

The war on aggressive TAX STRATEGIES:

new offensives

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With the American Jobs Creation Act (the ‘Jobs Act’), passed in late 2004, Congress moved forcefully against tax shelters, real and imagined (depending, as always, on the viewpoint of the beholder). The Jobs Act gave the Treasury and its creature, the Internal Revenue Service (the ‘IRS’), new weapons to carry into the tax shelter battle and even impressed taxpayers’ own advisers into the service of the IRS. Half a year later, the Treasury used its own rulemaking powers to regulate the form and substance of written communications from a tax adviser to his client. Once an isolated conflict concerning few players, the war on tax shelters now touches many taxpayers who think themselves a long way from the tax shelter business. Even the most innocent of taxpayers should be aware of the new rules.

BACKGROUND

The Treasury and the Congress have recognised that the first, and perhaps the most important, task in combating aggressive tax schemes is simply finding them. Thus, in a nutshell, the statutory and regulatory framework for combating tax shelters is a system of required disclosure.

In early 2000, the Treasury published temporary and proposed regulations containing three mechanisms for dealing with tax shelters:

- the requirement that taxpayers report specified transactions in categories deemed suspect by the IRS;¹
 - a separate requirement that ‘confidential tax shelters’ be registered;² and
 - a requirement that tax shelter promoters keep lists of investors who participated in the shelters.³
- Those mechanisms were refined in a series of temporary and proposed regulations issued over the next three years and eventually took final form in early 2003.⁴
- The Jobs Act restructured these mechanisms to make transaction reporting the core tool for combating tax shelters. The tax shelter registration requirement is now gone, replaced by a requirement that ‘material advisers’ – not just taxpayers – report reportable transactions.⁵ Similarly, the list-keeping requirements now fall on material advisers, who must keep lists of the participants in reportable transactions.⁶

Note that material advisers can include the taxpayer's own accountants and lawyers, if they were involved in the transaction.⁷ In addition to restructuring the anti-tax shelter framework, the Jobs Act added new penalties for both taxpayers and material advisers.

REPORTABLE TRANSACTIONS

Types of reportable transactions

There are six types of reportable transactions:

- listed transactions;
- confidential transactions;
- transactions with 'contractual protection';
- large loss transactions;
- book/tax difference transactions; and
- short holding period tax credit transactions.

Some of these types are broader in scope than one might expect.

Listed transactions

The first category is 'listed transactions.'⁸ A more obvious term would be 'blacklisted transactions,' as this category is an evolving list of specified transactions that the IRS has marked as the objects of its distemper. The IRS publishes the current list on its website.⁹ A transaction that is substantially similar to a listed transaction is treated for purposes of the reporting rules in the same manner as a listed transaction.¹⁰ A transaction is substantially similar if it is 'expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy.'¹¹ Note that the presence of a transaction on the list does not necessarily mean that the taxpayer's legal (tax) position on the transaction ultimately will be found incorrect. However, a taxpayer can anticipate that a listed transaction will be challenged on audit by the IRS.¹²

Confidential transactions

A confidential transaction is a transaction in which:

- the tax treatment or tax structure of the structure is supposed to be kept confidential (regardless of whether the confidentiality requirement is binding); and
- an adviser has received a fee – not just for tax-related services – of at least US\$250,000 for corporate taxpayers (or pass-through entities composed entirely of corporate taxpayers) and US\$50,000 for non-corporate taxpayers.¹³

As a result, it became commonplace to find statements on private placement memoranda that the tax treatment or tax structure of the transaction was not confidential, even though the placement memorandum itself might be confidential as a result of securities law requirements.

Transactions with 'contractual protection'

A transaction has 'contractual protection' and therefore is reportable if the adviser's fees depend on the tax benefits enjoyed by the taxpayer.¹⁴ Thus, a transaction in which an adviser agrees to refund some, or all of its fees, if the transaction does not produce the desired tax results, is a reportable transaction.¹⁵

Large loss transactions

Any transaction is a reportable transaction if it produces a tax loss of more than:

- US\$10m in a single year or US\$20m in a combination of years, in the case of a corporation or a partnership composed wholly of corporate partners;
- US\$2m in a single year or US\$4m in a combination of years, in the case of individuals, S corporations, trusts, or partnerships all of whose partners are not corporations; or
- US\$50,000 in a single year for an individual or trust if the transaction is a 'section 988 transaction' (generally, a foreign currency transaction).¹⁶

