16, 2003 (*i.e.*, the day after the 18-month notification period) through May 6, 2004 (*i.e.*, 21 days after the IRS provided the taxpayer adequate notice of the liability).

The legislative purpose for introducing the interest-suspension rule in 1998 was three-fold. First, Congress wanted to prevent large amounts of interest and time-based penalties from accruing on taxpayers who were completely unaware of the existence of any additional tax liability until they were contacted by the IRS.<sup>14</sup> Second, Congress wanted to encourage the IRS to work more diligently by essentially imposing an economic penalty (*i.e.*, the amount of the forgone interest) in cases where the IRS failed to inform taxpayers promptly of their tax obligations.<sup>15</sup> Finally, Congress was worried that delayed examinations would tarnish the IRS's public image, creating the impression that it prioritized gathering money over ensuring justice. The relevant congressional report framed it more diplomatically, explaining that the Senate Finance Committee was "concerned that accrual of interest and penalties absent prompt resolution of tax deficiencies may lead to the perception that the IRS is more concerned about collecting revenue than in resolving taxpayers' problems."<sup>16</sup>

Most tax provisions contain a general rule, which is then limited to varying degrees by a series of exceptions. Such was the case with the original Code Sec. 6404(g). This provision clarifies that the benefit of interest and penalty suspension was *not* applicable to late-payment penalties asserted under Code Sec. 6651, cases involving fraud, criminal penalties, and interest or penalties with respect to any tax liability shown on the return.<sup>17</sup> This last exclusion is intended to clarify that the suspension benefit only applies to proposed adjustments (*i.e.*, tax increases) made by the IRS during the audit. The benefit does not extend to amounts the taxpayer voluntarily reported on her return, which are known as self-assessments.

The rationale for the exceptions is a matter of fault. According to the IRS, the four situations described above are excluded from the benefit of interest suspension because they represent cases where the taxpayer was "clearly blameworthy."<sup>18</sup> In addition to the four exceptions expressly listed, Code Sec. 6404(g)(1) does *not* apply to accuracy-related penalties (such as those for negligence, disregard of the rules or regulations, and substantial understatements of income) because these penalties consist of a percentage of the tax understatement; they are not computed by reference to the length of the period during which a taxpayer's violation continues, which is an explicit requirement of Code Sec. 6404(g)(1).<sup>19</sup> Moreover, late-filing penalties under Code Sec. 6651 are *not* assuaged by Code Sec. 6404(g)(1). This is not because an express exception exists, but rather because only those individual taxpayers who file

a tax return "on or before the due date for the return (including extensions)" are entitled to the benefits of Code Sec. 6404(g)(1).

Under the RRA, beneficial suspension under the new Code Sec. 6404(g) was effective for tax years ending after July 22, 1998.<sup>20</sup> Therefore, assuming that an individual taxpayer used a calendar year, the earliest year for which the new provision would have been effective was 1998, and the earliest date on which interest could be suspended was October 16, 2000, *i.e.*, 18 months after April 15, 1999, the due date for the 1998 return.<sup>21</sup>

Any celebrating by taxpayers about the passage of Code Sec. 6404(g) was short-lived. Indeed, both Congress and the IRS began curtailing its positive impact rapidly.

### American Jobs Creation Act

Many would argue that by 2004 those that were considered the abused back in 1998 (*i.e.*, the taxpayers) had become the abusers. This perception was due largely to the fact that the IRS found itself in a virtual bar-room brawl with promoters of, and participants in, so-called tax shelters. In an effort to halt these transactions, Congress passed the American Jobs Creation Act (AJCA) in 2004.<sup>22</sup> This legislation introduced two changes concerning Code Sec. 6404(g).

First, it extended the IRS's grace period from 12 months to 18 months.<sup>23</sup> As mentioned above, the original provision in the RRA expressly stated that interest and time-sensitive penalties would stop accruing to the taxpayer's detriment 18 months after the taxpayer filed her tax return. It further stated that, beginning with tax year 2004, these amounts would cease after a mere 12 months. This first change by AJCA took effect in 2004; therefore, the 12-month period was rescinded before it ever came into being.<sup>24</sup>

The second change generated by AJCA was more directly related to tax shelters. It added three new situations to which the beneficial suspension in Code Sec. 6404(g) would not apply, namely, cases involving "gross misstatements,"<sup>25</sup> reportable transactions that were not properly disclosed to the IRS,<sup>26</sup> and listed transactions.<sup>27</sup> The first new exception took effect in 2004, whereas the latter two were applicable to interest accruing after October 3, 2004.<sup>28</sup> With these recent additions, the number of exceptions to beneficial interest suspension, whether explicit or implicit, now numbered nine. Specifically, Code Sec. 6404(g) did not apply to late-payment penalties, cases involving fraud, criminal penalties, interest or penalties related to self-assessments, accuracy-related penalties, late-filing

penalties, gross misstatements, undisclosed reportable transactions and listed transactions.

