

CHADBOURNE & PARKE LLP

Expansive New IRS Tax Shelter Disclosure, List Maintenance And Registration Rules — Final Regulations Issued

*Potentially Applicable To And Must Be Considered For
Significant Transactions—Even Routine Transactions*

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TAX SHELTER DISCLOSURE, LIST MAINTENANCE AND REGISTRATION RULES

Background

- The Internal Revenue Service issued broad-sweeping final tax shelter disclosure, list maintenance and registration regulations on February 27, 2003. The final regulations revised temporary and proposed regulations issued in October 2002. The final regulations cover the following:
 - **Taxpayers must file IRS disclosure forms:** Taxpayers who participate in a transaction that is a so-called "potentially abusive tax shelter" must file tax shelter disclosure forms with their federal income tax returns.
 - **Advisors must maintain tax shelter lists:** Promoters and other advisors who discuss with an investor the potential tax consequences of any transaction that is a "potentially abusive tax shelter" must maintain lists of such investors and retain documents and tax advice pertaining to the transaction which must be turned over to the IRS upon request. This list maintenance rule also applies to persons who are not generally viewed as tax shelter promoters, including the taxpayer's own advisor.
 - **Tax shelter registration:** So-called "confidential corporate tax shelters" must be registered with the IRS.
- The key operative term is "**reportable transaction**" for list maintenance and disclosure (but not tax shelter registration).

Observation: *The nomenclature used by the IRS does not reflect common parlance and thus can be quite misleading. The dictionary meaning and everyday views of terms such as "tax avoidance", "tax shelter" and "potentially abusive tax shelter" does not properly capture the broad application of these rules. Tax-neutral transactions can be "potentially abusive tax shelters" within the meaning of the regulations.*

Observation: *The effect of these rules is that significant corporate transactions will have to be analyzed to see whether tax shelter disclosure and list maintenance is required. In certain cases, taxpayers may be able to make simple, non-substantive transaction modifications to avoid falling into the trap of having the transaction classified as a reportable tax shelter.*

Executive Summary

Reportable Transactions

- The final regulations require disclosure by "participants" and list maintenance by "material advisors" of any transaction that is required to be registered as a tax shelter or that falls within **one** of the following six categories of "reportable transactions":
 1. **Listed transactions:** Specific transactions listed by the IRS from time-to-time as tax-avoidance transactions.
 2. **Confidential transactions:** Transactions offered under conditions of confidentiality requiring the taxpayer to keep confidential the tax treatment and the tax structure of the transaction. This is a facts and circumstances test and does not depend on the existence of a binding confidentiality agreement. A presumption against confidentiality exists if confidentiality as to tax treatment and tax structure is expressly waived in writing by every person who provides a statement as to the potential tax consequences of the transaction. Such written authorization must be provided to the taxpayer no later than 30 days from the date of such statement, permitting the taxpayer to disclose the tax treatment and tax structure of the transaction. For certain M&A transactions, the confidentiality-waiver does not need to be in place until the transaction is publicly announced or signed. Such a confidentiality-waiver may become standard practice for many advisors, including investment bankers, promoters, advisors, lawyers and accountants.
 3. **Transactions with contractual protections:** Transactions offering contractual protections in the form of contingent fees and fee refunds against the loss of tax benefits.
 4. **Loss transactions:** Transactions that produce losses in excess of specified thresholds (e.g., \$10 million for a corporation; and \$2 million for an individual for any one year).
 5. **Book-tax differences:** For SEC-reporting companies and certain other companies with \$250 million or more of gross assets, any transaction with a book-tax difference in excess of \$10 million in any year, other than certain timing differences and various enumerated items (expanded by a recent revenue procedure to thirty items). Special rules deal with book-tax differences with respect to partnerships and U.S. shareholders of foreign corporations.
 6. **Brief holding periods:** Transactions involving brief holding periods for certain assets that generate tax credits in excess of \$250,000.
- *Special considerations with respect to confidentiality:* In the event a transaction is considered confidential within the meaning of the regulations, list maintenance and disclosure may be required. Thus, it may be prudent at the outset to include in initial transaction documents the explicit confidentiality-waiver set forth in the regulations. As described below, this may require a careful balancing of the competing considerations and practicalities.

Executive Summary

Observation: *The final regulations replace the "two out of five test" of the old (pre-October 2002) regulations that required disclosure only if a transaction satisfied at least two out of five enumerated characteristics.*

Observation: *The final regulations also eliminate exceptions available under the "two out of five" regime for "no reasonable basis for denying tax benefits" and for "customary commercial practice" transactions. This means that the taxpayer will generally not be able to merely rely on the opinion of counsel to escape the disclosure net. More practically this also means that common commercial transactions can also fall in the net. (These exceptions still have applicability for the tax shelter registration requirement described below).*

Participant disclosure requirements: IRS form must be filed with tax returns

- Any taxpayer that directly or indirectly participates in any reportable transaction reflected on its federal income tax return must attach the new IRS Form 8886 (to be issued in the future) to its federal income tax return for each year in which its federal income tax liability is affected by its participation in the transaction. A copy of Form 8886 must also be submitted to the Office of Tax Shelter Analysis at the same time Form 8886 is first filed with the IRS.