To restrict the flood of reports that the large loss category otherwise would produce, the IRS has released a list of transactions that are exempted from the category.¹⁷

Book/tax difference transactions

A company that enters into a transaction resulting in a difference of more than US\$10m between the US Federal Income Tax treatment and the US GAAP treatment of income, gain, loss, or expense generally has entered into a reportable transaction if the company (or an affiliate):

- reports to the Securities Exchange Commission; or
- has over US\$250m in gross assets (including those of affiliates)¹⁸

As is the case with the large loss transaction category, the IRS has issued a list of transactions that are exempt from reporting by virtue of book/tax differences.¹⁹

Short holding period tax credit transactions

A transaction is reportable if it generates more than US\$250,000 of tax credits with respect to an asset held for 45 days or less.²⁰ Once again, the IRS has published a list of transactions that need not be reported although they meet the test.²¹

The obligation to report

Taxpayers and material advisers have separate and independent obligations to report a reportable transaction.

Taxpayers

A taxpayer who engages in a reportable transaction must disclose it by filing Form 8886, Reportable Transaction Disclosure Statement, along with its tax return for the period in which the transaction took place.²² But taxpayers must keep reading their tax publications – or visiting the IRS website – on an ongoing basis. If a transaction becomes a listed transaction in a year after it was completed, the taxpayer must file Form 8886 with the return for the year in which the transaction became listed (unless the statute of limitations has ended the audit period for the last year in the transaction which affected the taxpayer's tax consequence).²³

Material advisers

Material advisers must move with more alacrity, making their own filings by the last day of the month that

follows the end of the calendar quarter in which they became material advisers.²⁴ The IRS has yet to give them a dedicated form to use, instead of directing them to use Form 8264, which was designed for the old tax shelter registration regime, with new directions.²⁵ Material advisers are not required to file with the IRS their lists of advisees in reportable transactions unless, and until, they receive a request for same, whereupon they have 20 business days to do so.²⁶

Penalties for non-compliance

A taxpayer that fails to comply with its obligation to report its reportable transactions will be penalised US\$50,000 (US\$10,000 if a human person), unless the reportable transaction in question is a listed transaction, in which case the penalty is US\$200,000 (US\$100,000 for a human person).²⁷ In the case of a listed transaction, the penalty cannot be waived, and in the case of other reportable transactions, waiver is unlikely.²⁸ Moreover, if the non-compliant taxpayer is a US public company, it is required to disclose the penalty to the SEC.²⁹

There can be more unhappy consequences if the taxpayer does not prevail with the legal position underlying the unreported reportable transaction. If the taxpayer does not disclose a listed transaction or a non-listed reportable transaction that has a significant purpose of tax avoidance or evasion (a Significant Purpose Transaction), and the taxpayer is ultimately found to have understated its tax by virtue of the positions arising from such a transaction, the taxpayer must pay a penalty of 30% of the understatement (and of course remains liable for the unpaid tax on the understatement, and interest).³⁰ There is no exception in such a case for reasonable cause on the taxpayer's part.³¹ If the taxpayer does report the listed transaction or Significant Purpose Transaction, the penalty drops to 20%, and relief may be had if the taxpayer shows reasonable cause.³² However, the reasonable cause exception for a listed transaction or Significant Purpose Transaction is harder to satisfy

than the reasonable cause exception for regular understatements of tax.³³ A taxpayer hoping for access to the former reasonable cause exception cannot rely on an opinion from counsel that was involved in the transaction.³⁴

Material advisers who fail to report a reportable transaction will feel a corresponding pain of their own – indeed, their pain can be worse than the taxpayer's. The penalty for non-compliance by a material adviser is US\$50,000 per non-listed reportable transaction and, for a listed transaction, is the greater of US\$200,000 or 50% (75% in certain cases) of the fees earned by the material adviser.³⁵ Moreover, a material adviser that fails timely to provide the government with a requested list of reportable transaction participants generally is subject to a penalty of US\$10,000 per day.³⁶