Congress did not mince words when explaining the rationale for the new exceptions related to reportable and listed transactions. The Senate seemed reasonably optimistic, hoping that these changes would serve as an incentive for future taxpayer compliance:

The [Senate Finance] Committee believes that extending the statute of limitations if a taxpayer required to disclose a listed transaction fails to do so will encourage taxpayers to provide the required disclosure and will afford the IRS additional time to discover the transaction if the taxpayer does not disclose it.<sup>29</sup>

For its part, the House of Representatives appeared considerably more aggravated with taxpayers and tax professionals involved in shelters, stating the following:

The [House Ways and Means] Committee has noted that some taxpayers and their advisors have been employing dilatory tactics and failing to cooperate with the IRS in an attempt to avoid liability because of the expiration of the statute of limitations [on assessment]. The Committee accordingly believes that it is appropriate to extend the statute of limitations for unreported listed transactions.<sup>30</sup>

### Rev. Proc. 2005-38

Unfortunately for taxpayers, especially those involved in tax shelters, the governmental crackdown was just beginning. The limitations on interest suspension continued to expand, this time thanks to the IRS. When large amounts of money are at stake, taxpayers tend to fight—administratively, judicially or both. In July 2005, the IRS issued Rev. Proc. 2005-38,<sup>31</sup> which showed the narrowness of the options available to taxpayers in this regard.

Code Sec. 6404(h)(1) provides that the Tax Court shall have jurisdiction over any petition filed by a taxpayer who does not surpass certain net worth limits to determine whether the IRS's failure to "abate interest" under Code Sec. 6404 was an abuse of discretion, if the taxpayer files the petition within 180 days after the IRS mails its "final determination" not to abate interest.<sup>32</sup> Rev. Proc. 2005-38 points out the fact that Code Sec. 6404(h)(1) only applies where the IRS has refused to *abate* interest, not where the IRS has declined to *suspend* interest under Code Sec. 6404(g).<sup>33</sup> In light of this harsh reality, Rev. Proc. 2005-38 sets forth three procedures, none of which are particularly encouraging for taxpayers.

First, taxpayers can notify the IRS that interest was assessed in violation of Code Sec. 6404(g) by filing a Form 843 (*Claim for Refund and Request for Abatement*) and writing at the top, "Code Sec. 6404(g) Notification."<sup>34</sup> The IRS will then review the Form 843 and notify the taxpayer of its decision. However, this notification will not constitute a "final determination" letter from which the taxpayer can petition the Tax Court.<sup>35</sup> In other words, Rev. Proc. 2005-38 makes it clear that the taxpayer has no pre-payment recourse in the Tax Court if interest suspension is denied.<sup>36</sup>

A taxpayer who is rebuffed by the IRS may pay the disputed interest, file an administrative claim for refund with the IRS, and, if the IRS disallows the claim or fails to take action on the claim for six months, the taxpayer may then file a suit for refund in the proper U.S. district court or Court of Federal Claims.<sup>37</sup> It does not take long to comprehend why this option is less than attractive. Filing a claim for refund seems futile; if the IRS already administratively rejected the "Code Sec. 6404(g) Notification" filed on Form 843, then it will likely reject the subsequent claim for refund raising the same arguments. Moreover, engaging in refund litigation is an expensive and time-consuming venture. It involves pre-payment of the entire amount at issue, lengthy and profound discovery, extensive briefing of the legal issues and significant legal fees.

The third option described in Rev. Proc. 2005-38 is to file a Form 843 asserting that the interest charges were the result of an unreasonable error or delay by the IRS.<sup>38</sup> In the event of such "unreasonableness" by the IRS, interest should be *abated* under Code Sec. 6404(e), as opposed to *suspended* under Code Sec. 6404(g). The IRS will consider the claim and issue a "final determination." If the IRS's response is negative, the taxpayer may generally file a petition with the Tax Court and dispute the issue in a pre-payment forum.

This final option described in Rev. Proc. 2005-38 seems appealing initially, but the shortfalls become quickly evident. Interest abatement under Code Sec. 6404(e) is granted in very narrow circumstances. The interest accumulation must be due to an unreasonable error or delay, by an IRS representative acting in her official capacity, while performing a "managerial act" or "ministerial act." The regulations make it clear that neither a decision concerning the proper application of federal tax law nor a general administrative decision, such as the decision on how to organize the processing of tax returns, constitutes a managerial act for which interest can be abated.<sup>39</sup> Likewise, the regulations define

the term “ministerial act” restrictively, describing it as a procedural or mechanical act that does not involve the exercise of judgment or discretion and that occurs during the processing of a taxpayer’s case after all prerequisites to the act, such as conferences and review by supervisors, have taken place.<sup>40</sup> There are other hurdles, too. For instance, interest abatement under Code Sec. 6404(e) is only appropriate where no significant aspect of the error or delay is attributable to the taxpayer. The taxpayer, therefore, must have the proverbial clean hands. Moreover, even if interest abatement is proper, it only applies to the interest accumulated *after* the IRS has contacted the taxpayer in writing regarding the proposed tax deficiency. Finally, legislative history clarifies that Congress did not intend Code Sec. 6404(e) to be used routinely; it was designed for situations where the failure to abate interest would be perceived as “grossly unfair.”<sup>41</sup>

### Gulf Opportunity Zone Act

Less than six months after the IRS issued Rev. Proc. 2005-38 explaining the limited options available to taxpayers whose requests for interest suspension are rejected, Congress enacted the Gulf Opportunity Zone Act (GOZA) in December 2005.<sup>42</sup> This new legislation was tied directly to IRS Announcement 2005-80, which contained a “global settlement initiative” applicable to 21 transactions deemed abusive by the IRS. Under the settlement initiative, the taxpayer had to act as if the transaction never occurred, pay all of the back taxes and interest, and shell out a portion of the penalty that the IRS would otherwise seek to impose. In exchange, the IRS would agree to forgo all action against the taxpayer with respect to the relevant transaction, thereby saving the taxpayer from incurring additional penalty amounts, legal fees, and interest charges. The deadline for participating in the settlement was January 23, 2006.<sup>43</sup>

