FINAL TAX SHELTER REGULATIONS

DICKSON G. BROWN, JOHN J. CREED, JONATHAN E. CANTOR,
JOSHUA R. ISENBERG & RACHEL D. BIRNBAUM
SIMPSON THACHER & BARTLETT LLP

MARCH 19, 2003

TABLE OF CONTENTS

Page

TAX SHELTER DISCLOSURE STATEMENTS 2

PARTICIPATION IN REPORTABLE TRANSACTIONS 2

EXCEPTIONS TO THE DISCLOSURE REQUIREMENT 8

TIME FOR PROVIDING DISCLOSURE 8

RULINGS AND PROTECTIVE DISCLOSURES 9

FAILURE TO FILE DISCLOSURE STATEMENT 9

LISTS OF INVESTORS IN POTENTIALLY ABUSIVE TAX SHELTERS 9

DEFINITION OF POTENTIALLY ABUSIVE TAX SHELTER 10

DEFINITION OF MATERIAL ADVISOR 10

DEFINITION OF TAX STATEMENT 11

PERSONS REQUIRED TO BE INCLUDED ON LISTS 11

FINAL TAX SHELTER REGULATIONS
TABLE OF CONTENTS

Page

CLAIMS OF PRIVILEGE 12

CONTENTS OF INVESTOR LISTS 12

RETENTION AND FURNISHING OF INVESTOR LISTS 13

DESIGNATION AGREEMENTS 13

PENALTIES FOR NON-COMPLIANCE 13

CORPORATE TAX SHELTER REGISTRATION 14

DEFINITION OF CONFIDENTIAL CORPORATE TAX SHELTER 14

THREE EXCEPTIONS TO THE REGISTRATION REQUIREMENT 15

PERSONS REQUIRED TO REGISTER 16

PENALTIES FOR NON-COMPLIANCE 16

ACCURACY-RELATED PENALTIES - EFFECT OF TAX SHELTER CLASSIFICATION 17

EXHIBITS

Exhibit A-Tax Avoidance Transactions Identified By The IRS 19
Exhibit B-Section 165 Losses Excepted From Loss Transaction 22
Exhibit C-Book Tax Differences Not Taken Into Account for Disclosure Purposes 23

FINAL TAX SHELTER REGULATIONS

The Internal Revenue Service ("IRS") has issued final regulations (the "Final Regulations") that:

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

(ii) require promoters to maintain lists of investors, and

(iii) require promoters to register confidential corporate tax shelters.

The regulations dealing with these matters have been subject to several revisions since their initial promulgation in February 2000. The substantially revised regulations dealing with disclosure and list maintenance requirements, published in October 2002 (the "October Regulations"), reflected the frustration of the IRS resulting from limited taxpayer compliance with the earlier versions of the regulations. The Final Regulations, together with two revenue procedures released at the same time, modify the October Regulations in response to widespread criticism regarding their breadth and ambiguity. The modifications:

- Narrow the broadest categories of transactions subject to the disclosure requirements,
- Add a number of exceptions to the disclosure and list maintenance requirements,
- Clarify who must provide tax return disclosure, and
- Provide guidance concerning the persons that must maintain investor lists and the persons that must be included on such investor lists.

For tax return disclosure requirements, the Final Regulations are effective for transactions occurring after 2002[1] and, thus, in the case of calendar year taxpayers, will begin to apply to

[1] See Treas. Reg. § 1.6011-4(h). The Final Regulations, with respect to tax shelter disclosure, apply to transactions entered into on or after March 4, 2003. The October Regulations apply to transactions entered into on or after January 1, 2003, but taxpayers can elect to apply the tax shelter disclosure rules under the Final Regulations to transactions entered into between January 1, 2003 and March 4, 2003. Transactions entered into before January 1, 2003 are generally subject to the tax shelter regulations in effect prior to that date. For a description of these rules, see our memorandum dated August 2, 2002.

returns filed in 2004. For list maintenance obligations, the Final Regulations are generally effective for transactions occurring on or after March 4, 2003.[2] The revisions in the Final Regulations do not affect the relatively limited sanctions applicable to the disclosure and listing requirements. Legislative proposals would impose more severe penalties and make other changes in an attempt to limit tax avoidance, but it is uncertain what legislation, if any, will be enacted. Accordingly, this memorandum does not discuss such legislative proposals in any detail.