List maintenance requirements: applies to "material advisors" (e.g., promoters, investment bankers, advisors, lawyers and accountants)

- The list maintenance regulations require "material advisors" to maintain certain records, including lists, with respect to (i) any transaction that is a "listed transaction", (ii) any transaction that, if at the time the transaction is entered into, the material advisor knows or reasonably expects to be a "reportable transaction", or (iii) any transaction that is subject to the tax shelter registration rules. Such records and lists must be turned over to the IRS within 20 days when requested.

Executive Summary

- A "material advisor" is defined as any person who (i) is required to register a confidential corporate tax shelter with the IRS, or (ii) receives, or expects to receive, a minimum fee in connection with the transaction and who makes a "tax statement" written or oral regarding the potential tax consequences of the transactions, to (x) any person required to, or reasonably expected by the material tax advisor to be required to, disclose the transaction as a "reportable transaction" on its federal income tax return; (y) any person required to register the transaction as a confidential corporate tax shelter; or (z) any person who purchases an interest in a transaction that is required to be registered as a confidential tax shelter.
- The minimum fee is \$250,000 (\$25,000 for listed transactions) if all persons who acquire an interest (directly or indirectly) in the transaction are corporations (other than S corporations), and \$50,000 (\$10,000 for listed transactions) for all other transactions. The determination of whether the minimum threshold is met is made separately with respect to each reportable transaction.
- The material advisor also must retain and turn over to the IRS, if requested, copies of any written materials, including tax analyses or opinions, relating to each transaction that have been shown or provided to any investor or to the investor's representatives, tax advisors or agents, by the material advisor or any related party or agent of the material advisor.

Observation: *Material advisors are not required to keep earlier drafts as long as the final document (or if none, the final draft) is retained and the final document (or most recent draft) contains all the information in the earlier drafts that is material to an understanding of the tax treatment or tax structure.*

- While multiple material advisors may designate one material advisor to maintain the list for a transaction, such designation will not relieve any other material advisor from its obligation to furnish the list to the IRS or from potential liability for the failure to do so.
- Under the regulations, the list maintenance rules now apply to the same categories of transactions as those of the disclosure rules (which is a change from the pre-October 2002 regulations).

Executive Summary

Tax Shelter Registration Requirements

- The final regulations make conforming changes to the rules in existence since February 2000 requiring tax shelter organizers to register "confidential corporate tax shelters" with the IRS.
- A "confidential corporate tax shelter" is any investment, entity, plan, arrangement or transaction (i) a significant purpose of the structure of which is the avoidance or evasion of Federal income tax for a direct or indirect corporate participant; (ii) that is offered to any potential participant under conditions of confidentiality, and (iii) for which the tax shelter promoters may receive fees in excess of \$100,000 in the aggregate.
- Tax avoidance transaction: A transaction is treated as structured for the avoidance or evasion of Federal income tax if the transaction is:
 - **Listed transaction:** The transaction is the same or substantially similar to a listed transaction; or
 - **Other tax-structured transaction:** The transaction has been structured to produce Federal income tax benefits that constitute an important part of the intended results of the transaction and the tax shelter promoter reasonably expects the transaction to be presented in the same or substantially similar form to more than one potential participant.
- Registration is not required for tax-structured transactions (other than listed transactions) where (i) the transaction is entered into in the ordinary course of business in a form consistent with commercial practice and there is generally accepted understanding of the tax benefits, or (ii) the tax shelter promoter reasonably determines that there is no reasonable basis for denying the tax benefits.

Observation: *Tax promoters may be relieved of the obligation to register a transaction as a tax shelter based on a well-reasoned opinion of tax counsel that the transaction satisfies the exceptions for "customary commercial practice" or "no reasonable basis for denying tax benefits". As noted earlier, this is not true of the tax shelter disclosure and listing rules which apply whether or not such an opinion is received.*

Reportable Transactions

- The final regulations require taxpayers to disclose on their federal income tax returns their "*participation*" in any transaction treated as a "*reportable transaction*". "*Participation*" in a reportable transaction is defined differently for each category of reportable transaction. Broadly speaking, a taxpayer participates in a reportable transaction if tax consequences or tax benefits from the transaction are reflected on the taxpayer's federal income tax return.

Category 1: Listed transactions: Any transaction that is the same or "substantially similar" to a transaction identified as a tax avoidance transaction by IRS notice, regulation or other published guidance is a reportable transaction.

- The listed transactions identified to date by the IRS are set forth on the next page.
- The regulations indicate that a transaction is "substantially similar" to a listed transaction if it is "expected to obtain the same or similar types of tax consequences and is either factually similar or based on the same or similar tax strategy." This is an extremely broad definition.
- The regulation goes on to say that the term substantially similar "must be broadly construed in favor of disclosure." The receipt of an opinion regarding the tax consequences is not relevant to the determination whether the transaction is the same or substantially similar.
- A taxpayer is treated as participating in a listed transaction and is therefore subject to these rules if (i) the taxpayer's tax return reflects tax consequences of or a tax strategy described in the published guidance describing a listed transaction, or (ii) the taxpayer knows or has reason to know that the taxpayer's tax benefits are derived directly or indirectly from tax consequences or a tax strategy reflected in such guidance.