GOZA contained a provision that the IRS characterized as a “meaningful incentive” for settlement pursuant to Announcement 2005-80.<sup>44</sup> It stated that the changes made by AJCA the previous year would also be applicable to interest accruing *on or before* October 3, 2004, unless (1) the taxpayer was participating in the global settlement initiative or the taxpayer had entered into a settlement agreement with the IRS under another initiative by January 23, 2006; (2) the taxpayer acted reasonably and in good faith in entering into the allegedly abusive transaction; or (3) the statute of limitations on assessment had expired or the taxpayer had already signed a closing agreement with the IRS regarding the transaction by December 14, 2005.<sup>45</sup> Stated differently, if the taxpayer failed to meet one of the three conditions

noted above, then GOZA served to *retroactively* apply certain exceptions to interest suspension added by AJCA (*i.e.*, those for undisclosed reportable transactions and all listed transactions).<sup>46</sup> Thus, interest suspension was effectively repealed for many taxpayers involved in abusive transactions, despite earlier laws to the contrary.

### Small Business and Work Opportunity Tax Act

The next congressional blow to interest suspension came from the Small Business and Work Opportunity Tax Act (“the Small Business Tax Act”), which was passed in May 2007.<sup>47</sup> This legislation made one enormous change to Code Sec. 6404(g); it lengthened the notification period from 18 months to 36 months.<sup>48</sup> Accordingly, interest suspension generally will not begin until three years after the taxpayer files her return, which coincidentally is the same amount of time that the IRS generally has to assess any additional taxes, penalties, and interest.<sup>49</sup> Therefore, unless an exception to the general three-year assessment period applies, the Small Business Tax Act ensures that taxpayers will *never* get the benefit of interest suspension.

In terms of timing, the new law provides that “[t]he amendments made by this section shall apply to notices provided by the Secretary of the Treasury or his delegate after the date which is 6 months after the date of enactment of this act.”<sup>50</sup> The Small Business Tax Act was passed on May 25, 2007, making the six-month marker November 26, 2007.

Perhaps the most interesting aspect of the Small Business Tax Act is its purpose: money! Tax legislation is divided into categories. These ordinarily include “tax relief provisions,” “administrative provisions” and “revenue raising provisions,” to name a few. Here, the provision extending the IRS’s notification period from 18 to 36 months is found in the third category, along with increases in fines for bad checks submitted to the IRS, sanctions for filing erroneous refund claims, and new penalties on tax return preparers.<sup>51</sup> Lest there be any lingering doubt about the rationale for doubling the notification period, the numbers speak for themselves. According to official estimates by the U.S. Joint Committee on Taxation, the rescission of interest suspension will generate approximately \$2.5 billion dollars for the government over the next 10 years.<sup>52</sup>

### New Regulations

Not even a month passed before the IRS issued two sets of regulations related to Code Sec. 6404(g), in June 2007. One set was *proposed* regulations, which

means that they are not effective until formerly adopted.<sup>53</sup> The other set was promulgated as *temporary* regulations, thereby giving them immediate effect.<sup>54</sup>

### ***Proposed Regulations***

The proposed regulations are broad in scope; they reflect changes to Code Sec. 6404(g) introduced by the RRA in 1998, AJCA in 2004, GOZA in 2005 and the Small Business Tax Act in 2007.<sup>55</sup> Among other things, these regulations provide guidance on the content and timing of the notices that the IRS must provide the taxpayer. In this regard, the regulations explain that the IRS may send the notice by regular U.S. mail to the taxpayer at her last known address or hand-deliver the notice to the taxpayer or her representative.<sup>56</sup> It is not necessary for the IRS to send notices by certified or registered mail, and notice is deemed to have been provided as of the date of mailing or personal delivery.<sup>57</sup> The regulations liberalize the requirements for making an IRS notice adequate for purposes of Code Sec. 6404(g). The notice must be in writing and must provide the taxpayer with sufficient information to identify which items of income, deduction, loss or credit the IRS has adjusted or proposes to adjust, along with the reason for such adjustment(s).<sup>58</sup> This does not obligate the IRS to provide a citation to or detailed explanation of any provision from the Internal Revenue Code or other legal authority.<sup>59</sup> Moreover, the IRS does not have to include all of the mandatory information in one single document, nor does it have to give all of the information at the same time.<sup>60</sup> In terms of examples, the regulations list a number of documents that may contain sufficient information to satisfy the notice requirement, either alone or in conjunction with other documents. These include statutory notices of deficiency, Forms 4549 (*Income Tax Examination Changes*); Forms 886-A (*Explanation of Items*); Forms 870 (*Waiver of Restrictions on Assessments and Collection of Deficiency in Tax and Acceptance of Overassessment*); 30-day letters; notices issued pursuant to Code Sec. 6213(b) highlighting mathematical or clerical errors on the tax return; and notices and demands for payment of a jeopardy assessment under Code Sec. 6861.<sup>61</sup>

The most important aspects of the proposed regulations are the rules concerning certain exceptions to interest suspension that were enacted under the RRA in 1998. As explained above, the original version of Code Sec. 6404(g) contained four exceptions under which interest and penalty suspension was not ap-

plicable. Taxpayers derived no benefits in cases of late-payment penalties, fraud, criminal penalties and self-assessments.<sup>62</sup> AJCA added additional exceptions in 2004, including denial of taxpayer benefits in cases involving “gross misstatements.”<sup>63</sup> The proposed regulations elaborate on two of these exceptions, fraud and gross misstatements.