TAX SHELTER DISCLOSURE STATEMENTS

The Final Regulations require any taxpayer that participates, directly or indirectly, in a "reportable transaction" to attach a completed IRS Form 8886, the "Reportable Transaction Disclosure Statement," to its tax return.[3]

PARTICIPATION IN REPORTABLE TRANSACTIONS

A transaction will be deemed a reportable transaction if it is described by any one of the following six categories enumerated in the Final Regulations.

i. Listed transactions

A transaction is a listed transaction if it is the same or substantially similar[4] to one of the transactions listed in notices, regulations, or other guidance published by the IRS. A taxpayer has participated in a listed transaction if the taxpayer's tax return reflects tax consequences or a tax strategy described in such IRS published guidance.[5] Participation in listed transactions also includes circumstances where the taxpayer knows or has reason to know that its tax benefits are derived directly or indirectly from tax consequences or a tax strategy described in such IRS

[2] See Treas. Reg. § 301.6112-1(j). Transactions occurring on or after February 28, 2000 that have been listed as tax avoidance transactions in IRS published guidance are also subject to the list maintenance requirements of the Final Regulations.

[3] See Treas. Reg. § 1.6011-4(a). The final version of this form is not yet available.

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

[5] See Treas. Reg. § 1.6011-4(c)(3)(i)(A).

published guidance. As of the date of this memorandum, the IRS has listed twenty-two such tax avoidance transactions in public guidance.[6]

ii. Confidential transactions.

A confidential transaction is a transaction that is offered to the taxpayer under conditions of confidentiality with respect to the tax treatment or tax structure. All of the facts and circumstances relating to a transaction are considered in determining whether a transaction is offered under conditions of confidentiality, including prior conduct of the parties. However, an offer will be considered made under conditions of confidentiality if:

- the taxpayer's disclosure of the tax structure or tax treatment of the transaction is limited in any way by an understanding or agreement with or for the benefit of any person who makes or provides a statement, oral or written, to the taxpayer (or for whose benefit a statement is made or provided to the taxpayer) as to the potential tax consequences that may result from the transaction, whether or not such understanding or agreement is legally binding, or

- the taxpayer knows or has reason to know that the taxpayer's use or disclosure of information relating to the tax treatment or tax structure of the transaction is limited in any manner for the benefit of any person who makes or provides a statement, oral or written, to the taxpayer (or for whose benefit a statement is made or provided to the taxpayer) as to the potential tax consequences that may result from the transaction.[7]

A taxpayer has participated in a confidential transaction if the taxpayer's tax return reflects a tax benefit from a transaction that was offered to the taxpayer under conditions of confidentiality.[8]

The Final Regulations continue to provide that disclosure restrictions reasonably necessary to comply with securities laws will not be treated as conditions of confidentiality for these purposes. In addition, the Final Regulations include a new exception to the confidentiality category for certain merger and acquisition transactions.[9] A limitation on a

---

6 See Exhibit A.

7 See Treas. Reg. § 1.6011-4(b)(3). The Final Regulations have narrowed the focus of the conditions of confidentiality from the transaction's structure to only the tax structure, which is defined as any fact that may be relevant to understanding the claimed federal income tax treatment of the transaction.

8 See Treas. Reg. § 1.6011-4(c)(3)(i)(B).

9 This exception applies to transactions which involve the acquisition of historic assets of a corporation that constitute an active trade or business that the acquiror intends to continue, or the acquisition of more than

taxpayer's disclosure of the tax treatment or tax structure of such transactions is not a condition of confidentiality if the taxpayer is permitted to disclose the tax treatment and tax structure of the transaction no later than the earlier of the date of the public announcement of discussions relating to the transaction, the date of the public announcement of the transaction, or the date of the execution of an agreement to enter into the transaction.[10]

The Final Regulations continue a safe harbor presumption against confidentiality, but modify it slightly to make it more flexible. Unless facts and circumstances indicate otherwise, a transaction will not be considered offered to a taxpayer under conditions of confidentiality if every person who makes or provides to the taxpayer an oral or written statement regarding the potential tax consequences from the transaction (or for whose benefit such a statement is provided to the taxpayer) also provides to the taxpayer express written authorization to disclose the tax treatment and tax structure of the transaction to any and all persons, without limitation of any kind on such disclosure.[11] The authorization must be effective as of the commencement of discussions with the person providing the authorization and must be given no later than 30 days after the person providing the authorization first provided the statement regarding the tax consequences. The authorization should be in substantially the following form:

> "The taxpayer (and each employee, representative, or other agent of the taxpayer) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the transaction and all materials of any kind (including opinions or other tax analyses) that are provided to the taxpayer relating to such tax treatment and tax structure."

iii. Contractual protection against loss of tax benefits.

