REVISED TAX SHELTER REGULATIONS

SIMPSON THACHER & BARTLETT LLP

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The Internal Revenue Service ("IRS") has updated temporary regulations (the "Tax Shelter Regulations") that:

(i) require taxpayers to disclose on their tax returns transactions that have characteristics common to tax shelters,

(ii) require promoters to register confidential corporate tax shelters, and

(iii) require promoters to maintain lists of investors.

These regulations, initially promulgated in February 2000, are intended to provide the IRS with better information about tax shelters and other tax-motivated transactions. They reflect the Treasury Department's latest efforts to address the proliferation of corporate tax shelters and their threat to the tax system. These regulations are but one of several steps that the government is taking to address the perceived tax shelter problem.

The balance of this memorandum discusses the Tax Shelter Regulations now in effect as modified. Congress is currently considering additional legislation with respect to tax shelters. It is uncertain, however, what legislation, if any, will be enacted, and accordingly this memorandum does not discuss such proposals.

TAX SHELTER DISCLOSURE STATEMENTS

The Tax Shelter Regulations require any taxpayer that participates, directly or indirectly, in a "listed transaction" and any corporate taxpayer that participates in an "other reportable transaction" to attach a disclosure statement to its tax return.[1] This disclosure statement must include information about the principal elements of the transaction, whether it has ever been registered as a tax shelter, its expected tax benefits and any parties who promoted, solicited or recommended the taxpayer's participation in the transaction and had a financial interest in the taxpayer's decision to participate.

DEFINITION OF LISTED AND OTHER REPORTABLE TRANSACTIONS

Listed transactions are defined as transactions that are the same or substantially similar[2] to those listed in notices, regulations, or other guidance published by the IRS. The IRS has listed nineteen such tax avoidance transactions in public guidance.[3] Other reportable transactions (which are relevant only for corporations) are defined as transactions that:

(i) have at least two of the five common corporate tax shelter characteristics described below, and

(ii) meet the "projected tax effect test".

TRANSACTIONS WITH CERTAIN COMMON CORPORATE TAX SHELTER CHARACTERISTICS

A transaction will satisfy the common corporate tax shelter characteristics requirement if it possesses at least two of the following five characteristics:

1. <u>Confidential</u>. The taxpayer has participated in the transaction under conditions of confidentiality (see "Conditions of Confidentiality" under the discussion below of "Corporate Tax Shelter Registration").

2. <u>Contractual protection against loss of tax benefits.</u> The taxpayer has obtained or been provided with contractual protection against

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[1] See Treas. Reg. §1.6011-4T(a)(1).

[2] The term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax benefits and that is either factually similar or based on the same or similar tax strategy. See Treas. Reg. §1.6011-4T(b)(1)(i).

[3] See Exhibit A.

the possibility that the intended tax benefits of the transaction will not be sustained (including rescission rights, the right to a full or partial refund of fees, fees that are contingent on the realization of tax benefits, insurance protection 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 of the transaction to the taxpayer).

3. <u>Fees in excess of $100,000.</u> The taxpayer's participation in the transaction was promoted, solicited or recommended by one or more persons who have received or are expected to receive fees, in the aggregate, of over $100,000, and such fees are contingent on the taxpayer's participation in the transaction.

4. <u>Book/tax difference greater than $5 million in any taxable year.</u> The expected treatment of the transaction for federal income tax purposes in any taxable year is expected to differ by more than $5 million from the treatment of the transaction for purposes of determining book income.

5. <u>Tax indifferent parties.</u> The transaction involves the participation of a person that the taxpayer knows or has reason to know is in a different federal income tax position (such as a tax-exempt entity or a foreign person), and the taxpayer knows or has reason to know that such difference in tax position has permitted the transaction to be structured on terms that are intended to provide the taxpayer with more favorable federal income tax treatment than it could have obtained without the participation of such person or another person in a similar tax position.