With respect to fraud, the proposed regulations engender some inter-statutory consistency, confirming that the concept of fraud is the same here as it is under the assessment period rule in Code Sec. 6501(c)(1).<sup>64</sup> The regulations then provide some positive news for taxpayers, explaining that just because a taxpayer files a fraudulent return for one year does not necessarily preclude her from obtaining the benefit of interest suspension in other years.<sup>65</sup> On the downside, the proposed regulations state that fraud affecting *one* item on a tax return for a particular year prevents interest suspension benefits from applying to *all* items on that return.<sup>66</sup>

The proposed rules regarding “gross misstatements” are considerably more unfavorable to taxpayers. AJCA did not define the term “gross misstatement” when it introduced this exception in 2004. Thus, taxpayers and tax practitioners were left to speculate about its meaning. Many presumed that Congress intended to say “gross valuation misstatement,” but simply omitted the middle word. It turns out that the IRS has a completely different idea. Under the proposed regulations, the term “gross misstatement” would encompass not only “gross valuation misstatements,” but also “substantial omissions” of income and positions taken on “frivolous tax returns.”<sup>67</sup> Grasping the potential impact of this exception requires understanding the key definitions:

- A “gross valuation misstatement” generally occurs where the value of any property (or the adjusted basis of any property) claimed on any income tax return is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis, as the case may be.<sup>68</sup>
- In the case of income taxes, a “substantial omission” exists where the taxpayer omits from her tax return more than 25 percent of the gross income that should have been reported on such return.<sup>69</sup>
- A taxpayer may be penalized for a “frivolous tax return” where she files what purports to be an income tax return, and such return either does not contain information on which the IRS can judge the substantial correctness of the self-assessment or contains information that on its face indicates that the self-assessment is substantially incorrect,

and the taxpayer's conduct is based on a position that the IRS has identified as frivolous or reflects a desire to delay or impede the administration of federal tax laws.<sup>70</sup>

Following the all-or-nothing concept applied to cases of fraud, the proposed regulations state that if a "gross misstatement" occurs, then interest will not be suspended with respect to *any* items of income omitted from the tax return, even though one or more of the omitted items would not constitute a gross valuation misstatement, substantial omission, or a frivolous tax return position.<sup>71</sup>

As proposed regulations, the preceding rules are not in force at the moment. This could change quickly, however. The IRS received few comments on the proposed rules, and the public hearing was canceled because nobody requested to speak.<sup>72</sup> With this lack of opposition, there should be few impediments to these proposed rules becoming final.

### ***Temporary Regulations***

The temporary regulations are narrower in scope, focusing solely on the exception to interest suspension introduced by AJCA in 2004 and later modified by GOZA in 2005. As mentioned above, AJCA added three new situations to which the beneficial suspension under Code Sec. 6404(g) would not apply. Among the undesirables were listed transactions and reportable transactions that were not properly disclosed to the IRS.<sup>73</sup> AJCA provided that denial of interest suspension in these two cases would apply to interest accruing *after* October 3, 2004. Therefore, a taxpayer who participated in a listed transaction or an undisclosed reportable transaction could theoretically still get at least partial benefit of interest suspension if the 18-month notification period in her case expired before October 3, 2004.

GOZA acted to change this rule *retroactively*, taking away interest suspension for all taxpayers who participated in a listed transaction or an undisclosed listed transaction. GOZA identified three exemptions from this harsh, backward-looking rule: (1) cases where the taxpayer was participating in the global settlement initiative described in IRS Announcement 2005-80 by January 23, 2006, or the taxpayer had already entered into a settlement agreement with the IRS under another initiative by January 23, 2006; (2) situations where the taxpayer acted reasonably and in good faith in entering into the allegedly abusive transaction; and (3) instances where the statute of limitations

on assessment had expired or the taxpayer had already signed a closing agreement with the IRS regarding the transaction by December 14, 2005.<sup>74</sup> The new temporary regulations provide greater detail regarding these three categories.

With respect to the first category, the regulations provide two clarifications. They confirm that this exemption does not apply if, after January 23, 2006, the taxpayer withdraws from or otherwise terminates her participation in the global settlement initiative, or the IRS determines that a settlement agreement will not be reached under the global settlement initiative within a reasonable period of time.<sup>75</sup> They further explain that this issue does not have to be resolved under the global settlement initiative described in Announcement 2005-80. Entering into a settlement agreement with the IRS under any formal or personalized initiative should suffice.<sup>76</sup>

The regulations provide the most guidance on the second category, which relates to taxpayers acting reasonably and in good faith when entering into a listed transaction or undisclosed reportable transaction. In determining whether a taxpayer meets the criteria, the regulations indicate that the IRS will consider "all the facts and circumstances surrounding the transaction," including the taxpayer's course of conduct *after* being identified as participating in the transaction.<sup>77</sup> In this regard, the IRS will take into account the taxpayer's response to opportunities to settle the transaction and whether the taxpayer engaged in unreasonable delay at any stage of the matter.<sup>78</sup> To facilitate the decision of whether the taxpayer acted reasonably and in good faith, the regulations contain a presumption. If a taxpayer promptly enters into a settlement agreement with respect to the transaction on terms proposed by the IRS (or on terms more favorable to the taxpayer in the event of atypical facts), and the taxpayer complies with the terms of the settlement agreement without unreasonable delay, then the IRS will presume that the taxpayer acted reasonably and in good faith, except in rare and unusual circumstances.<sup>79</sup> The regulations clarify that even if the presumption does not apply in a particular case, the taxpayer could still be granted interest suspension under the general facts-and-circumstances test.<sup>80</sup>

