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In this article, Sheppard examines whether securing employee retention credits under a contingent or refundable fee arrangement might trigger special obligations with the IRS, including the need to file Form 8886, "Reportable Transaction Disclosure Statements," and Form 8918, "Material Advisor Disclosure Statements."

I. Introduction

Most employers seeking employee retention credits focus on fundamental, immediate issues. For example, they analyze whether they meet the eligibility standards, the particular quarters for which they can make claims, how to calculate proper amounts, what documentation is necessary to support their positions if they are later challenged, and so on. They likely are thinking about money too, including the size and type of fees that they will need to pay the professionals assisting them in obtaining the credits. What escapes the minds of many employers and advisers is whether securing ERCs under a contingent or refundable fee arrangement might trigger special obligations with the IRS, including the need to file Forms 8886, "Reportable Transaction Disclosure Statements," and Forms 8918, "Material Advisor Disclosure Statements." This issue is not lost on the IRS, as revenue agents have started inquiring about these information returns during ERC audits and investigations. Therefore, it is important to address this obscure, yet critical, topic.

This article, another in a running list by the author, describes the ERC legislation, relevant administrative guidance, evolution of the regulations addressing "transactions with contractual protection," effects of reportable transaction status on employers and advisers, and previous exemptions from the IRS for tax credit transactions facilitated by contingent or refundable fees.

II. Glimpse of Relevant Legislation

Congress created the ERC when it enacted the Coronavirus Aid, Relief, and Economic Security Act in 2020.[1] That law generally provided that an eligible employer could get an ERC against certain employment taxes equal to 50 percent of the qualified wages it paid to each employee.[2] Coverage of the ERC changed several times later, but it originally applied to the second, third, and fourth quarters of 2020.[3]

Congress next passed the Taxpayer Certainty and Disaster Tax Relief Act.[4] It expanded the period during which eligible employers might

[1] Joint Committee on Taxation, "Description of the Tax Provisions of P.L. 116-136, the Coronavirus Aid, Relief, and Economic Security Act," JCX-12R-20 (Apr. 23, 2020); *see also* Notice 2021-20, 2021-11 IRB 922.

[2] CARES Act, section 2301(a).

[3] CARES Act, section 2301(m).

[4] Consolidated Appropriations Act, 2021, Division EE, section 207; JCT, "Description of the Budget Reconciliation Legislative Recommendations Relating to Promoting Economic Security," JCX-3-21, at 66-70 (Feb. 8, 2021); *See also* Notice 2021-23, 2021-16 IRB 1113.

benefit. They could now claim ERCs for the first and second quarters of 2021, too.[5] Also, eligible employers could get increased amounts of ERCs since two things changed under the relief act: The percentage of qualified wages for which the ERC could be claimed increased from 50 percent to 70 percent, and the amount was calculated per quarter, not per year.[6]

The following step by Congress was enacting the American Rescue Plan Act of 2021.[7] That legislation codified the ERC for the first time, making it section 3134. ARPA further expanded the ERC, allowing benefits for the third and fourth quarters of 2021.[8]

Things ended when Congress introduced the Infrastructure Investment and Jobs Act.[9] That law retroactively shortened the periods for which eligible employers could claim benefits. With one narrow exception, eligible employers could no longer solicit ERCs for the fourth quarter of 2021.

III. IRS Guidance

The IRS has issued a considerable amount of guidance to keep pace with Congress and address new ERC issues as they arise. This administrative direction has come in various forms, such as notices, revenue procedures, chief counsel advisories, frequently asked questions, checklists, regulations, and more.[10] Most recently, the IRS has published materials about a withdrawal option for taxpayers that previously filed ERC claims, did not yet receive the tax benefits, and want to reverse course with the IRS on the most favorable terms possible.[11] The IRS has also released data in the past few months about its voluntary disclosure program for taxpayers that submitted ERC claims, got the incentives, and found themselves second-guessing whether they deserved them.[12]

[5] Notice 2021-23, Section III.A.

[6] *Id.* at Section III.D.

[7] ARPA section 9651; *see also* Notice 2021-49, 2021-34 IRB 316.

[8] Notice 2021-49, Section III.A.

[9] *See also* Notice 2021-65, 2021-51 IRB 880.

[10] *See*, *e.g.*, Notice 2020-22, 2020-17 IRB 664; Notice 2021-20; Notice 2021-23; Notice 2021-24, 2021-18 IRB 1122; Notice 2021-49; Notice 2021-65; T.D. 9904; T.D. 9953; T.D. 9978; AM 203-005; and Rev. Proc. 2021-33, 2021-34 IRB 327.

