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Legal Alert:

New Tax Shelter Disclosure and List Maintenance Regulations

The IRS has just released new temporary regulations governing tax shelter reporting and maintenance of investor lists. The new temporary regulations are effective for transactions entered into on or after January 1, 2003. The new regulations are intended to simplify the definition of transactions that must be disclosed and improve coordination between the reporting and list maintenance requirements. The previous temporary regulations limited the reporting requirement to transactions involving federal income taxes. New regulations provide that listed transactions that involve estate, gift, employment, pension, or exempt organization excise taxes are now required to be reported. Disclosure of all reportable transactions must be made on a new Form 8886 "Reportable Transaction Disclosure Statement." Highlights of the new temporary regulations are discussed below.

Elimination of Safe Harbors Based on Taxpayer Determinations. The previous temporary regulations provided safe harbors for taxpayers who participated in a potentially reportable transaction in the ordinary course of business in a form consistent with customary commercial practice, and either (1) reasonably determined that they would have participated in the same transaction on substantially the same terms irrespective of the federal income tax benefits or (2) reasonably determined that there was a generally accepted understanding that the intended tax treatment of the transaction was properly allowable under the Code for substantially similar transactions. The previous regulations also provided a safe harbor if a taxpayer reasonably determined that there was no reasonable basis for denial of any significant portion of the expected federal income tax benefit from the transaction. All of these safe harbors have been eliminated.

Rulings and Protective Disclosure. The new temporary regulations provide that a potentially reportable transaction will not be considered a reportable transaction if the IRS makes a determination, by published guidance, individual ruling or otherwise, that the transaction is not subject to the reporting requirements.

- A taxpayer may request a ruling as to whether a transaction is subject to the disclosure requirements. If the request fully discloses all relevant facts relating to the transaction, the potential reporting obligation will be

suspended during the period that the ruling request is pending and for 60 days after issuance of the ruling or withdrawal of the ruling request.

- In the event of doubt, a taxpayer may make a protective disclosure.

Elimination of the Projected Tax Effect Test. Under the previous temporary regulations, transactions other than listed transactions were not required to be disclosed if they did not reduce the taxpayer's federal income tax liability by more than \$5 million in any single taxable year or by a total of more than \$10 million for any combination of taxable years. For categories of reportable transactions other than a new category involving losses, the projected tax effect test has now been eliminated. Accordingly, transactions that fall into any of the reportable categories other than losses must be reported regardless of the amount of their projected tax effect.

Categories of Reportable Transactions. The regulations redefine a reportable transaction as a transaction that falls into any one of six categories. Two of the reportable categories are new. Four of the categories are similar to those in the previous temporary regulations, including one category in the new regulations that subsumes two of the former categories. One of the categories found in the previous temporary regulations has been eliminated. The eliminated category related to transactions with a person that the taxpayer knew or had reason to know was in a tax position that differed from that of the taxpayer and which permitted the transaction to be structured to achieve more favorable tax treatment.

- **Listed Transactions.** As under the previous temporary regulations, taxpayers must report transactions that are the same as or substantially similar to a transaction that the IRS has determined to be a tax avoidance transaction and has identified in a notice, regulation, or other published guidance. The definition of "substantially similar" has not changed.
- **Confidential Transactions.** Taxpayers continue to be required to report transactions offered under conditions of confidentiality. Under the new regulations, conditions of confidentiality may be imposed 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 (or for whose benefit a statement is made or provided) as to the potential tax consequences that may result from the transaction. This is a change from the former regulations, which referred to Treas. Reg. § 301.6111-2T(c), which covers only agreements or understandings for the benefit of tax shelter promoters.
 - As in Treas. Reg. § 301.6111-2T(c), a transaction is not considered to be offered under conditions of confidentiality if disclosure is

subject to restrictions reasonably necessary to comply with federal or state securities laws.

- As in Treas. Reg. § 301.6111-2T(c), a presumption that the transaction is not offered under conditions of confidentiality is available if every person who makes or provides an oral or written statement (or for whose benefit a statement is made or provided) as to the potential tax consequences that may result from the transaction provides express written authorization to the taxpayer permitting disclosure of the structure and tax aspects of the transactions and all materials provided to the taxpayer. This presumption is available only in cases in which the written authorization to disclose is effective without limitation from the commencement of discussions.
- **Transactions With Contractual Protection.** As under the previous temporary regulations, reportable transactions include those in which the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax consequences will not be sustained. Contractual protection includes rescission rights, the right to a full or partial refund of fees paid to any person, fees that are contingent on the taxpayer's realization of tax benefits, 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).
 - This category subsumes the category in the previous temporary regulations for transactions promoted under contingent fee arrangements. The previous temporary regulations required the aggregate value of the fee to be in excess of \$100,000. No threshold amount exists in the new regulations.
 - A new safe harbor is provided for transactions in which an issuer of a debt instrument agrees to pay additional interest to compensate the holder of such debt instrument for withholding tax imposed on interest on the debt instrument, or because the requirement to pay such additional interest entitles the issuer to redeem the debt instrument.

