

RECENT CORPORATE TAX SHELTER DISCLOSURE REGULATIONS

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The Treasury Department recently published temporary regulations that (i) require corporate taxpayers to disclose large 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 do not alter any substantive tax rules, but rather are intended to provide the Internal Revenue Service ("IRS") with better information about tax shelters and other tax-motivated transactions. The Treasury Department has expressed its grave concern about the proliferation of illegitimate corporate tax shelters and their threat to the tax system. Accordingly, the IRS also is establishing a central office dedicated to tax shelter analysis. In addition, the Clinton Administration's 2001 Budget Proposal contains several provisions aimed at curbing corporate tax shelters. These new temporary regulations, therefore, are but one of several steps that the government is taking to address the perceived tax shelter problem.

The regulations are expansively written and are likely to affect many corporate transactions in which federal income taxes are a relevant consideration. Because the regulations are so new, their ultimate impact is not yet known. However, possible effects include:

- Elimination of confidentiality agreements (or even the affirmative authorization of disclosure) to avoid the registration requirement;
- Registration of confidential corporate tax oriented transactions with the IRS before any offering is made;
- Maintenance by promoters of lists of corporate investors in tax oriented transactions that will be provided to the IRS upon request;
- Additional corporate tax return schedules detailing tax oriented transactions;
- Pressure on promoters and corporate finance personnel to conclude that transactions are "in the ordinary course of business in a form consistent with commercial practice" so as to satisfy part of one of the exceptions to the application of the regulations.
- Pressure on tax advisors to conclude that "there is a long-standing and generally accepted understanding that the expected federal income tax benefits from a transaction are allowable" or that "there is no reasonable basis under federal tax law for the denial

of any significant portion of the expected federal income tax benefits from the transaction”.

**TAX SHELTER DISCLOSURE
STATEMENTS**

The new regulations require any corporate taxpayer that participates, directly or indirectly, in a “reportable transaction” to attach a disclosure statement to its tax return. 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 REPORTABLE TRANSACTION

A reportable transaction is defined as a transaction that (i) is either a listed transaction or a transaction with certain common corporate tax shelter characteristics and (ii) meets the “projected tax effect test”.

LISTED TRANSACTIONS

A transaction is a listed transaction if it is the same as or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction and identified by notice, regulation or other published guidance as a listed transaction for these purposes. Concurrently with these regulations, the IRS published a notice listing ten such tax avoidance transactions.¹

1. The following were the ten identified tax avoidance transactions listed by IRS Notice 2000-15:

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

**TRANSACTIONS WITH CERTAIN COMMON CORPORATE
TAX SHELTER CHARACTERISTICS**

This second category describes transactions that are entered into after February 28, 2000, and possess at least two of the following six characteristics:

- (1) The taxpayer has participated in the transaction under conditions of confidentiality (see "Corporate Tax Shelter Registration-Conditions of Confidentiality" below for a discussion).
 - (2) The taxpayer has obtained or been provided with contractual protection against 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) 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) 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.
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- (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(l)-3(b); and
 - (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.

- (5) 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.
- (6) The expected characterization of any significant aspect of the transaction for federal income tax purposes differs from the expected characterization of such aspect of the transaction for purposes of taxation of any party to the transaction in another country.

EXCEPTIONS TO TRANSACTIONS WITH CERTAIN COMMON CORPORATE TAX SHELTER CHARACTERISTICS

There are several exceptions, however, under which transactions will not be treated as transactions within this second category even though they possess at least two of the above six characteristics. A transaction will be excluded from this second category if :

- (1) The taxpayer has participated in the transaction in the ordinary course of its business in a form consistent with commercial practice, and the taxpayer reasonably determines that it would have participated in the transaction on substantially the same terms irrespective of the tax benefits;
- (2) The taxpayer has 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 long-standing and generally accepted understanding that the expected federal income tax benefits from the transaction are allowable (for example, many leasing transactions will fall within this exception);
- (3) The taxpayer reasonably determines that there is no reasonable basis under federal tax law for denial of any significant portion of the expected federal income tax benefits from the transaction; or
- (4) The transaction is identified in published guidance as being excepted from disclosure for these purposes.