The following examples, paraphrased from the regulations, show the application of the general facts-and-circumstances test.<sup>81</sup> They reveal that a taxpayer has little maneuverability if she wants to get the benefit of interest suspension. The IRS apparently expects her to simply accept the settlement offer presented by the IRS (which would likely include no concessions on the

tax, coupled with significant penalties), fully pay the tax liability or enter into a payment plan that is palatable to the IRS, promptly satisfy her payment obligation, and otherwise comply with the terms of settlement.

The taxpayer participated in a listed transaction. The IRS sent the taxpayer a settlement offer in July 2005. The taxpayer informed the IRS of his interest in the settlement within the prescribed time period. The revenue agent assigned to the taxpayer's case was not able to calculate the taxpayer's liability under the settlement or tender a closing agreement to the taxpayer until March 2006. The taxpayer promptly executed the closing agreement and returned it to the IRS with a proposal for arrangements to pay the agreed-upon liability. The IRS agreed with the proposed arrangements for full payment. The taxpayer has acted reasonably and in good faith; therefore, interest accruing on or before October 3, 2004, relating to the transaction in which the taxpayer participated will be suspended.

The taxpayer participated in a listed transaction. In response to an offer of settlement extended by the IRS in August 2005, the taxpayer informed the IRS of her interest in entering into a closing agreement on the terms proposed by the IRS. The revenue agent assigned to the transaction calculated the taxpayer's liability under the settlement and tendered a closing agreement to the taxpayer in November 2005. The taxpayer executed the closing agreement but failed to make any arrangement for payment of the agreed-upon liability stated in the closing agreement. The taxpayer did not act reasonably and in good faith; therefore, interest accruing on or before October 3, 2004, relating to the transaction in which the taxpayer participated will not be suspended.

The regulations also contained examples illustrating the functioning of the presumption rules.<sup>82</sup> These are summarized below.

The taxpayer participated in a listed transaction. The IRS sent the taxpayer a settlement offer in July 2005. The IRS offer informed the taxpayer that, absent atypical facts and circumstances, the taxpayer should not expect to resolve the tax issues on terms more favorable than those proposed in the offer. The taxpayer declined the proposed settlement terms and proceeded to Appeals to present what the taxpayer

claimed were atypical facts and circumstances. The administrative file did not contain sufficient information bearing on atypical facts and circumstances, and the taxpayer failed to provide additional information when requested by Appeals. Therefore, Appeals determined that the taxpayer's facts and circumstances were not significantly different from those of other taxpayers who participated in that listed transaction, and thus were not atypical. In September 2006, the taxpayer and Appeals entered into a closing agreement on terms consistent with those originally proposed by the IRS in July 2005. The taxpayer is not presumed to have acted reasonably and in good faith; instead, the IRS will apply the general facts-and-circumstances test to determine whether to suspend interest accruing on or before October 3, 2004.

The facts are the same as those in the preceding example, except that Appeals agrees that atypical facts were present and that such facts warrant additional concessions by the IRS. A settlement is reached on terms more favorable to the taxpayer than those proposed in July 2005. This taxpayer is presumed to have acted reasonably and in good faith. Thus, absent evidence of rare or unusual circumstances, the taxpayer is eligible for suspension of interest accruing on or before October 3, 2004.

With respect to the third category, the regulations clarify that a transaction is considered closed and thus entitled to interest suspension if either of the following was true as of December 14, 2005: The assessment of all federal income taxes for the relevant year was legally barred, or the taxpayer had entered into a closing agreement with the IRS regarding the tax liability arising from the transaction.<sup>83</sup>

### Notice 2007-93

It is an understatement to say that most taxpayers and tax practitioners were unpleasantly surprised by the *retroactive* effect of GOZA; this legislation repealed taxpayer benefits that had been placed into the Internal Revenue Code over six years earlier. It is not unexpected, therefore, that the public has requested confirmation from the IRS that a similar situation would not occur with the Small Business Tax Act.<sup>84</sup>

With respect to effective dates, the Small Business Tax Act states that "[t]he amendments made by this section shall apply to notices provided by the Secretary of the Treasury or his delegate after the date which is six months after the date of enactment of

this act [*i.e.*, May 25, 2007].”<sup>85</sup> However, it failed to provide any explanation as to how the new Code Sec. 6404(g) is intended to apply to IRS notices issued on or after November 26, 2007, that relate to income tax returns that were timely filed before that date. To clarify these matters, the IRS recently issued Notice 2007-93.<sup>86</sup> This administrative pronouncement contains “interim guidance” that will remain in effect until the IRS gives further direction. According to Notice 2007-93, the IRS will adhere to the following rules:

- If the 18-month period has closed and the IRS has not provided adequate notice to the taxpayer by November 25, 2007, then interest and applicable penalties will be suspended beginning on the day after the close of the 18-month period and ending on the date that is 21 days after the notice is provided.
- In all other cases, interest and applicable penalties will be suspended beginning on the day after the close of the 36-month period and ending on the date that is 21 days after the notice is provided.