[11] IR-2023-169; IR-2023-193.

[12] IR-2023-169; Announcement 2024-3, 2024-2 IRB 364.

While the IRS has obviously issued lots of guidance covering diverse ERC topics, what is still missing is not so apparent to many taxpayers and advisers. The IRS has not yet published materials indicating whether it believes certain ERC claims constitute "reportable transactions" and, if so, whether they are exempt from the required filing and recording-keeping duties. To understand these key absences and their effects, readers first need some background on the reportable transaction regulations, corresponding obligations, and consequences for noncompliance.

IV. Evolution of Relevant Regulations

Taxpayers and others must file various returns, statements, forms, lists, and additional items with the IRS.[13] In situations involving reportable transactions, the main disclosure statements are Form 8886, which must be filed by those who participate in the transactions, and Form 8918, which pertains to material advisers to the transactions. The IRS has published several versions of regulations about reportable transactions over the years.[14] Among them are "transactions with contractual protection." The relevant portions are explored below.

The first set of proposed and temporary regulations, published in March 2000, focused on disclosure statements for corporate taxpayers.[15] The preamble said that the IRS was concerned about the proliferation of tax shelters, and the regulations were intended to give the IRS early notification of large corporate transactions that "may be indicative of such tax shelter activity."[16] The regulations identified two categories of reportable transactions, namely, those that the IRS had specifically identified as tax avoidance transactions, and those that warranted further scrutiny because they possessed characteristics common to tax shelters. Transactions in the second category included ones that featured

[13] Section 6011(a); reg. section 301.6011-1

[14] *See* T.D. 8875; T.D. 8876; T.D. 8877; T.D. 8896; T.D. 8961; T.D. 9000; T.D. 9017; T.D. 9018; T.D. 9046; T.D. 9108; T.D. 9350.

[15] T.D. 8877; REG-103735-00.

[16] T.D. 8877, Preamble.

contractual protection or contingent or refundable fees.[17]

The IRS decided to expand the reach of the disclosure requirements in June 2002. From that point forward, they would apply not only to corporations, but also to individuals, trusts, partnerships, and S corporations that participate in reportable transactions.[18]

The IRS changed course in October 2002 because it discovered that taxpayers were interpreting the tax shelter characteristics "in an overly narrow manner," while construing the exceptions "in an overly broad manner."[19] To remedy this, the IRS created more objective rules, featuring six new categories of reportable transactions.[20] One category was called "transactions with contractual protection," as defined below:

> A transaction with contractual protection is a transaction for which the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax consequences from the transaction will not be sustained, including, but not limited to, rescission rights, *the right to a full or partial refund of fees paid to any persons, fees that are contingent on the taxpayer's realization of tax benefits from the transaction*, insurance protection with respect to the tax treatment of the transaction, or a tax indemnity or similar agreement (other than a customary indemnity provided by a principal to the transaction that did not participate in the promotion or offering of the transaction to the taxpayer).[21] [Emphasis added.]

The IRS issued final regulations in March 2003.[22] It removed certain items from the scope of contractual protection in response to public comments but retained refundable or contingent fees. The preamble to the final regulations explained the IRS's change of heart:

> Commentators indicated that it was inappropriate to require the reporting of a transaction for which the taxpayer obtains tax insurance. Other commentators suggested that the contractual protection factor would require the reporting of numerous non-abusive types of transactions, such as legitimate business transactions with tax indemnities or rights to terminate the transaction in the event of a change in tax law. *In response to these comments, the IRS and Treasury Department changed the focus of the contractual protection factor to whether fees [instead of tax benefits] are refundable or contingent*.[23] [Emphasis added.]

The final regulations focused solely on refundable and contingent fees, as follows:

> A transaction with contractual protection is a transaction for which the taxpayer or a related party . . . has the right to a full or partial refund of fees . . . if all or part of the intended tax consequences from the transaction are not sustained. A transaction with contractual protection also is a transaction for which fees . . . are contingent on the taxpayer's realization of "tax benefits" from the transaction. All the facts and circumstances relating to the transaction will be considered when determining whether a fee is refundable or contingent, including the right to reimbursements of amounts that the parties to the transaction have not designated as fees or any agreement to provide services without reasonable compensation.[24]

The IRS, unsurprisingly, defines the concept of tax benefits expansively here. They include many things, such as tax credits and "any other tax consequences that may reduce a taxpayer's federal income tax liability by affecting the

[17] *Id.*; reg. section 1.6011-4T(b)(3)(B).