Observation: *As defined, the (i) category of participant presumably includes both sides of the transaction.*

Reportable Transactions

Category 1: Listed transactions (*continued*):

➤ The IRS has identified the following listed transactions to date:

- transactions in which taxpayers claim deductions for contributions to a qualified cash or deferred arrangement or matching contributions to a defined contribution plan where the contributions are attributable to compensation earned by plan participants after the end of the taxable year
- trust arrangements purported to qualify as multiple employer welfare benefit funds exempt from the limits of Sections 419 and 419A of the Code
- multiple-party transactions intended to allow one party to realize rental or other income from property or service contracts and to allow another party to report deductions related to that income (often referred to as "lease strips")
- transactions in which the reasonably expected economic profit is insubstantial in comparison to the value of the expected foreign tax credits
- transactions involving contingent installment sales of securities by partnerships in order to accelerate and allocate income to a tax-indifferent partner, such as a tax-exempt entity or foreign person, and to allocate later losses to another partner
- transactions involving distributions described in section 1.643(a)-8 from charitable remainder trusts
- transactions in which a taxpayer purports to lease property and then purports to immediately sublease it back to the lessor (that is, lease-in/lease-out or LILO transactions)
- transactions involving the distribution of encumbered property in which taxpayers claim tax losses for capital outlays that they have in fact recovered
- transactions involving fast-pay arrangements as defined in section 1.7701(l)-3(b)
- transactions involving the acquisition of two debt instruments the values of which are expected to change significantly at about the same time in opposite directions
- transactions generating losses resulting from artificially inflating the basis of partnership interests
- transactions involving the purchase of a parent corporation's stock by a subsidiary, a subsequent transfer of the purchased parent stock from the subsidiary to the parent's employees, and the eventual liquidation or sale of the subsidiary
- transactions purporting to apply section 935 to Guamanian trusts
- transactions involving the use of an intermediary to sell the assets of a corporation
- transactions involving a loss on the sale of stock acquired in a purported section 351 transfer of a high basis asset to a corporation and the corporation's assumption of a liability that the transferor has not yet taken into account for federal income tax purposes
- redemptions of stock in transactions not subject to U.S. tax in which the stock basis is purported to shift to a U.S. taxpayer
- transactions generating losses from loan assumption agreement with inflated basis in acquired assets
- transactions involving the use of notional principal contracts to claim current deductions for periodic payments made while disregarding the accrual of a right to receive offsetting payments in the future
- transactions using a tiered partnership structure, a straddle, a transitory partner, and the absence of a section 754 election to claim a permanent non-economic loss
- transactions involving an S corporation or a partnership and one or more transitory shareholders or partners to claim a loss while deferring an offsetting gain on a straddle position
- reinsurance arrangements used to divert income from a U.S. taxpayer to a captive insurance company that is subject to little or no federal income tax
- arrangements involving ESOPs that hold employer securities in an S corporation for the purpose of claiming eligibility for the delayed effective date of section 409(p) of the Code

Reportable Transactions

Category 2: Confidential transactions: Any transaction offered under "conditions of confidentiality" as to the *tax treatment* or *tax structure* of the transaction is a reportable transaction.

- The regulations set forth a very expansive definition of "confidentiality":
 - A transaction is considered to be confidential if a taxpayer's disclosure of the tax treatment or the tax structure of the transaction is *limited in any* way by an express or implied understanding or agreement with or for the benefit of any person who makes or provides a statement, oral or written regarding the potential tax consequences of the transaction, to or for the benefit of the taxpayer, regardless of whether the understanding is legally binding.
 - A transaction is also considered to be confidential if the taxpayer knows or has reason to know that its use or disclosure of information relating to the tax treatment or tax structure of the transaction is limited in any way such as where the transaction is claimed to be proprietary or exclusive.
 - Transactions are not treated as confidential solely as a result of disclosure restrictions under securities laws.

Observation: *The test is a facts and circumstances test and confidentiality can be found even where there is no legally binding understanding or agreement.*

- A taxpayer has "participated" in a confidential transaction and is therefore subject to these rules if the taxpayer's tax return reflects a tax benefit from the transaction and the taxpayer's disclosure of the tax treatment or tax structure is limited within the meaning of the confidentiality rules.
 - If a partnership, S corporation or trust's disclosure is limited but there is no limit on the partner, shareholder or beneficiary, then the former group and not the latter group has participated in a confidential transaction.

Reportable Transactions

- The definition of confidentiality is so broad that, as a practical matter in many cases, taxpayers will be required to **explicitly waive confidentiality** in writing to escape this reportable transaction category.
 - The confidentiality waiver is effective if the *taxpayer is authorized in writing to disclose* to any person, without any limitation of any kind, (i) the *tax treatment and tax structure of the transaction* and (ii) *all materials* of any kind (including tax opinions or analyses) that are provided to the taxpayer related to the tax treatment and tax structure of the transaction.
 - This written authorization must come from **every person** who provides a statement to the taxpayer as to the potential tax consequences of the transaction. The regulations suggest the following language for the confidentiality waiver:

"The taxpayer (and each employee, representative, or other agent of the taxpayer) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the transaction and all materials of any kind (including opinions or other tax analyses) that are provided to the taxpayer relating to such tax treatment and tax structure."
 - The written authorization must be provided no later than 30 days from the date the person granting the waiver first provides tax advice to the taxpayer regarding the transaction and must be effective from the commencement of discussions. Special timing rules (described below) apply to certain M&A transactions.