FOUR EXCEPTIONS TO THE DISCLOSURE REQUIREMENT

For transactions other than those listed in guidance published by the IRS, even if a transaction has two of the five characteristics listed above, it will nevertheless not be subject to disclosure if:

(i) the taxpayer participated in the transaction in the ordinary course of its business in a form consistent with customary commercial practice, and reasonably determines that it would have participated in the transaction on the same terms irrespective of the federal income tax benefits (the "Extraneous Tax Benefits Exception");[4]

(ii) the taxpayer participated in the transaction in the ordinary course of its business in a form consistent with commercial practice, and the taxpayer reasonably determines that there is a generally accepted understanding that the expected federal income tax benefits are allowable (the "Generally Accepted Understanding Exception");[5]

(iii) the taxpayer reasonably determines that there is no reasonable basis for the denial of any significant portion of the expected federal income tax benefits from the transaction (the "No Reasonable Basis Exception");[6] or

(iv) the IRS has identified the transaction in public guidance as not subject to these disclosure requirements (the "IRS Guidance Exception").[7]

PROJECTED TAX EFFECT TEST

Except in the case of a listed tax avoidance transaction, if a transaction meets two of the five common corporate tax shelter characteristics listed above and does not qualify for any of the exceptions, such transaction must still meet the projected tax effect test to trigger the disclosure requirement. A transaction meets the projected tax effect test if the estimated federal income tax reduction is more than $5 million in any one year or a total of more than $10 million for any combination of years.

4 See Treas. Reg. §1.6011-4T(b)(3)(ii)(A).

5 See Treas. Reg. §1.6011-4T(b)(3)(ii)(B). The regulation states that "[t]he mere fact the taxpayer may have received an opinion or advice from one or more knowledgeable tax practitioners to the effect that the taxpayer's intended tax treatment of the transaction should or will be sustained, if challenged by the IRS, is not sufficient to satisfy the requirements of [the Generally Accepted Understanding Exception]." Id.

6 See Treas. Reg. §1.6011-4T(b)(3)(ii)(C). This "no reasonable basis" standard would not be satisfied by an IRS position that would be "merely arguable" or would constitute "merely a colorable" claim. Id. The precise meaning of the "no reasonable basis" standard is not entirely clear, although it surely requires more than a "more likely than not" opinion. Whether a "should" opinion is sufficient or only a "will" opinion will satisfy the requirement is unknown, although one IRS official has indicated that a "should" opinion would not meet the requisite standard.

7 See Treas. Reg. §1.6011-4T(b)(3)(ii)(D).

TIME FOR PROVIDING DISCLOSURE

The required disclosure statement should be attached to the taxpayer's return for each taxable year for which the taxpayer's federal income tax liability is affected by its participation in the transaction. If a transaction becomes a reportable transaction on or after the date the taxpayer files its return for the first affected year, the taxpayer must file the disclosure statement as an attachment to its next tax return.[8]

FAILURE TO FILE DISCLOSURE STATEMENT

A taxpayer that is required to file a disclosure statement under the regulations and fails to do so may be subject to penalties that it otherwise would have avoided. If a taxpayer has an underpayment of tax for a particular year, that underpayment is potentially subject to an accuracy-related penalty of 20% and a fraud penalty of 75%. Normally, those penalties are inapplicable if the taxpayer establishes that there was reasonable cause for its position and that it acted in good faith. However, the preamble to the Tax Shelter Regulations indicates that by failing to file a disclosure statement, a taxpayer may be deemed not to have acted in "good faith" with respect to an underpayment, even if its return position has sufficient legal justification to satisfy the "reasonable cause" standard.[9] In such a case, the determination of whether a taxpayer has acted in "good faith" will depend on all of the facts and circumstances, including the reason or reasons for the nondisclosure.

CORPORATE TAX SHELTER REGISTRATION

The Tax Shelter Regulations require "confidential corporate tax shelters" to be registered with the IRS no later than the day on which the first offering of interests in the tax shelter occurs.[10] The taxpayer must register by filing IRS Form 8264, "Application for Registration of a Tax Shelter," which requires specific information about the tax shelter. [11]

DEFINITION OF CONFIDENTIAL CORPORATE TAX SHELTER

Three Requirements

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8 See Treas. Reg. §1.6011-4T(d)(1) and IRS Form 8275.