[18] T.D. 9000, Preamble; reg. section 1.6011-1T(a)(1).

[19] T.D. 9017, Preamble.

[20] *Id.*

[21] T.D. 9017; reg. section 1.6011-4T(b)(4).

[22] T.D. 9046.

[23] *Id.* at Preamble.

[24] T.D. 9046; reg. section 1.6011-4(b)(4)(i).

amount, timing, character, or source of any item of income, gain, expense, loss or credit."[25]

Taxpayers should note that the final regulations from 2003 contain critical definitions and exceptions when it comes to contractual protection. For instance, the disclosure rules broadly apply to fees paid by, or on behalf of, the taxpayer or a "related party" to any person who makes or provides an oral or written statement to the taxpayer or a related party as to the potential tax consequences that may result from the transaction.[26]

The regulations also contain an exception for certain previously reported transactions. They provide that a transaction will not be deemed to have contractual protection if a person charging a refundable or contingent fee makes a statement to a taxpayer about a transaction in a situation meeting the following three criteria: (1) the taxpayer has already entered into the transaction, (2) the taxpayer has already reported the transaction to the IRS on a prior tax return, and (3) the person making the statement has not previously received fees from the taxpayer in connection with the transaction (previously reported transaction exception).[27]

The IRS has not offered significant clarity regarding the previously reported transaction exception. The California Franchise Tax Board has offered some insight, though. The FTB first noted that the contractual protection category was causing "significant confusion" for taxpayers about whether they had a disclosure duty.[28] The FTB then provided additional thoughts on the previously reported transaction exception:

> Generally, if a taxpayer receives advice *after* entering into a transaction and filing an *original return* that reflects the consequences of the transaction, where the fees relating to that advice are contingent upon the taxpayer realizing certain tax benefits resulting from that advice by filing an *amended return*, and the advisor has not previously advised the taxpayer and not received fees from the taxpayer with respect to that transaction, then, consistent with the previously-reported-transaction exception under [the IRS regulation], the taxpayer has *not* participated in a transaction with contractual protection and the transaction is *not* reportable. For example, a taxpayer files an *original return* reflecting a wage expense. *After* the return has been filed, the taxpayer receives advice from a new advisor that the expenditure qualifies for a California-only enterprise zone credit and files an *amended return* claiming the credit. Even if the taxpayer has a right to a full or partial refund of fees paid for the advice in the event the tax treatment is not sustained or if the fees are contingent on the taxpayer's realization of the credit for the expenditure, the taxpayer has *not* participated in a reportable transaction under [the IRS regulation].
>
> If, however, a taxpayer receives advice *prior to filing an original return* and the taxpayer has a right to a full or partial refund of fees paid in the event the tax treatment is not sustained or if the fees are contingent as described [in the IRS regulation], then, even if the tax treatment based on that advice is only reflected on an amended return, the transaction may *not* be considered a previously-reported transaction as described in [the IRS regulation].[29] [Emphasis added.]

V. Effects of Reportable Status

Many items issued by the IRS thus far regarding ERCs focus on the fees charged by those assisting employers in making claims. However, the IRS has not formally announced a stance that any ERC claims, regardless of the fee structure involved, constitute reportable transactions. What would happen, though, if the IRS were to change course and characterize ERC

[25] Reg. section 1.6011-4(c)(6); *see also* reg. section 301.6111-2(c)(7).

[26] Reg. section 1.6011-4(b)(4)(ii). For the definition of related party, see sections 267(b) and 707(b).

[27] Reg. section 1.6011-4(b)(4)(iii)(B). The regulations emphasize that this exception does not create or affect any substantive rules about when a person is allowed to charge refundable fees. They point taxpayers to Circular 230 for specifics on that topic.

[28] FTB Notice 2007-4 (Oct. 18, 2007).

[29] *Id.*

claims linked to refundable or contingent fees as reportable? It would trigger various results, some of which are described below.