The Final Regulations substantially cut back the concept of contractual protection against loss of tax benefits ("Contractual Protection") contained in the October Regulations.[12] Under the Final Regulations, a transaction has Contractual Protection if the taxpayer or a

---

50% of the stock of a corporation that owns historic business assets used in an active trade or business the acquiror intends to continue. See Treas. Reg. § 1.6011-4(b)(3)(ii)(B).

[10] This exception is not available where the taxpayer's ability to consult any tax advisor regarding the tax treatment or tax structure of the transaction is limited in any way.

[11] See Treas. Reg. § 1.6011-4(b)(3)(iii).

[12] The Final Regulations do not, for instance, treat tax calls as Contractual Protection. See Treas. Reg. § 1.6011-4(b)(4)(iii)(A). Commentators were concerned that such calls could be considered Contractual Protection under the October Regulations.

related party has a right to a full or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained.[13] A transaction also has Contractual Protection if fees are contingent on the taxpayer's realizing tax benefits from the transaction. A taxpayer has participated in a transaction with Contractual Protection if its tax return reflects a tax benefit from a transaction with Contractual Protection and it is the recipient of such protection.

iv. Loss transactions.

The loss transaction category of the October Regulations was roundly criticized as overbroad. The Final Regulations apply only to realized losses,[14] and a revenue procedure issued with the Final Regulations provides a number of exceptions that will materially limit the loss transactions now included in this category. A transaction is a loss transaction if it results in the taxpayer claiming a loss under section 165[15] of at least:

- $10 million in any single taxable year or $20 million in any combination of taxable years for corporations or partnerships that have only corporations as partners,
- $2 million in any single taxable year or $4 million in any combination of taxable years for all other partnerships, individuals, S corporations or trusts, or
- $50,000 in any single taxable year for individuals or trusts if the loss arises with respect to foreign currency transactions under section 988.[16]

In determining whether a transaction crosses the threshold loss amount over a combination of taxable years, only losses claimed in the taxable year that the transaction is entered into and the five succeeding taxable years are combined. The taxpayer has participated in a loss transaction if the taxpayer's tax return reflects a loss under section 165 and the amount of the loss equals or

[13] Fees are specifically defined as those payable by the taxpayer or related party to any person who makes or provides a statement, oral or written, to the taxpayer or related party (or for whose benefit a statement is made or provided to the taxpayer or related party) as to the potential tax consequences that may result from the transaction. See Treas. Reg. § 1.6011-4(b)(4)(ii).

[14] Under the October Regulations, loss transactions included transactions in which it was reasonably expected that losses would be realized in the future.

[15] Unless otherwise indicated, all section references are to the sections of the Internal Revenue Code of 1986, as amended (the "Code").

[16] See Treas. Reg. § 1.6011-4(b)(5)(i).

exceeds the threshold that applies to that taxpayer.[17] In the case of partnerships, S corporations and trusts, a taxpayer who owns the applicable interest has participated in a loss transaction if the losses that flow through to the taxpayer equal or exceed the threshold that applies to that taxpayer.

Under Revenue Procedure 2003-24,[18] a loss under section 165 is not treated as a loss transaction if each of the following is satisfied:

1. the basis of the asset (less adjustments for any allowable depreciation, amortization, or casualty loss) is equal to the cash paid or is otherwise a qualifying basis,

2. the asset is not an interest in a partnership, trust, regulated investment company, real estate investment trust or other passthrough entity,[19]

3. the loss is not treated as ordinary under section 988,

4. the asset has not been separated from any portion of the income it generates, and

5. the asset has never been part of a straddle within the meaning of section 1092(c).

An asset has a "qualifying basis" if:

1. the basis is equal to, and is determined solely by reference to, the amount of cash paid by the taxpayer for the asset including payments for any improvements,

2. the basis is determined under section 358 by reason of a transaction under either section 355 or 368, and the basis of the property exchanged was a qualifying basis,

3. the basis is determined under section 1014,

---

17 See Treas. Reg. § 1.6011-4(c)(3)(D).

18 2003-11 IRB.