9 See T.D. 8877 (2000).

10 See Treas. Reg. § 301.6111-2T(e)(2).

11 The registration must include information identifying and describing the tax shelter, a description of its intended tax benefits and any written materials that are presented to potential participants in connection with the offering of sales of interests in the tax shelter, including any analyses or opinions relating to its intended tax benefits.

The Tax Shelter Regulations requiring registration define a confidential corporate tax shelter as a transaction that satisfies each of the following three requirements:

1. Fees in excess of $100,000. The tax shelter promoters may receive fees in excess of $100,000 in the aggregate;[12]

2. Conditions of confidentiality. The transaction is offered to any potential participant under conditions of confidentiality (as discussed below); and

3. Tax benefits important. A significant purpose of the structure is the avoidance or evasion of federal income tax for a direct or indirect corporate participant, which is the case if:

    (a) the transaction both (x) has been structured to produce federal income tax benefits that constitute "an important part of the intended results" of the transaction and (y) the tax shelter promoter (or other person who would be responsible for registering the tax shelter) reasonably expects the transaction to be presented in substantially similar form to more than one potential participant (the "Tax Benefits Test"), [13] or

    (b) the transaction is listed in published guidance by the IRS as a tax avoidance transaction subject to registration. [14]

Conditions of Confidentiality

All of the facts and circumstances relating to a transaction are considered in determining whether an offer is made under conditions of confidentiality, including prior conduct of the parties. However, an offer will be considered made under conditions of confidentiality if (i) an offeree's disclosure of the structure or tax aspects of the transaction is limited in any way by an understanding or agreement with or for the benefit of any promoter, whether or not such

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[12] All of the facts and circumstances relating to a transaction are considered in determining the fees that the promoters may receive. For these purposes, all consideration that the promoters may receive is taken into account, including contingent fees, fees in the form of equity interests, and fees the promoters may receive for other transactions as consideration for promoting the tax shelter. All fees from substantially similar transactions are considered part of the same tax shelter and aggregated for purposes of determining whether the $100,000 threshold has been reached. See Treas. Reg. § 301.6111-2T(d).

[13] See Treas. Reg. § 301.6111-2T(b)(3).

[14] See Exhibit A.

understanding or agreement is legally binding or (ii) any promoter knows or has reason to know that the transaction is protected from disclosure or use in any other manner (such as where the transaction is claimed to be proprietary or exclusive to the promoter).[15]

An offeree's privilege to maintain the confidentiality of a communication relating to a tax shelter in which the taxpayer might participate or has agreed to participate, including an offeree's confidential communication with the offeree's attorney, is not itself a condition of confidentiality for these purposes. Further, conditions of confidentiality necessary to comply with securities law will not make an offer "confidential" for registration purposes. In other words, an offer is not considered made under conditions of confidentiality if disclosure of the structure or tax aspects of the transaction is subject to restrictions reasonably necessary to comply with federal or state securities laws and such disclosure is not otherwise limited.

The Tax Shelter Regulations provide a safe harbor presumption against confidentiality. Unless facts and circumstances clearly indicate otherwise, an offer will not be considered made under conditions of confidentiality if the tax shelter promoter provides express written authorization to each person who participates or discusses participation in the transaction permitting such persons to disclose the structure and tax aspects of the transaction with any and all persons, without limitation of any kind on such disclosure.

THREE EXCEPTIONS TO THE REGISTRATION REQUIREMENT

The registration rules contain three of the same exceptions as the disclosure rules. Even if a transaction satisfies the three requirements of a confidential corporate tax shelter, it will not satisfy the Tax Benefits Test, and thus will escape registration, if the promoter reasonably determines that any of the following three exceptions are met:

(i) the Generally Accepted Understanding Exception;[16]

(ii) the No Reasonable Basis Exception;[17] or

(iii) the IRS has identified the transaction in public guidance as not subject to the registration requirements.[18]

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15 See Treas. Reg. § 301.6111-2T(c).