Notice 2007-93 contains three examples to illustrate the preceding transitional rules.

1. An individual files a federal income tax return for 2006 by April 17, 2007 (the last day to timely file pursuant to Section 7503). On January 2, 2009 (less than 36 months after the due date of the return), the IRS provides adequate notice to the taxpayer. Because the 18-month period has not closed as of November 25, 2007, interest and applicable penalties will not be suspended with respect to the taxpayer’s return.
2. An individual files a federal income tax return for 2005 by April 17, 2006 (the last day to timely file pursuant to Section 7503). On December 26, 2007, the IRS provides adequate notice to the taxpayer. Because the 18-month period has closed as of November 25, 2007, interest and applicable penalties will be suspended with respect to the taxpayer’s return beginning on October 17, 2007 (the day after the close of the 18-month period), and ending on January 16, 2008 (the date that is 21 days after the notice is provided).
3. An individual files a federal income tax return for 2006 by April 17, 2007 (the last day to timely file pursuant to Section 7503). The individual consents to extend the time within which the IRS may assess any tax due on the return until June 30, 2011. On December 20,

2010, the IRS provides adequate notice to the taxpayer. Because the 18-month period has not closed as of November 25, 2007, interest and applicable penalties will be suspended beginning on April 17, 2010 (the day after the close of the 36-month period), and ending on January 10, 2011 (the date that is 21 days after the notice is provided).

### Tax Increase Prevention Act of 2007

The Small Business Tax Act, as clarified by Notice 2007-93, provides that, for IRS notices issued on or after November 26, 2007, interest on any tax underpayment is not suspended until 36 months after the due date of the return or the date on which the taxpayer filed the return, whichever is later. Coincidentally, the general statute of limitations on assessment of additional amounts by the IRS is also 36 months.<sup>87</sup> This parity produces a clear result: Most taxpayers will never be entitled to interest suspension. This is because the IRS is ordinarily required to complete its audit and assess additional taxes and/or penalties within 36 months. If it fails to do so within this period, then the IRS has essentially lost its chance. And, if the IRS is precluded from imposing additional taxes and penalties, it certainly cannot charge interest on these (nonexistent) amounts.

Interest suspension could still apply, though, in special situations where the assessment period is longer than 36 months. For instance, the IRS may assess additional amounts up to 72 months (*i.e.*, six years) after the return is filed in cases of a “substantial omission” from gross income.<sup>88</sup> The challenge here is that many of the situations to which the extended assessment period applies have already been expressly excluded from the benefits of Code Sec. 6404(g), and the broad definition of “gross misstatement” under the proposed regulations would serve to exclude others. Acknowledging this state of affairs, Congress recently considered making it official. The House report related to the Tax Increase Prevention Act (TIPA) of 2007 stated the following:

As a result of the [Small Business Tax Act], interest suspension only applies in the small number of cases in which the IRS may assess additional tax more than three years after the filing of the tax return ... The [House Ways and Means] Committee believes that the rules regarding the accrual of interest on underpayments of tax

should be applied, to the extent possible, in a consistent manner. Thus, the Committee believes the suspension of interest and penalties provision should be repealed.<sup>89</sup>

As passed by Congress, TIPA did not contain a provision formally repealing Code Sec. 6404(g).<sup>90</sup> Nevertheless, its inclusion in earlier versions of the bill may be an indicator of things to come.

### Conclusion

Taxpayer protection was relatively strong when Code Sec. 6404(g) was first introduced by the RRA in 1998. Indeed, this provision generally prohibited the IRS from charging interest or time-sensitive penalties 18 months (12 months beginning in 2004) after an income tax return was filed. This taxpayer benefit has been gradually eroded ever since.

From the outset, RRA had various explicit and implicit limitations; the advantages were not applicable to late-payment penalties, cases involving fraud, criminal penalties, self-assessments by the taxpayer, accuracy-related penalties and late-filing penalties. In 2004, AJCA added three additional exclusions to the list, thereby making taxpayer benefits unavailable in cases of gross misstatements, undisclosed reportable transactions, and listed transactions. AJCA extended the IRS's grace period from 12 months to 18 months, too. The IRS chimed in the following year by issuing Rev. Proc. 2005-38. This pronouncement showed just how limited the options are for those taxpayers whose interest suspension requests are snubbed by the IRS. GOZA came in late 2005. This legislation, which was tightly linked to the tax shelter global settlement initiative set forth in Announcement 2005-80,<sup>91</sup> acted to *retroactively* repeal the benefit of interest suspension for all but a few categories

of taxpayers who participated in undisclosed reportable transactions or listed transactions. The next assault to taxpayer protection originated from the Small Business Tax Act in early 2007. Under this new law, the interest and penalty cutoff was expanded from 18 months to 36 months for IRS notices issued on or after November 26, 2007.<sup>92</sup> Approximately one month later, the IRS simultaneously issued proposed and temporary regulations to elaborate on the interest-suspension rules. The temporary regulations, which have immediate applicability, address the exception related to undisclosed reportable transactions and listed transactions. These temporary regulations leave little doubt that few, if any, taxpayers who participated in so-called tax shelters will be granted any benefits under Code Sec. 6404(g). The most interesting—or perhaps disconcerting—aspect of the proposed regulations is the broad definition of “gross misstatements.” If these regulations were to become finalized, no interest suspension would be available in cases of gross valuation misstatements, substantial omissions of income and frivolous tax return positions. This expansive definition would bring the total number of exclusions to eleven.