19 A passthrough entity is defined by reference to section 1260(c)(2) which includes any one of the following: a regulated investment company, a real estate investment trust, an S corporation, a partnership, a trust, a common trust fund, a passive foreign investment company (as defined in section 1297 without regard to subsection (e) thereof), a foreign personal holding company, a foreign investment company (as defined in section 1246(b)), and a REMIC.

4. the basis is determined under section 1015, and the donor's basis was a qualifying basis, or

5. the basis is determined under section 1031(d), and the basis of the property exchanged for the asset in the section 1031 transaction was a qualifying basis, and any debt instrument issued or assumed by the taxpayer in connection with the section 1031 transaction is otherwise treated as a payment in cash under the revenue procedure.

Certain other losses under section 165 specifically are not taken into account when determining whether a loss transaction is reportable. Included among the specific exceptions are certain losses resulting from mark-to-market treatment of an asset and losses arising from a properly identified hedging transaction.[20]

v. Significant book/tax difference.

This category was also subject to substantial criticism when it was introduced in the October Regulations. In response to the criticism, the list of exceptions in the October Regulations has been expanded in Revenue Procedure 2003-25.[21] There are now 30 exceptions for items such as cancellation of indebtedness income, charitable contributions of cash or tangible property, and tax exempt interest.[22]

This category is only applicable to reporting companies under the Securities Exchange Act of 1934 and business entities that have at least $250 million in gross assets for book purposes.[23] A transaction results in a significant book-tax difference if the amount for tax purposes of any item or items of income, gain, expense or loss from a transaction differs by more than $10 million from the treatment of the item or items for book purposes in any taxable year. A taxpayer has participated in a transaction with a significant book-tax difference if the taxpayer's tax treatment of an item from the transaction differs from the book treatment by more than the threshold amount.[24] The amount of an item for book purposes is determined using U.S. generally accepted accounting principles ("U.S. GAAP"). However, if a taxpayer, in

---

[20] See Exhibit B.

[21] 2003-11 IRB.

[22] See Exhibit C.

[23] Additionally, the Final Regulations contain special rules that address the treatment of affiliated corporations that file a consolidated return, foreign persons, owners of disregarded entities and partners of partnerships. See Treas. Reg. § 1.6011-4(b)(6)(ii)(B) through (E).

[24] See Treas. Reg. § 1.6011-4(c)(3)(E).

the ordinary course of its business, consistently uses a method other than U.S. GAAP for its financial reporting books and does not maintain U.S. GAAP books for any purpose, such taxpayer may determine its book amount according to the taxpayer's own method of book accounting.

vi. Transactions involving a brief asset holding period.

A transaction with a brief asset holding period is a transaction that results in a tax credit greater than $250,000 if the asset generating the credit is held for 45 days or less. A taxpayer has participated in a transaction involving a brief asset holding period if the taxpayer's tax return reflects items giving rise to a tax credit described in the previous sentence.[25]

EXCEPTIONS TO THE DISCLOSURE REQUIREMENT

The Final Regulations provide an exception for transactions the IRS determines are not reportable transactions. Additionally, the Final Regulations have new general exceptions for regulated investment companies and investment vehicles owned 95% or more by regulated investment companies (but no exception applies to real estate investment trusts) and for customary leasing transactions that are otherwise excepted from the registration and list maintenance requirements.[26]

TIME FOR PROVIDING DISCLOSURE

The required disclosure statement must be attached to the taxpayer's return for each taxable year for which the taxpayer participates in the transaction. In addition, the taxpayer must send a copy of the disclosure statement to the Office of Tax Shelter Analysis at the same time such statement is first filed with the taxpayer's tax return. If a reportable transaction results in a loss carryback, the required disclosure statement must be attached to the taxpayer's application for refund or amended federal tax return. If a transaction becomes a listed transaction after the date the taxpayer files its final tax return that reflects either the tax consequences or a tax strategy described in the IRS published guidance listing the transaction and before the end of the statute of limitations period for that return, then the taxpayer must file a disclosure statement as an attachment to its next tax return.[27]

---

[25] See Treas. Reg. § 1.6011-4(c)(3)(F).

[26] See Treas. Reg. § 1.6011-4(b)(8)(ii) & (iii); see also Notice 2001-18, 2001-1 CB 731 (customary leasing transactions excepted from registration requirements under section 6111(d) and the list maintenance requirements under section 6112).

[27] See Treas. Reg. § 1.6011-4(e)(2).

