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Client Alert

A report for clients and friends of the firm

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New IRS Disclosure and List Maintenance Regulations

On October 22, 2002, the Internal Revenue Service (the "IRS") issued new rules attacking tax shelters by requiring taxpayers to highlight transactions on their federal income tax returns if they provide the taxpayer with certain tax benefits. The regulations are very broad in scope and require disclosure of commonplace transactions that ordinarily would not be considered "tax shelters," in many cases regardless of the size of the transaction and even if its tax consequences are well settled under current law. This new approach to disclosure is based on the presumption that, if the tax consequences of a transaction are clear, the taxpayer's disclosure of its participation in the transaction to the IRS should not be controversial. The rules are generally effective for transactions entered into on or after January 1, 2003.

The rules, issued in the form of temporary and proposed regulations, have three principal elements, each of which is discussed below:

- Specific disclosure of transactions by taxpayers;
- Document retention by taxpayers; and
- Maintenance of lists of transactions and participants by advisors.

Disclosure Obligation

Beginning January 1, 2003, any taxpayer that participates in a "reportable transaction" must submit a Form 8886 "Reportable Transaction Disclosure Statement" with the taxpayer's annual federal income tax return for each year that such transaction affects the taxpayer's federal income tax liability. The taxpayer also must submit Form 8886 to the Office of Tax Shelter Analysis when it first discloses the transaction to the IRS.

A "reportable transaction" includes any transaction described in any one of six categories described below. A taxpayer "participates" in a reportable transaction if its federal tax liability is affected by the transaction, even if the taxpayer is not a direct party to the transaction. In addition, in the case of a partnership or S corporation, a partner or shareholder will be considered to "participate" in a reportable transaction if its tax liability is reasonably likely to be affected by the transaction. A taxpayer also will be treated as participating in a transaction if the taxpayer knows or has reason to know that the tax benefits claimed from the transaction are derived from a reportable transaction. Accordingly, the disclosure obligation may apply to taxpayers who were only tangentially involved in a transaction.

UPDATE: IRS Notice 2003-11

In response to numerous comments regarding the regulations, the IRS issued Notice 2003-11 on January 17, 2003. According to the Notice, the IRS intends to publish final, revised regulations in February 2003 to clarify the disclosure and list maintenance obligations. Among other things, the IRS is considering revisions to the "reportable transaction" categories of loss transactions and transactions with a significant book-tax difference. Although the regulations issued in October 2002 will continue to apply to transactions entered into on or after January 1, 2003, the revised regulations will permit taxpayers who entered into transactions on or after January 1, 2003, and before publication of the revised regulations, to elect to apply the revised regulations instead of the October temporary regulations. In addition, except for "listed transactions," the effective date of the list maintenance regulations is deferred until the revised regulations are published. The October 2002 list maintenance regulations continue to apply to listed transactions. While Notice 2003-11 is a welcome development, we anticipate that the revised regulations will remain very broad in scope and will continue to require disclosure of a wide variety of business transactions.

The six categories of reportable transactions are:

1. Listed Transactions
A listed transaction includes any transaction that the IRS has identified in regulations or by other published guidance. Additionally, any transaction that a taxpayer enters into that is the same as or substantially similar to a listed transaction must be disclosed. The IRS intends for "substantially similar" to be broadly construed in favor of disclosure. Transactions that have been identified by the IRS to date as listed transactions are summarized in the Appendix to this bulletin.

2. Confidential Transactions
Transactions subject to confidentiality agreements must be disclosed to the IRS. A transaction is considered to be subject to confidentiality, regardless of its size, if a taxpayer's disclosure of the structure or tax aspects of the transaction is limited for the benefit of any person who makes a statement regarding the potential tax consequences of the transaction. As a result, the presence of a standard confidentiality provision in a transaction document may create a disclosure obligation.