Observation: *This confidential transaction category potentially applies to a broad array of routine transactions that have very little tax sensitivity. The practical effect is that the parties to be safe may include the explicit confidentiality-waiver language allowing disclosure of the tax treatment and tax structure.*

Observation: *It is difficult to draw the line between transactions where the facts and circumstances demonstrate there is no confidential tax treatment or tax structure and those where there might be a risk that the IRS views the transaction as confidential. The regulations are brand new and this is an evolving area. If there is a confidentiality agreement generally covering the transaction, then a confidentiality-waiver provision covering tax treatment and tax structure may be advisable. If there is no general confidentiality agreement covering the transaction and the taxpayer consults a tax advisor for tax advice on the transaction, consideration may need to be given to providing a confidentiality waiver.*

Reportable Transactions

Observation: *If a transaction would otherwise be classified as a reportable transaction under some other category, it might appear that the express confidentiality waiver is of no benefit. However, the IRS will likely continue to refine the categories and issue updated guidance on carve-outs, for example, from the significant book-tax difference and Section 165 loss categories. For this reason, some judgment should come into play in determining whether an explicit confidentiality waiver should be sought in a transaction that will be classified as a reportable transaction under some other category.*

- The regulations contain a special confidentiality waiver rule for the following **M&A transactions**:
 - A proposed taxable or tax-free asset acquisition of the historic assets of a corporation that constitute an active trade or business the acquirer intends to continue.
 - A proposed taxable or tax-free acquisition of more than 50% of the stock of a corporate target that owns historic assets used in an active trade or business that the acquirer intends to continue.
- Under this special M&A transaction rule, disclosure must be permitted for a qualifying M&A transaction no later than the earliest of (i) the date of the public announcement of discussions relating to the transaction; (ii) the public announcement of the transaction; or (iii) the date of execution of an agreement with or without conditions to enter into the transaction.

Observation: *The special M&A rule does not encompass, or is unclear in its application to, many routine M&A transactions, including*

- Stock acquisitions of 50% or less of target company.
- Asset acquisitions where the acquirer intends to use the assets in a new rather than continued trade or business.
- Stock or asset acquisitions where the business is still in a start-up phase (e.g., acquisition of a power plant facility that is not yet placed in service).
- Stock acquisitions where the assets are newly - or relatively newly -acquired.
- Stock acquisitions of holding company (is active business test satisfied); acquisition of partnership or LLC interest (presumably such a transaction should not fall outside the rule; if it is within the rule, should it be treated as an asset acquisition (so that the acquisition of a smaller percentage interest can qualify) or a stock acquisition (so that a more than 50% interest must be satisfied).

Reportable Transactions

Category 3: Transaction with contractual protection: *Any transaction in which some or all of the fees payable by the taxpayer are refundable or contingent depending on whether part or all of the intended tax consequences of the transaction are not sustained is a reportable transaction.*

- The regulations indicate that a transaction where a party has a *right to terminate* the transaction upon the happening of an event affecting the taxation of one or more parties is *not* viewed as contractual protection.

Observation: *The final regulations focus on fee protection arrangements, thus cutting back significantly on the temporary regulations which defined contractual protection very broadly to include even routine tax indemnities between two parties to a transaction as well as rescission rights.*

Observation: *The rule does not apply where the tax advisor charges refundable or contingent fees in handling a tax audit proceeding involving a filed tax year where the tax advisor had not previously received fees from the taxpayer in connection with the transaction. The regulations then provide that this exception is not meant to establish a substantive rule as to when a tax advisor may charge refundable or contingent fees.*

- A taxpayer has "participated" in a transaction with contractual protection and therefore is subject to these rules if the taxpayer's tax return reflects a tax benefit from such a transaction.
 - If a partnership, S corporation or trust has the right to a full or partial refund or fees or has a contingent fee arrangement, but the partner, shareholder or beneficiary does not individually have the right, only the former group has participated in such a transaction.

Reportable Transactions

Category 4: Loss transactions: *Any transaction that results in, or is reasonably expected to result in, a taxpayer claiming a loss under Section 165 in excess of a specified threshold is a reportable transaction.*

- The term "loss" is defined very broadly to include any amount deductible by virtue of a provision that treats a transaction as a sale or disposition or otherwise results in a loss deduction under Section 165.
- Losses are determined on a gross basis and are not offset by gains or other income from related transactions or other limitations (e.g., the limitation on the deductibility of capital losses). However, the amount of the loss can be offset by insurance, salvage value and other similar compensation.
- The full amount of the loss is taken into account in the year sustained regardless of whether it is carried forward or back under Section 172.

➤ Loss thresholds

Entity/Individual*	Single taxable year	All taxable years***
Corporation	\$10 million	\$20 million
Partnerships	\$5 million	\$10 million
S-Corporation	\$5 million	\$10 million
Individuals/Trusts	\$2 million	\$4 million
Individuals/Trusts **	\$50,000**	

* Threshold applies regardless of number of partners, shareholders or beneficiaries

** Lower limit applies if loss arises (directly or as a flow-through item) in foreign currency transactions

*** Taxable year of transaction and next 5 years

Observation: *The "loss transaction" category is very broad, reflecting the IRS's frustration that many transactions that produce tax losses without economic losses were not picked up under the prior set of rules.*

Reportable Transactions

Category 4: Loss transactions (*continued*):