For passthroughs such as partnerships and trusts, comments to the October Regulations suggested that only the passthrough be required to file a disclosure statement with respect to reportable transactions entered into by such passthrough. However, the Final Regulations do not adopt this approach. As a result, partners and beneficiaries may be required to disclose transactions that are also subject to disclosure by the partnership or trust.

RULINGS AND PROTECTIVE DISCLOSURES

A taxpayer may submit a request to the IRS for a ruling on whether a particular transaction is subject to the disclosure requirements. Alternatively, a taxpayer who is uncertain about whether a transaction must be disclosed under the Final Regulations may disclose the transaction and indicate on the disclosure statement that the taxpayer is uncertain about the proper treatment and is filing on a protective basis.

FAILURE TO FILE DISCLOSURE STATEMENT

A taxpayer that is required to file a disclosure statement under the Final Regulations and fails to do so may be subject to penalties that it otherwise would have avoided. As discussed in the final section of this memorandum, 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 an earlier version of these 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.[28] In addition, although taxpayers may generally be deemed to have acted with reasonable cause and in good faith if they reasonably relied upon the advice of a professional tax advisor, recently proposed regulations under section 6664 would not allow a taxpayer to establish that it reasonably relied on a opinion or advise of a tax advisor if such opinion or advice relates to the appropriate tax treatment of a reportable transaction for which the taxpayer failed to file a disclosure statement.[29]

LISTS OF INVESTORS IN POTENTIALLY ABUSIVE TAX SHELTERS

Each "material advisor" of a "potentially abusive tax shelter" is generally required to maintain a list that identifies persons to whom (or for whose benefit) such material advisor

28 See T.D. 8877 (2000).

29 See Prop. Treas. Reg. § 1.6664-4(c)(2).

made a "tax statement" with respect to the transaction and to make that list available for inspection upon request by the IRS. The list must also include detailed information about the transaction and the persons required to be included on the list.[30]

DEFINITION OF POTENTIALLY ABUSIVE TAX SHELTER

The following transactions qualify as "potentially abusive tax shelters" for purposes of the obligation to maintain an investor list:

1. Transactions required to be registered under section 6111 (see discussion below),

2. Transactions listed by the IRS in published guidance as tax avoidance transactions,[31] and

3. Transactions that a potential "material advisor" (as defined below) knows is, or reasonably expects to become, one of the reportable transactions other than IRS listed transactions (as described above in "Tax Shelter Disclosure Statements – Participation in Reportable Transactions").

DEFINITION OF MATERIAL ADVISOR

A person is a material advisor with respect to a potentially abusive tax shelter, and thus responsible for maintaining investor lists, if such person is required to register the transaction under section 6111 or meets the following two criteria. First, the person must provide a "tax statement" (as defined below) to or for the benefit of:

- a taxpayer required to disclose the transaction under the disclosure regulations because the transaction is listed in IRS published guidance as an abusive transaction,

- a taxpayer that the material advisor knows is or reasonably expects to be required to disclose the transaction because it is or is reasonably expected to become one of the reportable transactions under the disclosure regulations (other than IRS listed transactions), or

- a taxpayer required to register the transaction under section 6111 or who purchases or otherwise acquires an interest in a section 6111 tax shelter.

---

[30] See Treas. Reg. § 301.6112-1(e)(3).

[31] See Exhibit A.

Second, the person must receive, or expect to receive, a "minimum fee" ($250,000 if every person to whom or for whose benefit the potential material advisor makes or provides a tax statement with respect to the transaction is a corporation,[32] and $50,000 for any other qualifying transaction)[33] with respect to the transaction.[34]

DEFINITION OF TAX STATEMENT

A tax statement is any statement, oral or written, that relates to a tax aspect of the transaction that causes the transaction to be a tax shelter as set forth in section 6111 or a reportable transaction under the disclosure regulations. Specifically, for confidential transactions and transactions with contractual protection, a statement will be considered a tax statement if such statement concerns a tax benefit related to the transaction, and the transaction otherwise meets the conditions under the disclosure regulations as to the person making the statement or to another person if the person making the statement knows of such conditions. For loss transactions, transactions with a significant book-tax difference and transactions involving a brief asset holding period, a statement will be treated as a tax statement if such statement concerns an item that gives rise to the loss, book-tax difference or tax credit, respectively, as described under the disclosure regulations. However, if the tax statement includes only information about the transaction contained in publicly-available documents which are filed with the Securities and Exchange Commission by the close of the transaction, such tax statement will not be considered made to or for the benefit of any person identified under the list maintenance regulations.