A. Effect on Taxpayers

Taxpayers participating in reportable transactions generally have to file Forms 8886 with the IRS in two ways. They must enclose Forms 8886 with their tax returns for every year of participation, as well as send copies for the first year to the Office of Tax Shelter Analysis.[30] The concept of "participation" varies, but when it comes to transactions with contractual protection, it means that the tax return reflects a tax benefit from the transaction and the taxpayer has the right to a full or partial refund of fees, or the fees are contingent.[31]

Noncompliance by participants triggers various consequences. For example, if participants fail to file timely and complete Forms 8886, the IRS can assert a penalty equal to 75 percent of the tax savings resulting from their participation.[32] It is crucial to note that these sanctions are "immediately assessable" by the IRS.[33] That means that the participants cannot fight them as they would other penalties — by filing a protest letter and addressing matters with the Appeals Office or by submitting a petition with the Tax Court. They must dispute the penalties through the collection process or by paying them, submitting a claim for refund, and, if the IRS ignores or rejects that claim, by filing a refund suit in federal court.[34]

The regulations mandate that participants retain a copy of "all documents and other records" related to a transaction disclosed on Form 8886 that "are material to an understanding of the tax treatment or tax structure of the transaction."[35] Participants must retain the materials until the assessment period related to the final year for which a Form 8886 must be filed has expired.[36] The items that might need to be retained include (1) marketing materials; (2) written analyses used in decision-making related to the transaction; (3) correspondence and any agreements between the taxpayers and any adviser, lender, or other party to the transaction; (4) documents discussing, referencing, or demonstrating the purported tax benefits; and (5) documents referencing the business purposes for the transaction.[37]

Participants are allowed to file protective Forms 8886 if they are uncertain about whether a particular transaction is reportable.[38] Provided that they are completed in full, the IRS will not treat protective Forms 8886 differently than standard ones.[39]

B. Effect on Material Advisers

The possibility of classifying a transaction as reportable has significance for material advisers too.

The IRS defines the term "material adviser" broadly. It generally means a person who provides material aid, assistance, or advice for organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and that person derives a certain amount of gross income from doing so.[40] Persons have material involvement in this context if they (1) make or provide a tax statement; (2) directly to, or for the benefit of, taxpayers or other material advisers; (3) before the first tax return reflecting the benefits of the reportable transaction has been filed with the IRS; and (4) derive a certain amount of income from doing so.[41] A "tax statement" generally means any statement, oral or written, that relates to a tax aspect of a transaction that causes it to be reportable.[42]

[30] Reg. section 1.6011-4(d) and (e).

[31] Reg. section 1.6011-4(c)(3)(C).

[32] Section 6707A(a) and (b); reg. section 301.6707A-1(a).

[33] Section 6707A(d)(2); *Barzillai v. United States*, 137 Fed. Cl. 788 (Apr. 30, 2018); *Larson v. United States*, 888 F.3d 578 (Apr. 25, 2018).

[34] *See, e.g.*, *Barzillai*, 137 Fed. Cl. 788; *Larson*, 888 F.3d 578.

[35] Reg. section 1.6011-4(g)(1).

[36] *Id.*

[37] *Id.*

[38] Reg. section 1.6011-4(f)(2).

[39] *Id.*

[40] Reg. section 301.6111-3(b)(1).

[41] Section 6111(b)(1)(A); reg. section 301.6111-3(b)(2)(i).

[42] Reg. section 301.6111-3(b)(2)(ii)(A). This term takes on additional meaning in the context of transactions with contractual protection. *See* reg. section 301.6111-3(b)(2)(ii)(C).

Material advisers normally must send Forms 8918 to alert the IRS of their involvement.[43] They must be filed with the Office of Tax Shelter Analysis by the last day of the month after the end of the quarter in which an adviser became a material adviser for a reportable transaction.[44] The IRS asserts penalties when violations occur, of course. The normal sanction for an unfiled Form 8918 is $50,000.[45]

In addition to filing Forms 8918, material advisers must maintain for each transaction a list of information about their clients, the transactions in which they participated, the amounts they invested, the tax benefits they derived, and so on.[46] Material advisers must safeguard these lists for seven years and provide them to the IRS upon written request.[47] If they fail to supply the list within 20 days of a written request, the IRS can ordinarily assert a penalty of $10,000 per day.[48]

If potential material advisers are uncertain whether involvement in a transaction must be disclosed, Forms 8918 can be filed on a protective basis. The IRS treats Forms 8918 filed on a protective basis the same as regular ones.[49]

C. Effects on Return Preparers

In addition to pursuing taxpayers and material advisers involved with reportable transactions, the IRS might pursue penalties against accountants, enrolled agents, or others serving as return preparers.[50]

The IRS generally can penalize a return preparer in situations in which all of the following factors are met: (1) the preparer prepared a tax return or refund claim; (2) it contained a position that resulted in an understatement of the taxpayer's liability; (3) the preparer knew, or reasonably should have known, about the position; (4) the position related to a reportable transaction; and (5) it was not reasonable for the preparer to believe that the position would more likely than not be upheld if the IRS were to challenge it.[51] The penalty for violations equals the greater of $1,000 or 50 percent of the income that the preparer derived (or will derive) for the relevant tax return or refund claim, whichever amount is larger.[52] The IRS cannot assert a penalty if the preparer demonstrates that there was reasonable cause for the tax understatement and they acted in good faith.[53]

VI. Assuaging Anxiety

Some taxpayers reading this article might be concerned at this point, asking themselves if they were required to file Forms 8886 in connection with their ERC claims, whether they did so, whether they can fix matters now if they inadvertently fell into noncompliance, and what negative consequences might occur. Professionals falling within the definition of material adviser might be asking similar questions about Forms 8918.