16 See Treas. Reg. §301.6111-2T(b)(3)(i) & (ii). The regulation states that "[t]he mere fact that one or more knowledgeable tax practitioners have provided an opinion or advice to the effect that the intended tax treatment of the transaction should or will be sustained, if challenged by the IRS, is not sufficient to satisfy the requirements of [the Generally Accepted Understanding Exception.]" Id.

17 See Treas. Reg. §301.6111-2T(b)(4)(i). This "no reasonable basis" standard would not be satisfied by an IRS position that would be "merely arguable" or would constitute a "merely colorable" claim. Id.

18 See Treas. Reg. §301.6111-2T(b)(4)(ii).

The exceptions are not available for transactions listed in guidance published by the IRS.

PERSONS REQUIRED TO REGISTER

The tax shelter promoter is generally the party responsible for registering a tax shelter. Under the Tax Shelter Regulations, the category of "promoter" includes any person who participates in the organization, management or sale of a tax shelter (other than (i) a person unrelated to the tax shelter who does not participate in the entrepreneurial risks or benefits of the tax shelter or (ii) a person who performs only ministerial functions such as typing, photocopying or printing) or any related person.[19] Law firms that charge a standard hourly rate for their services will generally not be treated as participating in the entrepreneurial risks or benefits of a transaction, and thus will generally not be responsible for registering corporate tax shelters.[20] There is a procedure by which promoters who are required to register a confidential corporate tax shelter may designate one single person to register the shelter.

CLAIMS OF PRIVILEGE

If an attorney or federally authorized tax practitioner is the person required to register the tax shelter, that person is not required to disclose any information that he or she believes is protected by the attorney-client privilege (or the confidentiality privilege that relates to federally authorized tax practitioners). The attorney or federally authorized tax practitioner must attach a statement to IRS Form 8264 that is signed under penalties of perjury and identifies each document or category of information for which the claim of privilege is made. Furthermore, such person must specifically represent that (a) the information omitted was a confidential practitioner-client communication and that (b) he or she did not disclose the omitted information to any person whose receipt of such information would result in a waiver of the privilege. Moreover, inasmuch as the statutory privilege for accountants and other federally authorized tax practitioners is not available with communications involving corporate tax shelters, such persons must additionally represent that the omitted information was not part of tax advice that constituted the promotion of a corporate tax shelter.

PENALTIES FOR NON-COMPLIANCE

A person who is required to register a confidential corporate tax shelter and fails to do so in a timely manner will be subject to a penalty in an amount equal to the greater of (i) 50% of the fees paid to all promoters with respect to offerings made prior to the date of late registration, or (ii) $10,000. If the failure to file is intentional, however, the applicable percentage will be 75% instead of 50%. No penalty will be imposed for a failure to register a confidential corporate tax shelter if the failure is due to reasonable cause.

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[19] Special rules apply if all promoters of a tax shelter are foreign persons.

[20] See Treas. Reg. §301.6111-1T A-30.

RULING REQUESTS

If a promoter is uncertain whether a particular transaction is properly classified as a confidential corporate tax shelter under the Tax Shelter Regulations, such promoter can submit a ruling request to the IRS.

LISTS OF INVESTORS IN POTENTIALLY ABUSIVE TAX SHELTERS

Any person who organizes or sells an interest in a "potentially abusive tax shelter" is generally required to maintain a list identifying each person who was sold an interest in such shelter and to make that list available for inspection upon request by the Secretary of the Treasury. The list must include detailed information about the tax shelter and about the investors in the shelter. [21]

DEFINITION OF POTENTIALLY ABUSIVE TAX SHELTER

The term "potentially abusive tax shelter" means any transaction a significant purpose of which is the avoidance or evasion of federal income tax. As described under "Corporate Tax Shelter Registration" above, a transaction meets this test if it is either (1) structured to produce federal income tax benefits that constitute an important part of the transaction and the promoter (or other person who would be responsible for registering the transaction) reasonably expects the transaction to be presented in substantially similar form to more than one potential participant, or (2) one of the transactions listed in public guidance published by the IRS as a tax avoidance transaction subject to registration.[22]