PERSONS REQUIRED TO BE INCLUDED ON LISTS

A material advisor must list those persons to whom or for whose benefit the material advisor makes or provides a tax statement with respect to a transaction that is a potentially abusive tax shelter. In a transaction that must be disclosed, a material advisor must also list any subsequent participant if the material advisor knows the identity of the subsequent participant. If a material advisor is required to register a transaction under section 6111, such material

---

[32] The $250,000 minimum fee also applies to a tax statement made or provided to a partnership or trust if all owners or beneficiaries are corporations (looking through any partners or beneficiaries that are themselves partnerships or trusts).

[33] In the case of a transaction listed in IRS published guidance as an abusive transaction, the minimum fee thresholds are reduced from $250,000 to $25,000 and from $50,000 to $10,000.

[34] A person will not be considered a material advisor if such person makes a tax statement solely in the person's capacity as an employee, shareholder, partner or agent of another person. Tax statements made by such persons will be attributed to that person's employer, corporation, partnership or principal. See Treas. Reg. § 301.6112-1(c)(2)(ii).

advisor must list each person who purchases or otherwise acquires an interest in the transaction.

CLAIMS OF PRIVILEGE

If an attorney or federally authorized tax practitioner is required to maintain a list with respect to a potentially abusive tax shelter, and that person has a reasonable belief that any information contained in any of the written materials (including tax analyses or opinions) required to be maintained under the list maintenance regulations is protected by the attorney-client privilege (or the confidentiality privilege that relates to federally authorized tax practitioners),[35] such person is nonetheless required to maintain the investor list. When the list is requested by the IRS, however, the material advisor may assert a privilege claim if he or she also provides a statement that is signed under penalties of perjury and identifies each document 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 (ii) he or she (and all others in possession of the omitted information) did not disclose the omitted information to any person whose receipt of such information would result in a waiver of the privilege. 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.[36]

CONTENTS OF INVESTOR LISTS

Under the Final Regulations, each list must contain the following information:

- the name, registration number, if any, and Taxpayer Identification Number (“TIN”) of each transaction that is a potentially abusive tax shelter,
- the name, address and TIN of each person required to be on the list,
- the number of units acquired by each person required to be on the list, if applicable and known by the material advisor,
- the date on which each person required to be on the list entered into each transaction and the amount invested in each transaction by such person, if known by the material advisor,

---

35 The preamble to the Final Regulations specifically indicates that the IRS and Treasury Department do not believe that information other than that contained in the written materials required to be maintained under the list maintenance regulations is protected by privilege. See T.D. 9046 (2003).

36 See Treas. Reg. § 301.6112-1(g)(2)(ii)(A).

- a detailed description of each transaction, including its tax structure and expected tax treatment,
- a summary or schedule of the tax treatment that each person is intended or expected to derive from participation in each transaction, if known by the material advisor, and
- copies of additional written materials, including tax analyses and opinions, that (i) relate to each transaction, (ii) are material to an understanding of the tax treatment or tax structure of the transaction, and (iii) have been shown or provided to any person who acquired or may acquire an interest in the transaction (or its representatives, tax advisors or agents) by the material advisor (or its related party or agent).[37]

The Final Regulations clarify that a material advisor is not required to retain earlier drafts of documents, provided that (i) the material advisor saves a copy of the final or most recent draft of the document and (ii) the final or most recent draft of the document reflects all of the information in the earlier drafts that is material to the understanding of the tax treatment and tax structure of the transaction.

RETENTION AND FURNISHING OF INVESTOR LISTS

Each material advisor must maintain the list of investors in a potentially abusive transaction for seven years following the earlier of the date on which the material advisor last made a tax statement regarding the transaction or the date the transaction was entered into, if known. The list of a material advisor which is an entity that dissolves or liquidates before the seven-year period ends must be maintained and furnished by the person responsible for winding up the affairs of the entity. Each material advisor that receives a written request from the IRS must furnish the list to the IRS within twenty days of the date of the request.

DESIGNATION AGREEMENTS

Material advisors for a potentially abusive tax shelter may execute a written agreement that designates a single material advisor to maintain the list. However, such an agreement does not limit the obligation of any material advisor to furnish the list to the IRS. If a material advisor is unable to obtain the investor list from the designated material advisor, such material advisor will not be relieved from the requirements of the Final Regulations and may be subject to penalties.