- A taxpayer (including a pass-through entity such as a partnership, S-corporation or trust) has "participated" in a loss transaction and is therefore subject to these rules if its tax return reflects a Section 165 loss which exceeds the threshold.
 - A partner, S corporation shareholder or beneficiary of a trust is treated as participating only if the amount of the Section 165 loss that flows through to that taxpayer (disregarding netting at the entity level) equals or exceeds the threshold amount applicable to that type of taxpayer.
- Loss transactions that are picked up by this provision include:
 - loss on sale of stock, property or partnership interests
 - loss from a foreign currency transaction
 - losses from sales of securities
- Excluded from the Section 165 loss transaction category are losses resulting from deductions arising under Code provisions other than Section 165, including depreciation, rents, personal services payments and payments treated as part of cost of goods sold.
- Rev. Proc. 2003-24 excludes certain additional "real economic loss" transactions, including:
 - Losses from the sale or exchange of an asset with a "qualifying basis". Tax basis is a "qualifying basis" generally if it is determined solely by reference to the amount of cash paid (or is carryover or substituted basis determined by the amount of cash paid for the original asset).
 - Casualty losses; losses for compulsory or involuntary conversions.
 - Losses arising from any mark-to-market treatment of an item under certain enumerated Code sections, provided that taxpayer's original basis in the asset is a "qualifying basis".
 - Losses derived from certain hedging transactions.

Reportable Transactions

Category 5: Transactions with significant book-tax differences: *Any transactions of so-called "applicable taxpayers" where the federal income tax treatment of any item or items differs in any taxable year by more than \$10 million on a gross basis from book treatment is a reportable transaction.*

- Book income is generally determined by applying U.S. GAAP to world-wide income.
 - Taxpayers that do not keep books based on U.S. GAAP and do not use U.S. GAAP for any purpose are permitted to use books maintained by the taxpayer. (This rule would apply to many foreign corporations and to partnerships that keep their books using tax capital accounts rather than U.S. GAAP.)
 - Offsetting items are not netted for either book or tax purposes.
 - Adjustments to any reserves for taxes are disregarded in determining book-tax differences.
 - Book-tax differences arising solely because of differences in the book consolidation (50% test) and tax consolidation (80% test) rules are disregarded.
 - It is unclear how a "material advisor" monitors a taxpayer's book treatment of a transaction for list maintenance purposes or determines the computation of tax and book amounts.
- The book-tax category applies to ***applicable taxpayers, i.e.:***
- Companies that are SEC reporting companies (*i.e.*, companies that have publicly offered debt or equity in the United States).
 - Other companies that have \$250 million or more gross assets taking into account only entities related under a 50% relationship test (see special rule for foreign corporations, below).
- A taxpayer has "participated" in a transaction with a significant book-tax difference and therefore is subject to these rules if the taxpayer's book and tax treatment differ as described above. That's true even if the taxpayer's tax return does not reflect a "tax benefit", and indeed reflects a tax detriment, from the transaction.

Reportable Transactions

Category 5: Transactions with significant book-tax differences (*continued*):

- *Consolidated tax return filers*: Special rules apply to transactions between and among consolidated tax return filers:
 - Transactions solely among members filing consolidated tax returns are disregarded.
 - If two or more members of a consolidated group participate in a transaction that is not solely among members, items are aggregated (as if such members were a single taxpayer) but any offsetting items are not netted.
- *Foreign companies*: Special rules apply in the case of foreign companies that are not SEC reporting companies (or related to SEC reporting companies):
 - In the case of foreign companies doing business in the United States, only transactions affecting U.S. income taxes and, for purposes of the \$250 million gross asset test, only assets connected to their U.S. business are taken into account.
 - In the case of foreign companies that are not doing business in the United States (or do not satisfy the threshold in the preceding paragraph), U.S. shareholders of flow-through foreign corporations (CFCs, PFICs and FPHCs), receiving flow-through treatment can be treated as "participants" required to disclose. (See, "Disclosure Requirements," below).

Observation: *Under the present regulations, there may be a number of common clearly non-abusive transactions with book-tax differences that will be classified as significant book-tax difference transactions. The book-tax difference category will be difficult to administer. The accountants and tax advisors will need to work much closer together on many transactions than would otherwise be the case.*

Reportable Transactions

Observation: *Exceptions: Responding to comments that the book-tax difference category reflected in the temporary regulations was too broad and the exceptions enumerated in such regulations were too few, the IRS released Rev. Proc. 2003-25 which enumerated book-tax differences that would not be considered significant book-tax differences under the final regulations.*

- items generating a book loss or expense before or without a tax loss or expense
- items generating a tax gain or income before or without a book gain or income
- depreciation, depletion, and amortization relating solely to differences in methods, lives, or conventions
- percentage depletion and intangible drilling costs
- capitalization and amortization under §§ 195, 248 and 709
- bad debts or cancellation of indebtedness income
- federal, state, local, and foreign taxes
- compensation of employees and independent contractors (including stock options and pensions)
- charitable contributions of cash or tangible property
- tax-exempt interest
- dividends and distributions of previously taxed income (from CFCs, FPHCs, PFICs)
- dividends paid deduction of a publicly-traded REIT
- patronage refunds or dividends of cooperatives (without a § 267 relationship to the taxpayer)
- involuntary conversions under § 1033
- tax-free reorganization, spin-off treatment or like-kind exchanges (if the taxpayer fully complies with filing and reporting requirements)
- debt-for-debt exchanges
- items resulting solely from the treatment as a sale, purchase, or lease for book purposes and a financing arrangement for tax purposes (e.g., synthetic leases)
- certain REMIC transactions
- hedge accounting for book not tax purposes or vice versa; use of different hedge accounting methods for book and tax purposes
- mark-to-market accounting for book not tax purposes or vice versa; use of different mark-to-market methodologies for book and tax purposes
- certain § 1286 stripped bonds
- inside buildup, death benefits, or cash surrender value of life insurance or annuity contracts
- life insurance reserves determined under § 807; non-life insurance reserves determined under § 832(b)
- capitalization of policy acquisition expenses of insurance companies
- imputed interest income or deductions under §§ 483, 1274, 7872, or Treas. Reg. § 1.1275-4
- gains and losses arising under §§ 986(c), 987, and 988 (foreign currency)
- items excluded under § 883, § 921, or an applicable treaty from a foreign corporation's income that would otherwise be subject to tax under § 882
- § 481 adjustments
- inventory valuation differences whether attributable to differences in last-in, first-out (LIFO) computations or obsolescence reserves
- § 198 deductions for environmental remediation costs