Recently, early versions of TIPA included a provision that would have repealed interest and penalty suspension altogether. Was this intended as a final nail in the coffin or as simple recognition of the present circumstances? Either way, it spells bad news for taxpayers. Interest suspension may be on its last leg, but benefits are still available to a small group of taxpayers. In demanding a break from the IRS in this environment, though, taxpayers should be armed with a clear understanding of the evolution of Code Sec. 6404(g), the effective dates of each congressional or administrative change, the benefits that still exist, and the relevant transitional rules.

### ENDNOTES

<sup>1</sup> See, e.g., S. HRC. 105-529 (“IRS Restructuring”), 105th Cong., 2d Sess., Jan. 28, 29 and Feb. 5, 11 and 25, 1998), S. HRC. 105-190 (“Practices and Procedures of the Internal Revenue Service”), 105th Cong., 1st Sess., Sept. 23, 24 and 25, 1997.

<sup>2</sup> Unless otherwise stated, all uses of the terms “Code Sec.” refers to the Internal Revenue Code of 1986, as amended.

<sup>3</sup> Code Sec. 6072(a).

<sup>4</sup> Code Sec. 6151(a).

<sup>5</sup> Code Sec. 6601(a); Code Sec. 6651(a)(2).

<sup>6</sup> Code Sec. 6501(a).

<sup>7</sup> IRS Restructuring and Reform Act of 1998 (P.L. 105-206).

<sup>8</sup> Act Sec. 3305(a) of P.L. 105-206.

<sup>9</sup> *Id.*

<sup>10</sup> S. REP. NO. 105-174, 105th Cong., 2d Sess., Apr. 22, 1998, at 65; H. CONF. RPT. 105-599, 105th Cong., 2d Sess., June 24, 1998, at 260. The Senate wanted to allow the IRS a 12-month grace period from the start. As enacted, the RRA postponed the 12-month period until 2004, presumably to allow the IRS time to become more efficient and adapt to the new time constraints.

<sup>11</sup> Code Sec. 6404(g)(3).

<sup>12</sup> CCN N(35) 000-172 (Mar. 22, 2000); IRM §20.2.6.6.4 (08-01-2006).

<sup>13</sup> *Id.*

<sup>14</sup> FSA 200201010 (Jan. 4, 2002).

<sup>15</sup> S. REP. NO. 105-174, 105th Cong., 2d Sess., Apr. 22, 1998, at 64.

<sup>16</sup> *Id.*

<sup>17</sup> Act Sec. 3305(a) of P.L. 105-206; Code Sec. 6404(g)(2)(A)–(D), as in effect under RRA.

<sup>18</sup> FSA 200201010 (Jan. 4, 2002).

<sup>19</sup> CCN N(35) 000-172 (Mar. 22, 2000).

<sup>20</sup> Act Sec. 3305(b) of P.L. 105-206.