Good news exists. For starters, as noted, the IRS has not formally taken the position that ERC claims, even those involving refundable or contingent fees, should be classified as reportable transactions. Taxpayers and advisers would no doubt challenge that stance were the IRS to take it, particularly since it is now 2024, Congress introduced the ERC nearly four years ago in March 2020, and the IRS began issuing major guidance in March 2021.

Another positive point is that many transactions likely would not be subject to Form 8886 and Form 8918 filing duties thanks to the previously reported transaction exception.

Also, the regulations state that a transaction will not be considered reportable if the IRS "makes a determination by published guidance that the transaction is not subject to the reporting requirements."[54] This language is not just theoretical; the IRS has previously taken this action in various situations, including those

[43] Section 6111(a); reg. section 301.6111-3(a), (d)(1), and (g).

[44] Reg. section 301.6111-3(e).

[45] Section 6707(a) and (b)(1); reg. section 301.6707-1(a)(1)(ii)(A). The penalty is significantly higher if the violation involves a listed transaction. *See* section 6707(b)(2).

[46] Section 6112; reg. section 301.6112-1.

[47] Section 6112(b)(1); reg. section 301.6112-1(b), (d), and (e).

[48] Section 6708(a)(1); reg. section 301.6708-1(a).

[49] Reg. section 301.6111-3(g).

[50] REG-106228-22, at Explanation of Provisions — Section III.

[51] Section 6694(a)(1) and (2).

[52] Section 6694(a)(1).

[53] Section 6694(a)(3).

[54] Reg. section 1.6011-4(b)(8)(i).

focused on whether transactions have contractual protection.[55] For example, the IRS issued Rev. Proc. 2007-20, 2007-1 C.B. 517, identifying a long list of federal tax credits that are exempt from disclosure duties.[56] There is no doubt that the IRS was focused on tax credits obtained thanks to performance-based fees; it specifically says so. Rev. Proc. 2007-20 excludes from duties "transactions in which the refundable or continent fee is related to" several common tax credits, such as the work opportunity credit, low-income housing credit, and new markets tax credit.[57] Rev. Proc. 2007-20 also exempted a few transactions involving employment tax credits, namely, the empowerment zone employment credit, renewal community employment credit, and the ERC under former section 1400R.[58]

Also of interest to readers should be the effective date of Rev. Proc. 2007-20. Although the IRS published that guidance in January 2007, it said that certain filing exceptions applied to transactions going back to January 2003, while other exceptions affected transactions subject to reporting after January 2006. The IRS, in other words, made the exceptions retroactive to varying degrees, which favored taxpayers.[59]

VII. Conclusion

Regulations dating back more than two decades have identified "transactions with contractual protection" as potentially problematic. That category encompasses certain transactions involving refundable or contingent fees, and the IRS has started inquiring about this issue during ERC audits and investigations. Many taxpayers and advisers should be protected by the previously reported transaction exception. Moreover, given the IRS's earlier decision to issue Notice 2007-20 exempting from reportable status several tax credit transactions involving refundable or contingent fees, logic dictates that the IRS should do the same for the ERC. However, until that occurs, or until the IRS otherwise indicates that ERC claims are not reportable transactions irrespective of the fee structure, taxpayers and advisers need to be aware of this important issue and take appropriate steps. ■

[55] The IRS has recognized several exceptions to reportable transaction status. *See*, *e.g.*, Rev. Proc. 2004-68, 2004-2 C.B. 969 (exempting certain transactions with brief asset holding periods), Rev. Proc. 2004-67, 2004-2 C.B. 967 (exempting certain transactions with book-tax differences), and Rev. Proc. 2004-66, 2004-2 C.B. 966 (exempting certain transactions with losses).

[56] Rev. Proc. 2007-20, section 4.02 (superseding Rev. Proc. 2004-65, 2004 C.B. 965).

[57] *Id.*

[58] *Id.*

[59] Rev. Proc. 2007-20, section 6.