EXCEPTIONS TO LISTING REQUIREMENTS

As with the corporate tax shelter registration and disclosure rules, there are three exceptions to this significant tax avoidance definition in the Tax Shelter Regulations: the Generally Accepted Understanding Exception, the No Reasonable Basis Exception, and the exception for transactions listed in public guidance by the IRS.[23] Like the registration rules, none of these exceptions are available if the transaction is one listed in public guidance published by the IRS as a tax avoidance transaction subject to registration.[24]

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21 The listing requirements apply to corporate and noncorporate taxpayers and participants, and regardless of whether the transaction is offered under conditions of confidentiality.

22 See Exhibit A.

23 See "Three Exceptions to the Registration Requirement," page 8 above.

24 See Exhibit A.

In addition to these exceptions, there are two de minimis exceptions to the listing requirement. A purchaser of an interest in a tax shelter that is not subject to registration and has not been listed by the IRS as a tax avoidance transaction is generally is not required to be listed if either:

(i) the total fees and similar consideration paid to all organizers and sellers with respect to such purchaser's acquisition of the interest is less than $25,000, or

(ii) the organizer "reasonably believes" that such purchaser's acquisition of the interest will not result in a reduction of the federal income tax liability of any corporation or corporations that exceeds, or exceeds in the aggregate, $1 million in any single taxable year or a total of $2 million for any combination of taxable years, and will not result in a reduction of the federal income tax liability of any noncorporate taxpayer or taxpayers that exceeds, or exceeds in the aggregate, $250,000 in any single taxable year or $500,000 for any combination of taxable years.[25]

DEFINITION OF ORGANIZER

The Tax Shelter Regulations provide that an "organizer" responsible for maintaining investor lists includes any person who participates in the organization or management of the tax shelter (other than (i) a person unrelated to the tax shelter who does not participate in the entrepreneurial risks or benefits of the tax shelter or (ii) a person who performs only ministerial functions such as typing, photocopying or printing) or any person who sells an interest in the tax shelter. Underwriters would be characterized as organizers in many instances, and thus would be subject to the investor list requirement. However, under certain procedures, organizers may designate one single person to maintain the list.

CLAIMS OF PRIVILEGE

If an attorney or federally authorized tax practitioner is required to maintain the investor list, such person is not required to disclose any information which he or she believes is protected by the attorney-client privilege (or the confidentiality privilege that relates to federally authorized tax practitioners). To claim the privilege, however, the attorney or federally authorized tax practitioner must provide the IRS with a statement signed under penalties of perjury that contains the same information and representations that a tax shelter organizer must provide to omit privileged information from a corporate tax shelter registration statement, as discussed above.

25 See Treas. Reg. § 301.6112-1T, A-8(b).

PENALTIES FOR NON-COMPLIANCE

Any person who is responsible for maintaining an investor list and fails to do so is subject to a penalty of $50 for each person with respect to whom there is a failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. However, the maximum penalty imposed on any given taxpayer for failing to maintain an investor list is $100,000 per calendar year.

RULING REQUESTS

As with the corporate tax shelter registration requirement, a person unsure of whether he is responsible for maintaining an investor list can submit a ruling request to the IRS to resolve the ambiguity.

ACCURACY-RELATED PENALTIES - EFFECT OF TAX SHELTER CLASSIFICATION

As discussed below, the possible imposition of the accuracy-related penalty of 20% depends on a number of factors, including whether any of the transactions are "tax shelters" under the penalty provisions. A tax shelter for purposes of Section 6662 is defined, in part, as any plan or arrangement if a significant purpose of such plan or arrangement is the avoidance or evasion of Federal income tax.[26]

Under Section 6662 of the Code, penalties may generally be imposed on a taxpayer if the taxpayer reports an understatement of income tax for any taxable year that exceeds 10% of the tax required to be shown on the return for such taxable year. The penalty is an amount equal to 20% of the portion of the tax underpayment. Under most circumstances, for purposes of this accuracy-related penalty, a taxpayer may reduce the amount of the understatement if (i) there is "substantial authority" for the manner in which the taxpayer reported a tax item, or (ii) the taxpayer discloses the facts affecting the item's tax treatment and there is a "reasonable basis" for the manner in which the taxpayer reported such item.