PENALTIES FOR NON-COMPLIANCE

---

[37] See Treas. Reg. § 301.6112-1(e)(3).

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 investor lists is $100,000 per calendar year.

CORPORATE TAX SHELTER REGISTRATION

The corporate tax shelter registration requirements were not substantially modified in the Final Regulations. A "confidential corporate tax shelter" must be registered with the IRS no later than the day on which the first offering of interests in the tax shelter occurs.[38] Registration is accomplished by filing IRS Form 8264, "Application for Registration of a Tax Shelter," which requires specific information about the tax shelter.[39] Legislation pending before the U.S. Congress would modify section 6111 to require registration of transactions that must be disclosed on Form 8886 (see discussion above), and the IRS intends to modify the regulations under section 6111 when such legislation is enacted.[40]

DEFINITION OF CONFIDENTIAL CORPORATE TAX SHELTER

Three Requirements

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

(i) Fees in excess of $100,000. The tax shelter promoters may receive fees in excess of $100,000 in the aggregate,[41]

---

38 See Treas. Reg. § 301.6111-2(e)(1).

39 See Treas. Reg. § 301.6111-2(e)(2). 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.

40 See T.D. 9017 (2002).

41 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. § 301.6111-2(d).

(ii) Conditions of confidentiality. The transaction is offered to any potential participant under conditions of confidentiality,[42] and

(iii) 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"), [43] or

(b) the transaction is listed in published guidance by the IRS as a tax avoidance transaction subject to registration. [44]

THREE EXCEPTIONS TO THE REGISTRATION REQUIREMENT

Even if a transaction otherwise 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. The taxpayer is expected to participate in the transaction in the ordinary course of its business in a form consistent with commercial practice, and there is a generally accepted understanding that the expected federal income tax benefits from the transaction are properly allowable,[45]

---

[42] The analysis to determine whether a transaction is offered under conditions of confidentiality for purposes of registration is substantially the same as the analysis for purposes of disclosure, which is discussed in detail above in "Tax Shelter Disclosure Statements – Participation in Reportable Transactions – Confidential transactions." Compare Treas. Reg. § 301.6111-2(c) with Treas. Reg. § 1.6011-4(b)(3).

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

[44] See Exhibit A.

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

(ii) The No Reasonable Basis Exception. There is no reasonable basis for the denial of any significant portion of the expected federal income tax benefits from the transaction,[46] or

(iii) The IRS Guidance Exception. The IRS has identified the transaction in public guidance as not subject to the registration requirements.[47]

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

PERSONS REQUIRED TO REGISTER

The tax shelter promoter is generally the party responsible for registering a tax shelter. Under the Final 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.[48] 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.[49] 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.

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

---

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.]"

[46] See Treas. Reg. § 301.6111-2(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.

[47] See Treas. Reg. § 301.6111-2(b)(4)(ii).

[48] Special rules apply if all promoters of a tax shelter are foreign persons. See Treas. Reg. § 301.6111-2(g)(2).

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

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.

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.[50]

Under section 6662, 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. The penalty is generally not applicable to a taxpayer if such taxpayer establishes it acted with reasonable cause and in good faith.[51] In addition, for purposes of this accuracy-related penalty, a taxpayer may generally 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.[52] The regulations provide that a taxpayer reasonably believes the 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

[50] See section 6662(d)(2)(C)(iii).

[51] However, as discussed previously, the proposed regulations under section 6664 would not allow the taxpayer to use this exception in circumstances where the taxpayer fails to disclose a reportable transaction. See Prop. Treas. Reg. § 1.6664-4(c)(2).

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

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.

* * *

The foregoing is intended only as a general summary, and the Final Regulations are more complex in their entirety. In addition, any legislation with respect to tax shelters, if enacted, could substantially modify the discussion above. If you have any questions about the Final Regulations or would like more information regarding specific provisions, please do not hesitate to call Dickson G. Brown (dbrown@stblaw.com;,212-455-2850), John J. Creed (jcreed@stblaw.com, 212-455-3485), Jonathan E. Cantor (jcantor@stblaw.com, 212-455-2237), Joshua R. Isenberg (jisenberg@stblaw.com, 212-455-3512), Rachel D. Birnbaum (rbirnbaum@stblaw.com, 212-455-2322) or any other member of our tax department.