For purposes of exceptions (1) and (2), the determination of whether a transaction is entered into in the ordinary course of a taxpayer's business in a form consistent with commercial practice is ultimately a question of fact. Corporate taxpayers, promoters and/or investment bankers will probably be in the best position to make this factual determination. The question of whether there is a long-standing and generally accepted understanding that the expected federal income tax benefits are allowable, however, is more of a legal question, as is

the determination in exception (3). Accordingly, law firms and other tax advisors are likely to be requested to give opinions on these matters.

PROJECTED TAX EFFECT TEST

A listed transaction will meet the projected tax effect test if, at the time the taxpayer enters into the transaction or any time thereafter, the taxpayer reasonably estimates that the transaction will reduce its federal income tax liability by more than \$1 million in any one year or by a total of \$2 million for any combination of years. Transactions that have at least two of the common corporate tax shelter characteristics, listed above, and that do not qualify for one of the exceptions will meet the projected tax effect test if the estimated federal income tax reduction is \$5 million in any one year or \$10 million for any combination of years.

EFFECTIVE DATE; TIME FOR PROVIDING DISCLOSURE

These temporary regulations apply to corporate tax returns that are filed after February 28, 2000. 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 taxpayer's return is filed before August 26, 2000, however, the taxpayer has the option of filing the disclosure statement as an amendment to the return no later than such date. 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 corporate tax return.

FAILURE TO FILE DISCLOSURE STATEMENT

A corporate taxpayer that is required to file a disclosure statement under the new 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%. Those penalties are inapplicable if the taxpayer establishes that there was reasonable cause for its position and that it acted with good faith. The preamble to the regulations indicates that by failing to file a disclosure statement, a corporate 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. 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 new regulations expand the class of tax shelters that must be registered with the IRS to include "confidential corporate tax shelters". Any confidential corporate tax shelter must

generally be registered not later than the day on which the first offering of interests in the shelter occurs. 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. As discussed below, the regulations adopt a broad definition of confidential corporate tax shelter.

DEFINITION OF CONFIDENTIAL CORPORATE TAX SHELTER

A confidential corporate tax shelter is defined as a transaction (i) a significant purpose of which is the avoidance or evasion of federal income tax for a corporate participant, (ii) which is offered to any potential participant under conditions of confidentiality and (iii) for which the promoters may receive fees in excess of \$100,000 in the aggregate.

AVOIDANCE OR EVASION OF FEDERAL INCOME TAX

A transaction will be considered to have a significant purpose of federal income tax evasion if it is (i) a listed transaction, as described above, identified by the IRS to be a tax avoidance transaction, (ii) a transaction lacking economic substance or (iii) a tax-structured transaction.

TRANSACTIONS LACKING ECONOMIC SUBSTANCE

A transaction will be deemed to lack economic substance if the present value of the participant's reasonably expected pre-tax profit from the transaction is insignificant relative to the present value of the participant's expected federal income tax savings from the transaction. Although the regulations do not provide guidance with respect to the meaning of "insignificant" for these purposes, a common sense interpretation of the word would suggest that pre-tax profit of as little as 20% of the expected federal tax savings, or perhaps even less, might be sufficient to satisfy the economic substance requirement. If the substance of the transaction is the borrowing of money or acquisition of financial capital, however, such transaction will be considered to lack economic substance only if the present value of the federal income tax deductions of the taxpayer to whom the loan or financial capital is provided significantly exceeds the present value of the pre-tax return of the person providing the loan or financial capital.

TAX-STRUCTURED TRANSACTIONS

A transaction will be deemed a tax-structured transaction if (i) it has been structured to produce federal income tax benefits that constitute an important part of the transaction and (ii) the promoter reasonably expects the transaction to be presented in the same or substantially similar form to more than one potential participant. This "important part" language appears to establish a very low threshold; many legitimate transactions that are driven primarily by non-tax reasons also enjoy tax advantages that are important benefits of the transaction. These

regulations would treat such transactions as “tax-structured” if they are offered to more than one participant.