Thus, in the new age, aggressive taxpayers cannot take the silence of their advisers for granted. And lest Congress' intent be mistaken, it revoked the confidentiality privilege between taxpayers and federally authorised tax practitioners in the case of a 'tax shelter,' here defined generally as any partnership or other arrangement, a significant purpose of which is the avoidance or evasion of federal income tax.³⁷

CIRCULAR 230

Cued by Congress in the Jobs Act,³⁸ some months later the Treasury promulgated detailed regulations about the form and content of the written advice that tax advisers provide to their clients.³⁹ And so it was that on June 21, 2005, e-mail inboxes from Wall Street to the Wilford J. Huddleston Home for Retired Post Office Ladies greeted the arrival of e-mails with the following legend:

'IRS Circular 230 notice: any advice expressed herein as to tax matters was not written to be used and cannot be used by any US taxpayer for the purpose of avoiding US tax penalties that may be imposed under US tax law.'⁴⁰

No doubt this was puzzling to some recipients, who had yet to learn that Circular 230 had divided the world of written communications into five categories:

- 'covered opinions' meeting the standards of Circular 230;⁴¹
- 'covered opinions' failing the standards of Circular 230;⁴²
- 'excluded advice';⁴³
- 'other written advice';⁴⁴ and
- communications not concerning a federal tax issue.⁴⁵

Lawyers and other tax practitioners had two choices about how to handle their outgoing e-mails: analyse every one to determine which category it fit into and what rules consequently would apply to it, or take the escape hatch Circular 230 provided them.⁴⁶ Inevitably they dove for the latter, setting their e-mail programs to paste a Circular 230 legend on every transmission. For the recipient who was highly sophisticated in tax or finance, the legends quickly became as exciting and useful as a danger warning on a stepladder. For the more innocent client who straightforwardly relied on his tax adviser for tax advice, the legends are a source of suspicion.

As the legend implies, the 'covered opinion' scheme of Circular 230 is designed to prevent taxpayers from claiming relief from US tax penalties on the ground that they relied on the advice of an adviser in circumstances where such reliance is unjustified, such as where the written advice was not based on a thorough analysis or was based on unjustifiable assumptions. The legend voids the advice on which it appears. Thus, the scheme generally forces the taxpayer to obtain a covered opinion if it wants to be able to claim penalty relief.

Consistent with the approach of the Jobs Act, Circular 230 aims for compliance by applying pressure to tax advisers as well as taxpayers. Tax advisers who provide non-compliant written advice to taxpayers are subject to censure, suspension, or disbarment.⁴⁷

An adviser writing a covered opinion generally must prepare a full-blown reasoned opinion, based on all relevant facts (which the adviser must make reasonable efforts to ascertain), covering all significant federal income tax issues.⁴⁸ Needless to say, such an opinion can be time consuming and expensive.

Circular 230 requires written advice to comply with the covered opinion requirements if it concerns a federal tax issue arising from:

- (i) a listed transaction (or a transaction substantially similar to a listed transaction);
- (ii) an entity, plan, or arrangement, the principal purpose of which is to avoid or evade any tax imposed by the Internal Revenue Code; or
- (iii) an entity, plan, or arrangement, a significant purpose of which is to avoid or evade such tax if the advice is (A) a 'reliance opinion,' (B) a 'marketed opinion,' (C) subject to conditions of confidentiality, or (D) subject to contractual protection.⁴⁹

The correspondence between the covered opinion rules and the categories of reportable transactions is evident.

Reliance opinions and marketed opinions, however, call for some elaboration. A reliance opinion is advice to the effect that at least one federal tax issue would, more likely than not, be resolved in the taxpayer's favour (unless, of course, the advice bears the legend described above).⁵⁰ A marketed opinion generally is advice that the adviser 'knows or has reason to know will be used or referred to by [another person] in promoting, marketing, or recommending' an entity, plan, or arrangement.⁵¹ Written advice that otherwise would be a marketed opinion is spared that classification if it contains an expanded version of the reliance opinion legend, adding a confession that it was written to support the promotion or marketing of the transaction or matter to which it relates and an admonishment to the reader to seek tailored tax advice from an independent adviser.⁵² Thus, many adviser firms include the expanded legends on their e-mails warning the reader that the

e-mail may have been written for that purpose and including the admonishment.⁵³

CONCLUSION

With the Jobs Act, Congress created a web of disclosure requirements that is likely to ensnare many more participants in tax shelters (and alleged tax shelters) than were captured by the previous set of rules. Impressing tax advisers into the disclosure web is likely to prove a particularly powerful device. With Circular 230, the Treasury made it much more difficult for taxpayers to seek successful penalty relief by claiming reliance on advice from their advisers. The combination of the Jobs Act and Circular 230 is likely to be as effective as it is heavy handed.

