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Tax Court Affirms That Reportable Transaction Penalty Is Constitutional

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In *Thompson v. Commissioner*, 148 T.C. No. 3 148 (2017), the US Tax Court confirmed that the Internal Revenue Code (IRC) Section 6662A penalty for reportable transactions is constitutional and does not violate the Excessive Fines Clause of the Eighth Amendment.

IRC Section 6662A(a) imposes a penalty on any "reportable transaction understatement." A "reportable transaction understatement" generally refers to the difference between the increase in the amount of federal income tax that is calculated from the proper treatment of an item that results from a reportable or listed transaction and the taxpayers actually treatment of that item. IRC Section 6662A(b). If a taxpayer fails to adequately disclose a reportable transaction giving rise to an understatement under IRC section 6662A, the penalty is imposed at a rate of 30 percent, and there are no available defenses. IRC Section 6662A(c). However, if a taxpayer sufficiently discloses the details of the transaction, the penalty rate is 20 percent of the amount of the reportable transaction understatement. IRC Section 6662A(a). In this latter instance, a taxpayer may avoid the penalty if he shows reasonable cause and good faith, as well as that there is substantial authority for a position he claimed on the tax return, and the taxpayer reasonably believed that such treatment was more likely than not the proper treatment of the transaction in question. IRC Section 6664(d)(1) and (3).

The Eighth Amendment provides that “[e]xcessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted.” The Excessive Fines Clause limits the government’s power to extract payments, whether in cash or in kind, as punishment for some offense. Yet if a tax is motivated by revenue raising rather than punitive purposes, it is not constrained by the Excessive Fines Clause. Thus, in order for a taxpayer to show that the Excessive Fines Clause has been violated, he needs to prove: (1) that the tax in question was intended as a punishment rather than a revenue raiser; and (2) that the tax was “excessive” or in the words of the Supreme Court, “grossly disproportionate to the gravity of the offense.”

In *Thompson*, the taxpayers claimed a loss on their 2005 tax return from a flow-through “distressed asset debt” (DAD) transaction. The Internal Revenue Service (IRS) listed the DAD transaction as a tax avoidance transaction in IRS Notice 2008-34. The loss was partially carried back to the 2003 and 2004 tax years, and carried forward to the 2006 and 2007 tax years to shield their income from taxation. Because the taxpayers failed to disclose the relevant facts relating to the transaction, the IRS determined that they were subject to a 30 percent penalty pursuant to IRC Section 6662A(c). The taxpayers conceded the substantive issues related to the case, but contested the issue of liability for penalties.

The taxpayers argued that because Congress intended IRC Section 6662A to deter taxpayers from entering into tax avoidance transactions, it is not purely remedial and is subject to review under the Eighth Amendment as a form of punishment. In rejecting the taxpayers’ argument, the Tax Court emphasized that tax shelters represent the most significant compliance problem confronting the US system of taxation. Those abusive transactions reduce the tax base, said the court, and waste valuable public and private sector resources. As a result, Congress enacted a number of penalties related to disclosure of certain transactions and failure to report them.

The court explained that the primary goal in enacting IRC Section 6662A was to reinforce voluntary compliance with the existing disclosure requirements and deter taxpayers from using tax shelters. The IRC Section 6662A penalty, opined the court, imposes a financial risk on those who fail to comply and thus serves a revenue-raising purpose. Therefore, the court concluded that the penalty under IRC Section 6662A does not violate the Eighth Amendment.

The court also held, in the alternative, that even if the Excessive Fines Clause was implicated in the case, the penalty imposed under IRC Section 6662A is not grossly disproportionate to the gravity of the offense and, accordingly, is not “excessive” under the Eighth Amendment.

Point: When a taxpayer is confronting an assertion of penalties by the IRS, the Eighth Amendment’s Excessive Fines Clause may be an option to consider as part of a defense. For example, there was much discussion in the tax practitioner community several years ago regarding the application of this argument to FBAR penalties, which, pursuant to the relevant statute, could greatly exceed the value of the unreported accounts at issue. As this case demonstrates, Excessive Fines challenges can be difficult to mount, but may be worthy of consideration in an appropriate case.