However, if an item is determined to be attributable to a tax shelter for purposes of Section 6662 as described above, a taxpayer may not reduce the amount of the understatement by disclosing the facts affecting the item's tax treatment. Moreover, a taxpayer will not be able to reduce the amount of the understatement by establishing "substantial authority" unless the taxpayer also reasonably believed that the tax treatment of such item was "more likely than not" the proper treatment.[27] The regulations provide that a taxpayer reasonably believes the

26 See Section 6662(d)(2)(C)(iii). Unless otherwise indicated, all section references are to the sections of the Internal Revenue Code of 1986, as amended (the "Code").

27 See Treas. Regs. § 1.6662-4(g)(4)(i), 1.6664-4(e)(2)(i)(B).

tax treatment of such item is more likely than not the proper treatment if (i) the taxpayer analyzes the pertinent facts and authorities, and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50% likelihood that the tax treatment of the item will be upheld if challenged by the IRS or (ii) the taxpayer reasonably relies in good faith on the opinion of a professional tax advisor, and the opinion analyzes the pertinent facts and authorities and unambiguously states that the tax advisor concludes there is a greater than 50% likelihood that the tax treatment of the item will be upheld if challenged by the IRS".[28]

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The foregoing is intended only as a general summary, and the Tax Shelter Regulations are more complex in their entirety. If you have any questions about the Tax Shelter Regulations or would like more information regarding specific provisions, please do not hesitate to contact Dickson G. Brown (dbrown@stblaw.com, 212-455-2850), Jonathan E. Cantor (jcantor@stblaw.com, 212-455-2237), Joshua R. Isenberg (jisenberg@stblaw.com, 212-455-3512), or any other member of our tax department.

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[28] Id.

EXHIBIT A – TAX AVOIDANCE TRANSACTIONS IDENTIFIED BY THE IRS

The following are tax avoidance transactions listed by IRS in published guidance:

(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;[29]

(2) certain trust arrangements purported to qualify as multiple employer welfare benefit funds exempt from the limits of sections 419 and 419A of the Code;

(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");

(4) transactions in which the reasonably expected economic profit is insubstantial in comparison to the value of the expected foreign tax credits;

(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 losses to another partner;

(6) transactions involving distributions described in Treas. Reg. § 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 (often referred to as "lease-in/lease-out" or "LILO" transactions);

(8) transactions involving the distribution of encumbered property in which taxpayers claim tax losses for capital outlays that they have in fact recovered;

(9) transactions involving fast-pay arrangements as defined in Treas. Reg. § 1.7701(1)-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;

(11) transactions generating losses resulting from artificially inflating the basis of partnership interests;

(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;

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[29] See Notice 2002-51, 2001-34 IRB 190 (listing transactions 1-16 below).

(13) transactions purporting to apply Section 935 of the Code to Guamanian trusts;

(14) transactions involving the use of an intermediary to sell the assets of a corporation;

(15) 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;

(16) 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;

(17) certain transactions involving the use of a loan assumption agreement to claim an inflated basis in assets acquired from another taxpayer;[30]

(18) certain transactions involving the use of a notional principal contract to claim current deductions for periodic payments made by a taxpayer while disregarding the accrual right to receive offsetting payments in the future;[31] and

(19) transactions involving the creation of a tiered partnership that does not make a Section 754 election used to duplicate straddle losses.[32]

30 See Notice 2002-21, 2002-14 IRB 730.

31 See Notice 2002-35, 2002-21 IRB 992.

32 See Notice 2002-50, 2002-28 IRB 98 (also discussing substantially similar transactions).