Notes:

1. T.D. 8877, 65 Fed. Reg. 11205 (3/2/00), modified by T.D. 8961, 66 Fed. Reg. 41133 (8/7/01).
2. *Id.*
3. T.D. 8875, 65 Fed. Reg. 11211 (3/2/00), modified by T.D. 8896, 65 Fed. Reg. 49909 (8/16/00), effective August 11, 2000.
4. T.D. 9046, 68 Fed. Reg. 10161 (3/4/03).
5. I.R.C. § 6111.
6. *Id.* § 6112.
7. *Id.* § 6111(b)(1).
8. Treas. Reg. § 1.6011-4(b)(2).
9. <http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html>
10. Treas. Reg. § 1.6011-4(b)(2).
11. *Id.* § 1.6011-4(c)(4).
12. There are approximately 30 listed transactions at the time of this writing, including such notorious transactions as the 'Son of BOSS' transaction and 'Lease In/Lease Out' or 'LILLO' transactions.
13. *Id.* § 1.6011-4(b)(3).
14. *Id.* § 1.6011-4(b)(4).
15. *Id.*
16. *Id.* § 1.6011-4(b)(5).
17. Rev. Proc. 2004-66, 2004-50 I.R.B. 966.
18. *Id.* § 1.6011-4(b)(6).
19. Rev. Proc. 2004-67, 2004-50 IRB 9672003.

20. Treas. Reg. § 1.6011-4(b)(7).
21. Rev. Proc. 2004-68, 2004-50 I.R.B. 969.
22. Treas. Reg. § 1.6011-4(e)(1). Certain corporate taxpayers filing consolidated tax returns report book-tax difference transactions on Schedule M-3 to their tax returns. Rev. Proc. 2004-45, 2004-31 IRB 140.
23. Treas. Reg. § 1.6011-4(e)(2)(i). In the case of a listed transaction, waiting out the statute of limitations in the hope of not being discovered is not a promising strategy, given that the Jobs Act extended the statute of limitations in such a case to make it almost indefinite for practical purposes. I.R.C. § 6501(c)(10).
24. Notice 2005-22, 2005-12 IRB 756.
25. Id.
26. I.R.C. § 6708.
27. I.R.C. § 6707A.
28. See id.
29. Id.
30. Id. § 6662A.
31. See id. § 6663(d)(2)(A).
32. Id. §§ 6662A(a), 6664(d).
33. Compare id. § 6664(d) to id. § 6664(c).
34. Id. § 6664(d)(3)(B)(i)-(ii).
35. Id. § 6707.
36. Id. § 6708.
37. Id. §§ 7525(b), 6662(d)(2)(C)(ii). Although it is not quite clear whether Congress revoked the common law privilege for communications between clients and their lawyers (including their tax lawyers), neither did it relieve lawyers of their obligations to report reportable transactions.
38. Jobs Act § 822.
39. Treas. Reg. § 10, more popularly known as Circular 230 (rev'd as of June 20, 2005).
40. There are a number of slight language variations in circulation, but all of them are based on text helpfully supplied by Circular 230. Treas. Reg. § 10.35(b)(4).
41. Treas. Reg. § 10.35(c).
42. See id.
43. Id. § 10.35(b)(2)(ii).
44. Id. § 10.37(a).
45. See id. §§ 10.35(b)(2)(i), 10.37(a).
46. The same choice is presented for letters and any other written communication concerning a federal tax issue.
47. Id. § 10.50(a).
48. Id. § 10.35(c).
49. Id. § 10.35(b)(2).
50. Id. § 10.35(b)(4).
51. Id. § 10.35(b)(5).
52. Id.
53. One wonders, however, whether such a legend actually achieves the intended result, as one wonders whether it actually conveys any information to the reader.



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