The regulations contain two exceptions to this disclosure category. First, disclosure restrictions that are reasonably necessary to comply with federal or state securities laws will not give rise to a confidentiality agreement requiring taxpayer disclosure. Second, a taxpayer's privilege to maintain the confidentiality of communications, including attorney-client communications, will not create a disclosure obligation. In addition, the regulations presume that there is no confidentiality agreement (and therefore there will be no disclosure obligation) if every person that makes a statement regarding the potential tax consequences of the transaction authorizes the taxpayer, in writing and from the commencement of discussions, to disclose the structure and tax aspects of the transaction and all related materials provided to the taxpayer.

3. Transactions with Contractual Protection
If a taxpayer is provided with contractual protection against the possibility that part or all of the intended tax consequences of the transaction will not be realized, the taxpayer must disclose the transaction to the IRS. Under this requirement, disclosure may be required based on the presence of unwind clauses, call rights and rescission rights. Additionally, a disclosure obligation may arise as a result of a right to a refund of fees, fees contingent on the tax benefits from the transaction, insurance protection with respect to the tax treatment of a transaction, or certain tax indemnities.

Under a limited exception, a disclosure obligation will not arise as a result of interest withholding tax gross-up provisions in debt instruments or provisions that enable the issuer to redeem the debt instrument because of such interest payment gross-ups. However, absent future IRS relief, economically similar contractual protections in non-debt contexts may create a disclosure obligation.

4. Loss Transactions
A transaction that causes or that is reasonably expected to cause an I.R.C. Section 165 loss to a taxpayer that equals or exceeds a certain threshold must be disclosed to the IRS. The thresholds are:

- for corporations, $10 million in any single year or $20 million in any combination of years;
- for partnerships or S corporations, $5 million in any single year or $10 million in any combination of years;
- for individuals or trusts, $2 million in any single year or $4 million in any combination of years; and
- for foreign currency transactions, $50,000 in any year for individuals or trusts.

Taxpayers may not take offsetting gains into account when measuring their losses. Therefore, any Section 165 loss that exceeds the above threshold will create a disclosure obligation without regard to any gains from the transaction. The IRS is considering, but has not yet adopted, exceptions to this disclosure category for sales of securities that were acquired by the taxpayer for cash and that are sold on an established securities market, and losses from the sale of securities that are subject to certain mark-to-market rules.

5. Transactions with Significant Book-Tax Differences
Any transaction where the federal income tax and book accounting treatment of one or more items is reasonably expected to differ by more than $10 million on a gross basis in any year must be disclosed to the IRS. Taxpayers may not take offsetting items into account when calculating the amount of any book-tax disparity.

This disclosure category does not apply to all taxpayers. Rather, this category applies only to (1) taxpayers (including foreign taxpayers) that are reporting companies under the Securities Exchange Act of 1934 and related business entities, or (2) business entities that have $100 million or more in gross assets. Specific rules are provided on the application of these rules to taxpayers that file consolidated returns, foreign corporations and U.S. shareholders of "controlled foreign corporations" and similar foreign corporations. The regulations contain various exceptions to this disclosure category which we can provide to you upon request.

6. Transactions Involving Brief Asset Holding Period
A transaction resulting in, or that is reasonably expected to result in, a tax credit exceeding $250,000 must be disclosed to the IRS if the underlying asset giving rise to the credit is held by the taxpayer for less than 45 days. This disclosure category will be strictly applied and may create a disclosure obligation even in instances where there is favorable case law supporting the taxpayer's right to the credit.

Document Retention Requirement

The regulations also impose a document retention obligation on taxpayers. Specifically, a taxpayer that enters into a "reportable transaction" must retain all documents relating to the transaction that are material to (i) an understanding of the facts of the transaction, (ii) the expected tax treatment of the transaction, or (iii) the taxpayer's decision to participate in the transaction. The types of documents that taxpayers must retain include marketing materials; correspondence and agreements between the taxpayer and any advisor or party to the transaction; documents discussing the tax benefits arising from the transaction; and documents referring to the business purposes for the transaction. This record retention obligation exists until the expiration of the statute of limitations applicable to the final taxable year for which disclosure of the transaction was made.