- **Loss Transactions.** This category of reportable transactions is new. For corporations, a loss transaction is defined as any transaction resulting in, or that is reasonably expected to result in, a loss under section 165 of at least \$10 million in a taxable year or \$20 million in any combination of taxable years. The monetary threshold is adjusted for salvage value and insurance, but does not take into account offsetting gains, other income, or loss limitations. A loss under section 165 includes amounts deductible by virtue of any provision that treats a transaction as a sale or other disposition.
 - The regulations provide a safe harbor for casualty losses and losses from involuntary conversions. The IRS has requested comments on two other potential safe harbors: one for sales of securities on an established securities market where the basis of the securities is equal to the amount of cash paid for them, and one for losses claimed under the mark-to-market provisions of sections 475(a) or 1296(a).

- **Transactions With a Significant Book-Tax Difference.** As under the previous temporary regulations, a transaction is reportable if it produces a significant book-tax difference. A significant book-tax difference exists under the new regulations if the tax treatment differs or is reasonably expected to differ from the book treatment by more than by more than \$10 million on a gross basis (versus \$5 million in the previous temporary regulations). The new regulations provide that offsetting items are not netted for either tax or book purposes. Book income is determined by applying U.S. GAAP. This category of reportable transactions does not apply to RICs.
 - Under the new regulations, this category of reportable transactions applies only to reporting companies under the 1934 Act (and related entities) and to business entities with \$100 million or more in gross assets.
 - Specific rules govern consolidated returns, foreign persons, disregarded entities, partnerships, and shareholders of certain foreign corporations.
 - The regulations provide thirteen safe harbors for book-tax differences. The IRS is seeking comments on the safe harbors and on whether additional safe harbors should be provided.

- **Transactions Involving Tax Credits and a Brief Asset Holding Period.**

This new category of reportable transactions requires reporting of any transaction that results or is reasonably expected to result in a tax credit exceeding \$250,000 (including a foreign tax credit) if the asset giving rise to the credit is held for less than 45 days. This category of reportable transactions does not apply to RICs.

Changes to the Definition of Indirect Participants. Participation in reportable transactions must be disclosed by all direct and indirect participants. New rules provide that shareholders in a foreign corporation are not considered to be indirect participants unless they are “reporting shareholders,” i.e., United States shareholders in a foreign personal holding company, controlled foreign corporation, or a 10 percent shareholder of a qualified electing fund.

Record Retention Requirements. The requirement to retain records of a reportable transaction is unchanged from the previous temporary regulations.

List Maintenance Requirements. New temporary regulations under section 6112 provide for the maintenance of investor lists by “material advisors.” They are generally effective as of January 1, 2003. Highlights of the list maintenance regulations include:

- **Consistent Definition of Reportable Transaction.** The new regulations provide for a definition of a reportable transaction consistent with the new temporary regulations governing reporting.
- **Requirement for Material Advisors to Maintain Investor Lists.** The new regulations significantly broaden the range of persons who are required to maintain investor lists. Under the new regulations, any “material advisor” with respect to a potentially abusive tax shelter must maintain an investor list. A material advisor is defined as any person who makes or provides any oral or written statement to any person as to the potential tax consequences of a potentially abusive tax shelter and receives or expects to receive at least a minimum fee in connection with a transaction that is a potentially abusive tax shelter. The list required to be maintained includes only those persons who are participants in the transaction for which the minimum fee threshold is satisfied. The minimum fee is \$250,000 if all participants are C corporations, \$50,000 for all other transactions. The minimum fee requirement applies separately to each transaction that is a potentially abusive tax shelter. The IRS is considering whether the minimum fee requirement should be eliminated with respect to listed transactions.

- **Lengthening of the Period for Which Lists Must be Maintained.** The previous temporary regulations had required lists to be maintained for a period of 7 years following the date of the last acquisition of an interest required to be included on the list. The new regulations require maintenance of the list for 10 years following the date of the last oral or written statement regarding the potential tax consequences of the transaction.
- **Privilege Issues.** The new regulations provide procedures for material advisors to assert the attorney-client or confidentiality privileges with respect to investor lists.

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