Reportable Transactions

Category 6: Transactions involving a brief asset holding period: *Any transaction resulting in, or that is reasonably expected to result in, a tax credit exceeding \$250,000 (including a foreign tax credit) is a reportable transaction if the underlying asset giving rise to the credit is held by the taxpayer for less than 45 days.*

- Under certain circumstances the principles of Code Section 246(c)(3) and (c)(4) could toll the running of the 45-day holding period.
- A taxpayer has participated in such a transaction if the taxpayer's tax return reflects items giving rise to such a tax credit.
- This category was intended to cover transactions where taxpayers acquired stock of a foreign corporation shortly before the payment of a dividend and sold the stock immediately thereafter to capture a foreign tax credit.

Reportable Transactions

Exceptions to Reportable Transactions -- certain leasing transactions (tangible personal property) and regulated investment companies:

- *Regulated investment companies* are not required to disclose any reportable transaction other than a category 1 listed transaction.

- Certain *customary leasing transactions* (described in an IRS notice) involving *tangible personal property* are automatically excluded from all categories of reportable transactions (including category 2 confidential transactions) except for category 1 listed transactions. To qualify for the exception, such leasing transactions must satisfy the following criteria:
 - the transaction is a lease or sale leaseback between an owner-lessor of tangible personal property and a lessee who is the user of the property;
 - the terms of the lease (including any related agreements) are consistent with customary commercial practice, for the leasing of similar items of property;
 - the transaction qualifies as a lease for federal income tax purposes under Rev. Proc. 75-21, 1977-1 C.B. 715 (or its successor), or under generally accepted case law principles;
 - the lessor and lessee agree to consistently report the transaction as a lease for federal income tax purposes; and
 - the transaction is not the same as or substantially similar to a listed transaction (or part of a listed transaction).

- *Future exceptions*: The final regulations contemplate that the IRS will fine-tune the reportable transaction rules from time-to-time by publishing guidance carving out specific types of transactions.

Disclosure Requirements

IRS filing requirements for "reportable transactions"

- New IRS Form 8886 (to be issued in the future) must be completed and filed by any taxpayer who has "participated" in a reportable transaction. The "participation" rules differ for each category and are described above in "Reportable Transactions."
 - Form 8886 must be attached to the taxpayer's federal income tax return for each taxable year in which the taxpayer's federal income tax liability is affected, including amended returns for carryback years, or, in the case of an S corporation or partnership, for the first year in which the partner or shareholder's federal income tax liability is affected.
 - If a transaction becomes a reportable transaction after the first return is filed (e.g., transaction subsequently becomes a listed transaction or there is a change in facts), Form 8886 must be filed with the taxpayer's next federal tax return (whether or not tax liability is affected on that return).
 - In addition, Form 8886 must be sent to the IRS office of Tax Shelter Analysis at the same time the first such tax return is filed.

Pass-through entities

- Partnerships, trusts and S corporations that engage in reportable transactions are required to file Form 8886.
 - Partners, beneficiaries and S corporation shareholders are generally treated as participants who are separately subject to the disclosure rules only if they independently satisfy the criteria for the category (e.g., the partner as well as the partnership is subject to confidentiality; the partner's share of Section 165 loss exceeds the thresholds). These rules are described above for each specific category of reportable transactions.
- U.S. shareholders of pass-through foreign corporations (FPHC, CFC, PFIC) are generally treated as participants if the category criteria are satisfied by the foreign corporation (or would have been satisfied if it were a U.S. corporation) even if, for example, the shareholder's share of the Section 165 loss would not independently satisfy the criteria.

Disclosure Requirements

Protective disclosure; rulings on disclosure

- Taxpayers are permitted to file "protective disclosures" indicating they are uncertain whether a transaction needs to be disclosed.
- Taxpayers can request a ruling from the IRS whether disclosure is required and, if the request discloses all the relevant facts and is submitted prior to the due date of the disclosure, the disclosure obligation is suspended while the request is pending.

Observation: It is not clear whether anyone would utilize this procedure.

Document retention

- Taxpayers are required to retain copies of all documents and records relating to the transaction that are material to an understanding of the tax treatment or tax structure of the transaction.
 - These documents must be retained until the expiration of the statute of limitations applicable to the final taxable year for which disclosure was made.
 - The documents that must be retained include:
 - Marketing materials and other written analyses used in decision-making;
 - Correspondence and agreements between the taxpayer and any advisor, lender, or other party to the transaction that relates to the transaction;
 - Documents discussing, referring to, or demonstrating tax benefits arising from the transaction;
 - Documents referring to the business purpose for the transaction.