Even if a transaction satisfies these two prongs, however, it will not be deemed a tax-structured transaction if the promoter reasonably determines that (i) the potential participant is expected to participate in the transaction in the ordinary course of its business in a form consistent with commercial practice, and (ii) there is a long-standing and generally accepted understanding that the expected federal income tax benefits are allowable. Many leasing transactions will presumably fall within this exception. As discussed above, in order to qualify for this exception the taxpayer, promoter and/or investment banker will likely need to determine whether the participation is in the ordinary course of the taxpayer’s business and whether it is in a form consistent with commercial practice. Law firms and other tax advisors are likely to be asked to opine as to whether there is a long-standing and generally accepted understanding that the tax benefits are allowable.

EXCEPTIONS

The regulations provide two further exceptions under which transactions will not be considered to have a significant purpose of tax evasion. First, a transaction other than a listed transaction will not be deemed to have a significant purpose of tax evasion if the promoter reasonably determines that there is no reasonable basis for the denial of any significant portion of the expected federal income tax benefits. The meaning of this “no reasonable basis” standard is not 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. Second, a transaction will not be treated as having a significant purpose of tax evasion if the IRS makes a determination that the transaction is not subject to these registration requirements.

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 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). 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. Moreover, unless facts and circumstances clearly indicate otherwise, an offer will not be considered made under conditions of confidentiality if the tax shelter promoter enters into a written agreement with each person who participates or discusses participation in the transaction and such

agreement expressly authorizes such persons to disclose every aspect of the transaction with any and all persons, without limitation of any kind.

DETERMINATION OF FEES

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.

RULING REQUESTS

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

PERSONS REQUIRED TO REGISTER

The tax shelter promoter is generally the party responsible for registering a tax shelter. Under these temporary regulations, the category of "promoter" includes any person who participates in the organization, management or sale of a tax shelter (other than a person who performs only ministerial functions such as typing, photocopying or printing) or any related person. Law firms would presumably be characterized as promoters in many instances, and thus would be subject to the registration requirement. There is a procedure, however, by which promoters who are required to register a confidential corporate tax shelter may designate one single person to register the shelter.

If all promoters of a particular tax shelter are foreign persons, any person who discusses participation in the transaction is responsible for registering the shelter within 90 days after beginning such discussions. For these purposes, a person must presume that all promoters are foreign persons unless such person either discusses participation in the transaction with a promoter that is a U.S. person or obtains and reasonably relies on a written statement from one of the promoters that at least one of the promoters is a U.S. person. A person will not be required to register a tax shelter, however, if either (i) that person does not participate in the transaction and notifies the promoter in writing, within 90 days of beginning discussions, that he or she will not participate, or (ii) within 90 days of beginning discussions, that person obtains and reasonably relies on both a written statement from one of the promoters that such promoter has registered the tax shelter and a copy of such registration. A person will be treated as participating indirectly in a confidential corporate tax shelter if a foreign person controlled by such first person participates in the shelter and a significant purpose of the shelter is the avoidance or evasion of the first person's federal income tax.

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 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 (i) the information omitted was a confidential practitioner-client communication and that (ii) 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, federally authorized tax practitioners must additionally represent that the omitted information was not part of tax advice that constituted the promotion of a tax shelter.

EFFECTIVE DATE; REGISTRATION PROCEDURES

These regulations apply to confidential corporate tax shelters in which interests are offered for sale after February 28, 2000. To register a confidential corporate tax shelter, the person responsible for registering the tax shelter must file Form 8264, "Application for Registration of a Tax Shelter", not later than the day that the first offering for sale of interests in the tax shelter occurs. If the tax shelter is registered no later than August 26, 2000, however, such registration will be deemed timely. Any interest in a confidential corporate tax shelter that is sold after February 28, 2000 is treated as offered for sale after February 28, 2000, unless the sale was pursuant to a written binding contract entered into on or before February 28, 2000.