Potential Penalties for Failing To Disclose a Transaction

Legislation has been proposed that, if enacted, will impose stringent penalties for taxpayers who fail to comply with the disclosure requirements. While under current law there are no specific sanctions for failing to comply with the disclosure regulations, the taxpayer may nevertheless be exposed to penalties that might otherwise have been avoided. For example, the IRS believes, that depending on the facts and circumstances, the failure to file a disclosure statement may jeopardize a taxpayer's ability to rely on the reasonable cause exception to the substantial underpayment penalty.

List Maintenance Obligation

The new regulations also require certain persons to maintain lists of participants in certain tax-motivated transactions. The list maintenance obligation applies to those who organize or sell an interest in a transaction that is included in one of the six "reportable transaction" categories discussed above. The regulations also impose a list maintenance obligation on each "material advisor," which term includes attorneys, accountants, bankers, and other advisors who provide tax advice to the taxpayer in connection with the transaction and who receive a certain amount of fees with respect to the transaction.

The regulations provide that the list must be maintained for 10 years from the date of the most recent statement as to the potential tax consequences of the transaction. The list must be furnished to the IRS within 20 days of a list request. If the IRS requests a list from a law firm, it is expected that the firm may assert the attorney-client privilege when necessary to prevent the disclosure of confidential communications relevant to the legal advice provided to a client.

Appendix

The IRS has identified the following transactions as "listed transactions" for tax shelter disclosure and list maintenance purposes:

(1) 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. See Rev. Rul. 90-105.

(2) Certain trust arrangements purported to qualify as multiple employer welfare benefit funds exempt from the limits of I.R.C. Sections 419 and 419A. See Notice 95-34.

(3) Certain 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"). See Notice 95-53.

(4) Transactions in which the reasonably expected economic profit is insubstantial in comparison to the value of the expected foreign tax credits. See Notice 98-5, Part II.

(5) 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. See ASA Investerings Partnership v. Commissioner and ACM Partnership v. Commissioner.

(6) Transactions involving distributions described in Treas. Reg. Sec. 1.643(a)-8 from charitable remainder trusts.

(7) Transactions in which a taxpayer purports to lease property and then purports to immediately sublease it back to the lessor (a LILO transaction). See Rev. Rul. 99-14.

(8) Transactions involving the distribution of encumbered property in which taxpayers claim tax losses for capital outlays that they have in fact recovered. See Notice 99-59.

(9) Transactions involving fast-pay arrangements as defined in Treas. Reg. Section 1.7701(l)-3(b).

(10) Certain 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. See Rev. Rul. 2000-12.

(11) Transactions generating losses resulting from artificially inflating the basis of partnership interests. See Notice 2000-44.

(12) 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. See Notice 2000-60.

(13) Transactions purporting to apply I.R.C. Section 935 to Guamanian trusts. See Notice 2000-61.

(14) Transactions involving the use of an intermediary to sell the assets of a corporation. See Notice 2001-16.

(15) Transactions involving a loss on the sale of stock acquired in a purported I.R.C. 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. See Notice 2001-17.

(16) Transactions that use a loan assumption agreement to claim an inflated basis in assets acquired from another party. See Notice 2002-21.

(17) Transactions involving notional principal contracts to claim deductions for periodic payments made by a taxpayer while disregarding the accrual of a right to receive offsetting payments in the future. See Notice 2002-35.

(18) Certain redemptions of stock in transactions not subject to U.S. tax in which the basis of the redeemed stock is purported to shift to a U.S. taxpayer. See Notice 2001-45.

(19) Transactions involving the creation of a tiered partnership that does not make an election under I.R.C. Section 754 and that is used to duplicate straddle losses. See Notice 2002-50.

(20) Transactions involving the use of an S corporation or partnership and one or more transitory shareholders or partners to claim a loss while deferring an offsetting gain on a foreign currency straddle. See Notice 2002-65.

(21) Certain reinsurance arrangements used to shift income from U.S. taxpayers to related insurance companies that are subject to little or no U.S. federal income tax. See Notice 2002-70.

(22) Transactions using an employee stock ownership plan that holds employer securities in an S corporation to claim eligibility for the delayed effective date of I.R.C. Code Section 409(p) under Section 656(d)(2) of the Economic Growth and Tax Relief Reconciliation Act of 2001. See Rev. Rul. 2003-6.

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