Observation: Taxpayers are not required to keep early drafts if they keep the final document (or if none, the most recent draft) and such document (or draft) contains all information in the earlier drafts that is material to an understanding of the purported tax treatment or tax structure of the transaction.

Disclosure Requirements

Penalties for failure to file

- There is no specific statutory penalty for failure to file Form 8886.
 - The IRS recently promulgated proposed regulations which preclude taxpayers which have not filed Form 8886 from relying on the "reasonable cause" and "good faith" exception to the imposition of an understatement penalty.
 - Even in the absence of explicit penalties, Form 8886 is a required part of the tax return. Tax returns are signed by the taxpayer under penalties of perjury.

Observation: *Query whether a responsible tax return preparer will counsel taxpayers to forego Form 8886 filings because of a lack of specific penalties. We doubt it.*

Observation: *The IRS may also be counting on new legislation to provide new weapons in the form of tax shelter penalties. The penalties would have been significantly increased under legislative proposals last year.*

List Maintenance Requirement

In general

- The final regulations require any "material advisor" with respect to a "potentially abusive tax shelter" to maintain certain records, including lists of persons engaging in these transactions. These lists must be turned over to the IRS upon request.
- Under the regulations, the list maintenance rules now basically apply to the same categories of transactions as those of the disclosure rules (which is a change from the pre-October regulations).

"Potentially abusive tax shelter"

- A "potentially abusive tax shelter" is (i) any transaction that is subject to the tax shelter registration rules (described infra), (ii) any listed transaction (Category 1 transaction), (iii) any other reportable transaction (Category 2-Category 6 transaction) if the potential material advisor (at the time the transaction is entered into or an interest is acquired) knows or reasonably expects will become a reportable transaction, (iv) any interest in a listed transaction that is transferred if the transferor knows or reasonably expects that the transferee will sell or transfer an interest in that type of transaction to another transferee.

Observation: *Duty to monitor: As a practical matter, it may be necessary for material advisors to monitor transactions on which they advise to make sure they do not unexpectedly become reportable transactions. While the regulations look to what was reasonably known at the time of the transaction, 20-20 hindsight may suggest that it was unreasonable for the material advisor to have concluded, for example, that the loss transaction thresholds would not be exceeded.*

List Maintenance Requirement

Material Advisor

- A "material advisor" is defined as any person who (i) is required to register a confidential corporate tax shelter with the IRS, or (ii) receives, or expects to receive, a "minimum fee" in connection with the transaction and who makes a "tax statement" written or oral regarding the potential tax consequences of the transactions, to any person (x) required, or reasonably expected by the material tax advisor to be required, to disclose the transaction as a "reportable transaction" on its federal income tax return; (y) required to register the transaction as a confidential corporate tax shelter; or (z) who purchases an interest in a transaction that is required to be registered as a confidential tax shelter.

Observation: *Such tax advice may be provided by persons who are not tax experts, including investment advisors, promoters, bankers, sales people and other similar persons who discuss the tax consequences of a transaction in connection with their sales pitch.*

Observation: *As a practical matter, everyone involved in pitching a particular transaction may be treated as a material advisor, so the only question will be whether the minimum fee thresholds are exceeded.*

Tax Statement

- A "tax statement" means any statement, oral or written, that relates to a tax aspect of a transaction that causes the transaction to be a reportable transaction or a registration-required tax shelter. The final regulations describe how this general rule applies to each category of reportable transaction.

Observation: *Presumably anyone who renders tax advice on a portion of the transaction unrelated to the issues that cause the transaction to become a reportable transaction is not making a tax statement and is therefore not subject to listing requirements. Proof of such a limited role may be difficult, however.*

List Maintenance Requirement

Minimum Fee threshold

- An advisor is a "material advisor" if it receives a fee of at least \$250,000 and all persons acquiring an interest (directly or indirectly) are corporations other than S corporations or \$50,000 for any other transaction that is a potentially abusive tax shelter. For listed transactions, the minimum fee is reduced to \$25,000 (in the case of corporations) and \$10,000 (in all other cases), respectively.
- The definition of fees is broad and includes all fees for services for advice (whether or not tax advice) or for the implementation of the transaction. The regulations indicate that the IRS will carefully scrutinize whether consideration received in connection with the transaction constitutes fees.
- The fee threshold applies on a transaction-by-transaction basis so that an advisor might be required to list some transactions exceeding the fee threshold but not other identical transactions that do not satisfy the fee threshold.
- The fee threshold is satisfied even where the fee is mostly or wholly-unrelated to any tax advice provided.

Observation: *It may be prudent for anyone who advises on a reportable transaction in whatever capacity and receives fees in excess of \$250,000 to maintain the required list or at least avail themselves of the multiple tax advisors procedures described below because the word "tax" is mentioned at one time or another by almost everyone involved in a transaction (or is that just the myopic view of a tax lawyer).*

Multiple tax advisors

- Multiple tax advisors who participate in a transaction are permitted to designate by written agreement one person to maintain the list. The practical effect will be that tax advisors can be expected to enter into these agreements with their promoter client.