<sup>21</sup> 1999 IRS Non-Docketed Service Review 11031,

## ENDNOTES

- 1999 WL 33911260 (Mar. 1, 1999), note 1; see also *C.A. Nerad*, 78 TCM 795, Dec. 53,623(M), TC Memo. 1999-376, note 5; *J.H. Hunt*, 86 TCM 426, Dec. 55,313(M), TC Memo. 2003-283; *R.L. McElroy, Jr.*, 88 TCM 421, Dec. 55,797(M) TC Memo. 2004-254.
- <sup>22</sup> P.L. 108-357.
- <sup>23</sup> Act Sec. 903(a) of P.L. 108-357.
- <sup>24</sup> *Id.*
- <sup>25</sup> Act Sec. 903(b) of P.L. 108-357.
- <sup>26</sup> Act Sec. 903(c) of P.L. 108-357.
- <sup>27</sup> *Id.*
- <sup>28</sup> Act Sec. 903(d) of P.L. 108-357.
- <sup>29</sup> S. REP. No. 108-192, 108th Cong., 1st Sess. (Nov. 7, 2003), at 112.
- <sup>30</sup> H. REP. No. 108-548, Part 1, 108th Cong., 2d Sess. (June 16, 2004), at 267.
- <sup>31</sup> Rev. Proc. 2005-38, 2005-2 CB 81.
- <sup>32</sup> See also Tax Court Rule of Practice and Procedure 280(b).
- <sup>33</sup> Rev. Proc. 2005-38, §2.05.
- <sup>34</sup> Rev. Proc. 2005-38, §3.01.
- <sup>35</sup> *Id.*
- <sup>36</sup> *J. Goode*, 91 TCM 901, Dec. 56,454(M), TC Memo. 2006-48. The Tax Court has upheld the reasoning in Rev. Proc. 2005-38.
- <sup>37</sup> Rev. Proc. 2005-38, §3.02.
- <sup>38</sup> Rev. Proc. 2005-38, §3.03.
- <sup>39</sup> Reg. §301.6404-2(b)(1); The courts have also granted the IRS considerable latitude regarding how to prioritize cases, conduct audits and issue notices to taxpayers. See, e.g., *Mekulsia*, 85 TCM 1303, Dec. 55,152(M), TC Memo. 2003-138, *aff'd*, CA-6, 2005-1 USTC ¶15,108, 389 F3d 601.
- <sup>40</sup> Reg. §301.6404-2(b)(2).
- <sup>41</sup> T.D. 8150 (Aug. 13, 1987), Preamble; Rev. Proc. 87-42, §3.02.
- <sup>42</sup> The Gulf Opportunity Zone Act of 2005 (P.L. 109-135).
- <sup>43</sup> Announcement 2005-80, §5A.
- <sup>44</sup> Dustin Stamper, *IRS Highlights Shelter Settlement Incentive in Hurricane Relief Bill*, 2005 TNT 246-2 (Dec. 23, 2005).
- <sup>45</sup> Act Sec. 303(a) of P.L. 109-135.
- <sup>46</sup> Act Sec. 303(a) of P.L. 109-135; U.S. Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of H.R. 4440, the “Gulf Opportunity Zone Act of 2005,” as Passed by the House of Representatives and the Senate (JCX-88-05) (Dec. 16, 2005).
- <sup>47</sup> Small Business and Work Opportunity Tax Act (P.L. 110-28).
- <sup>48</sup> Act Sec. 8242(a) of P.L. 110-28.
- <sup>49</sup> Code Sec. 6501(a).
- <sup>50</sup> Act Sec. 8242(b) of P.L. 110-28.
- <sup>51</sup> Act Secs. 8241–8248 of P.L. 110-28; U.S. Joint Committee on Taxation. Technical Explanation of the Small Business and Work Opportunity Tax Act of 2007 and Pension Related Provisions Contained in H.R. 2206, as Considered by the House of Representatives on May 24, 2007. JCX-29-07 (May 24, 2007).
- <sup>52</sup> U.S. Joint Committee on Taxation. Estimated Revenue Effects of the Small Business and Work Opportunity Tax Act of 2007, and Pension-Related Provisions Contained in H.R. 2206, As Passed by the House of Representatives and the Senate on May 24, 2007. JCX-3-07, at 2.
- <sup>53</sup> REG-149036-04 (June 21, 2007), 72 FR 34204, as corrected July 25, 2007.
- <sup>54</sup> T.D. 9333 (June 21, 2007), as corrected on July 25, 2007.
- <sup>55</sup> REG-149036-04 (June 21, 2007), 72 FR 34204, as corrected July 25, 2007—Preamble. These regulations also reflect certain minor, technical changes in the Tax Relief and Health Care Act of 2006.
- <sup>56</sup> Proposed Reg. §301.6404(a)(4), (7)(i).
- <sup>57</sup> *Id.*
- <sup>58</sup> Proposed Reg. §301.6404(a)(6)(i).
- <sup>59</sup> *Id.*
- <sup>60</sup> *Id.*
- <sup>61</sup> *Id.*
- <sup>62</sup> Code Sec. 6404(g)(2)(A)–(D), as in effect under RRA.
- <sup>63</sup> Act Sec. 903(b) of P.L. 108-357.
- <sup>64</sup> Proposed Reg. §301.6404(b)(2).
- <sup>65</sup> *Id.*
- <sup>66</sup> Proposed Reg. §301.6404(b)(2).
- <sup>67</sup> Proposed Reg. §301.6404(b)(4).
- <sup>68</sup> Code Sec. 6662(h)(2)(A).
- <sup>69</sup> Code Sec. 6501(e)(1)(A). Similar rules exist in cases of partnerships. See Code Sec. 6229(c)(2).
- <sup>70</sup> Code Sec. 6702(a).
- <sup>71</sup> Proposed Reg. §301.6404(b)(4)(ii).
- <sup>72</sup> *IRS Cancels Hearing on Proposed Regs That Explain Interest, Penalty Suspension Rules and Exceptions*, 2007 TNT 193-10 (Oct. 3, 2007).
- <sup>73</sup> Act Sec. 903(b) of P.L. 108-357.
- <sup>74</sup> Act Sec. 303(a) of P.L. 109-135.
- <sup>75</sup> Reg. §301.6404-4T(b)(5)(iii)(A)(1).
- <sup>76</sup> Reg. §301.6404-4T(b)(5)(iii)(A)(2).
- <sup>77</sup> Reg. §301.6404-4T(b)(5)(iii)(B)(1).
- <sup>78</sup> *Id.*
- <sup>79</sup> Reg. §301.6404-4T(b)(5)(iii)(B)(2).
- <sup>80</sup> *Id.*
- <sup>81</sup> Reg. §301.6404-4T(b)(5)(iii)(B)(3), Examples 1 and 3.
- <sup>82</sup> Reg. §301.6404-4T(b)(5)(iii)(B)(3), Examples 4 and 5.
- <sup>83</sup> Reg. §301.6404-4T(b)(5)(iii)(C).
- <sup>84</sup> *Attorney Comments on Effective Date Under Proposed Interest and Penalty Suspension Rules for Listed, Reportable Transactions*, 2007 TNT 133-19 (July 6, 2007).
- <sup>85</sup> Act Sec. 8242(b) of P.L. 110-28.
- <sup>86</sup> Notice 2007-93, IRB 2007-48.
- <sup>87</sup> Code Sec. 6501(a).
- <sup>88</sup> Code Sec. 6501(e).
- <sup>89</sup> H.R. REP. No. 110-431, 110th Cong., 1st Sess., Nov. 6, 2007, at 121.
- <sup>90</sup> Tax Increase Prevention Act of 2007 (P.L. 110-166).
- <sup>91</sup> Announcement 2005-80, 2005-2 CB 967.
- <sup>92</sup> The IRS later clarified the effective date of the Small Business Tax Act in Notice 2007-93.

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