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%. In addition, there is a special rule that applies to persons that are responsible for registering a shelter because they have discussed participation in the shelter and all promoters are foreign. These required registrants will only be subject to penalties hereunder if they actually participate in the tax shelter. Furthermore, with respect to any such person, the amount of the penalty is determined by taking into account only the fees paid by such person. In no event will any penalty be imposed for a failure to register a confidential corporate tax shelter if the failure is due to reasonable cause.

**LISTS OF INVESTORS IN
POTENTIALLY ABUSIVE TAX
SHELTERS**

DEFINITION OF POTENTIALLY ABUSIVE TAX SHELTER

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 new regulations explain that for these purposes, the term “potentially abusive tax shelter” means any transaction a significant purpose of which is the avoidance or evasion of federal income tax.

The same rules and exceptions used to determine whether a particular transaction has a significant purpose of federal income tax avoidance or evasion for purposes of the registration requirement are also used in determining whether a transaction is a potentially abusive tax shelter subject to the investor list requirement. However, a transaction that has this proscribed purpose will be subject to this investor list requirement regardless of the potential fees of the promoters and whether it was offered under conditions of confidentiality. Thus, the reach of the investor list requirement is considerably broader than that of the corporate tax shelter requirement. Even if an organizer does not have to register a transaction, that organizer may still have to maintain an investor list.

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.

DEFINITION OF ORGANIZER

The regulations provide that an “organizer” responsible for maintaining investor lists includes any person who participates in the organization, management, or sale of the tax shelter or any related person. Law firms would presumably be characterized as organizers in many instances, and thus would be subject to the investor list requirement. There is a procedure, however, by which organizers who are required to maintain an investor list for transactions that are also confidential corporate tax shelters may designate one single person to maintain the list.

INFORMATION TO BE INCLUDED ON LIST

The new regulations provide that the following information that must be included on the investor lists:

- the name of the tax shelter and any registration number that was received;
- the taxpayer identification number (“TIN”), if any, of the tax shelter;
- the name, address and TIN of each person who is required to be included on the list and any indirect corporate participant in the tax shelter if known to the organizer or seller;
- if applicable, the number of units acquired by each person on the list;
- the date on which each interest was acquired;
- the amount of money invested or to be invested by each person on the list;
- a detailed description of the tax shelter that describes both its structure and intended tax benefits;
- a summary or schedule of the tax benefits that each person on the list is intended or expected to derive, if known by the organizer or seller;
- copies of any additional written materials, including tax analyses and opinions, relating to the tax shelter that have been given to any potential participant in the tax shelter or to any representatives, tax advisors or agents of potential participants by the organizer or seller or by any other person who has participated in the offering of the tax shelter (excluding any written materials that the organizer or seller has never possessed);
- if the interest was not acquired from the person maintaining the list, the name of the person from whom the interest was acquired; and
- the name and address of each agent of the person maintaining the list if such agent negotiates the transfer of any interest in the tax shelter for that tax shelter, an organizer, underwriter, broker or dealer.

Generally, a separate list must be maintained for each potentially abusive tax shelter. Under the new regulations, however, interests in substantially similar tax shelter transactions that are sold to different persons generally are to be treated as interests in the same tax shelter for purposes of this investor list requirement. Moreover, each list must identify each other tax shelter that the organizer or seller has offered that has not been treated as part of the same tax shelter, but that utilizes a similar structure or is intended to produce similar tax benefits.

CLAIMS OF PRIVILEGE

If an attorney or federally authorized tax practitioner is the person required to maintain the investor list, that 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.

EFFECTIVE DATE

An organizer or seller must maintain a list with respect to any interest acquired by an investor in a potentially abusive tax shelter after February 28, 2000. The IRS will not ask to inspect any list for a transaction that is considered a potentially abusive tax shelter by reason of these new regulations, however, until August 26, 2000.

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.

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The foregoing is intended only as a general summary, and the new temporary regulations are more complex in their entirety. If you have any questions about the temporary regulations or would like more information regarding specific provisions, please do not hesitate to call Dickson G. Brown (212-455-2850), Jonathan E. Cantor (212-455-2237), Karen S. Handler (212-455-2684), Steven C. Todrys (212-455-3750), or any other member of our tax department.

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