Observation: *The promoter had better be trustworthy, however. Any such agreement does not relieve the tax advisor from compliance with the listing obligations if the promoter does not do so.*

List Maintenance Requirement

Persons required to be listed

- A separate list of persons must be prepared and maintained for each transaction that is a potentially abusive tax shelter. However, one list must be maintained for substantially similar transactions that are potentially abusive tax shelters.
- Each material advisor is required to list **each person** to whom the material advisor makes or provides a tax statement (i) who is required or is reasonably expected by the material tax advisor to be required to disclose the transaction on its Federal income tax return, (ii) who is required to register the transaction as a tax shelter (discussed infra), (iii) who purchases an interest in a transaction required to be registered as a tax shelter, or (iv) who is a subsequent participant whose identity the material advisor knows or has reason to know.

***Observation:** The requirement that the advisor know or have reason to know that the person is "participating" in the transaction will limit the listing requirements to completed transactions.*

***Observation:** The person required to be listed is not the individual who receives the advice but the company for whom the individual is working.*

Information to be listed

- The list to be maintained by a material advisor must include:
 - The name of the transaction, the tax shelter registration number and taxpayer identification number, if any;
 - The name, address and taxpayer identification number of each person (described above) that is required to be on the list;
 - Number of units acquired;
 - Amount invested;
 - The person from whom the interest was acquired;

List Maintenance Requirement

- A detailed description of each transaction describing both the tax structure, its expected tax treatment and its intended tax benefits, and if known by the material advisor, a summary or schedule of the tax benefits that each person has intended or expected to derive from participating in a transaction; and
- Copies of any additional written materials, including tax analyses and opinions, relating to the transactions that have been shown to any potential participant or to its representatives, tax advisors or agents by any material advisor or its affiliates or agents.

Observation: *A material advisor is not required to retain earlier drafts provided the final document (or if none, the final draft) is retained and the final document (or final draft) contains all the information contained in the earlier drafts that is material to an understanding of the purported tax treatment or tax structure.*

Privilege claims

- The new promoter listing rules recognize that tax advisors may claim privilege and provide detailed steps that they must take to make that claim.

Observation: *Senior IRS officials have been quoted as saying that none of the information required to be listed is subject to privilege.*

Penalties for failure to maintain advisors lists

- The final regulations do not change the penalties for non-compliance with these rules.
 - The failure to maintain list records and lists required by these rules will result in the imposition of a penalty of \$50 for each person for whom there is a failure, not to exceed \$100,000 in any year.

Observation: *The IRS may be counting on new legislation to provide new weapons in the form of tax shelter penalties. Under legislative proposals last year, the failure to provide the IRS with a list within 20 business days of the IRS request (due to a failure to maintain the list or otherwise, unless due to reasonable cause) would be \$10,000 per day.*

Tax Shelter Registration Rules -- Confidential Corporate Tax Shelters

- Tax shelter organizers are required to register any confidential corporate tax shelter with the IRS.
- A "confidential corporate tax shelter" is any investment, entity, plan, arrangement or transaction
 - a significant purpose of the structure of which is the avoidance or evasion of Federal income tax for a direct or indirect corporate participant,
 - that is offered to any potential participant under conditions of confidentiality, and
 - for which the tax shelter promoters may receive fees in excess of \$100,000 in the aggregate.
- Tax avoidance transaction: A transaction is treated as structured for the avoidance or evasion of Federal income tax if the transaction is:
 - **Listed transaction:** The transaction is the same or substantially similar to a listed transaction; or
 - **Other tax-structured transaction:** The transaction has been structured to produce Federal income tax benefits that constitute an important part of the intended results of the transaction, and the tax shelter promoter reasonably expects the transaction to be presented in the same or substantially similar form to more than one potential participant.
- Tax structured transactions are not classified as tax avoidance transactions where (i) the taxpayer would participate in the transactions in the ordinary course of business (including stock or asset acquisitions and dispositions and acquisitions of capital) in a form consistent with commercial practice and (ii) there is a *generally accepted understanding* that the expected Federal income tax benefits from the transaction (taking into account any combination of intended tax consequences) are properly allowable under the Code for a substantially similar transaction.
 - There is no minimum period for which such a generally accepted understanding must exist, but information relating to the tax treatment and tax structure of the transaction must have been in the public domain (e.g., rulings, published articles, etc.) and widely known for a sufficient period of time (ordinarily a period of years) to provide knowledgeable tax practitioners and the IRS reasonable opportunity to evaluate the intended tax treatment.

Tax Shelter Registration Rules

- The mere existence of tax opinions provided by one or more tax advisors is not enough to satisfy this requirement.
- Tax-structured transactions are also not classified as tax avoidance transactions subject to registration where the tax shelter promoter reasonably determines that there is no reasonable basis under Federal tax law for the denial of a significant portion of the expected Federal income tax benefits from the transaction.
- The test for whether a transaction is offered under conditions of confidentiality under the tax shelter registration rules conforms to the confidentiality test for determining whether a transaction is a "reportable transaction."
- Similarly, the test for determining whether the fee thresholds have been satisfied is similar to the tests under the "reportable transaction" rules.
- The penalties for not registering a confidential corporate tax shelter are significant, including a penalty equal to 50% of the fees paid to all promoters (or 75% in the case of an intentional failure).

***Observation:** Other than conforming changes, the final tax shelter registration rules are substantially similar to the regulations issued in February 2000.*

Please contact us if you have any questions concerning the rules or if we can be of any assistance.

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