SIMPSON THACHER & BARTLETT

EXHIBIT A

TAX AVOIDANCE TRANSACTIONS IDENTIFIED BY THE IRS

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

(1) Pension contributions—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;[53]

(2) Welfare benefit plans—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) Lease strips—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) Foreign tax credits—transactions in which the reasonably expected economic profit is insubstantial in comparison to the value of the expected foreign tax credits;

(5) Contingent installment sales—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) Charitable remainder trusts—transactions involving distributions described in Treas. Reg. § 1.643(a)-8 from charitable remainder trusts;

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

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

(9) Fast-pay arrangements—transactions involving fast-pay arrangements as defined in Treas. Reg. § 1.7701(1)-3(b);

(10) Hedged debt instruments—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) Artificial basis—transactions generating losses resulting from artificially inflating the basis of partnership interests;

(12) Subsidiary's acquisition and transfer of parent stock—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;

(13) Guam trusts—transactions purporting to apply section 935 of the Code to Guamanian trusts;

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

(15) Contingent liabilities—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) Basis shift redemptions—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) Loan assumption agreements—certain transactions involving the use of a loan assumption agreement to claim an inflated basis in assets acquired from another taxpayer;[54]

(18) Contingent notional principal contracts—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;[55]

---

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

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

(19) Tiered partnerships—transactions involving the creation of a tiered partnership that does not make a section 754 election used to duplicate straddle losses;[56]

(20) Foreign currency straddles—transactions involving the use of an S corporation (or partnership) that enters into foreign currency straddle transactions and recognizes the loss leg of the straddles after the other shareholders (or partners) are redeemed and an election to treat the S corporation's (or partnership's) tax year as consisting of two separate years is made in order to allocate the loss to the remaining shareholder; [57]

(21) Reinsurance—transactions involving the use of a reinsurance arrangement to improperly divert income from a U.S. taxpayer to the taxpayer's reinsurance subsidiary that is subject to little or no federal income tax;[58] and

(22) ESOPs—arrangements involving employee stock ownership plans (ESOPs) that hold employer securities in an S corporation in order to claim eligibility for the delayed effective date of section 409(p), thereby avoiding a nonallocation year and current tax (and excise tax) for disqualified persons.[59]

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

[57] See Notice 2002-65, 2002-41 IRB 690.

[58] See Notice 2002-70, 2002-44 IRB 765.

[59] See Rev. Rul. 2003-6, 2003-3 IRB 286.

EXHIBIT B

SECTION 165 LOSSES EXCEPTED FROM LOSS TRANSACTION CATEGORY OF REPORTABLE TRANSACTIONS [60]

The following are section 165 losses not taken into account in determining whether a loss transaction is reportable:

(1) A loss from fire, storm, shipwreck, or other casualty, or from theft, under section 165(c)(3);

(2) A loss from a compulsory or involuntary conversion as described in section 1231(a)(3)(A)(ii) and section 1231(a)(4)(B);

(3) A loss arising from any mark-to-market treatment of an item under sections 475, 1256, 1296(a), or Treas. Regs. §§§ 1.446-4(e), 1.988-5(a)(6), or 1.1275-6(d)(2), provided that the taxpayer computes its loss by using a qualifying basis (as defined in section 4.02(2) of Rev. Proc. 2003-24) or a basis resulting from previously marking the item to market, or computes its loss by making appropriate adjustments for previously determined mark-to-market gain or loss as provided, for example, in section 475(a) or section 1256(a)(2);

(4) A loss arising from a hedging transaction described in section 1221(b), if the taxpayer properly identifies the transaction as a hedging transaction, or from a mixed straddle account under Temp. Treas. Reg. § 1.1092(b)-4T;

(5) A loss attributable to basis increases under section 860C(d)(1) during the period of the taxpayer's ownership;

(6) A loss attributable to the abandonment of depreciable tangible property that was used by the taxpayer in a trade or business and that has a qualifying basis under section 4.02(2) of Rev. Proc. 2003-24;

(7) A loss arising from the bulk sale of inventory if the basis of the inventory is determined under section 263A; or

(8) A loss that is equal to, and is determined solely by reference to, a payment of cash by the taxpayer (for example, a cash payment by a guarantor that results in a loss or a cash payment that is treated as a loss from the sale of a capital asset under section 1234A or section 1234B).

---

[60] As set forth in Rev. Proc. 2003-24, 2003-11 IRB.

EXHIBIT C

BOOK TAX DIFFERENCES NOT TAKEN INTO ACCOUNT FOR DISCLOSURE PURPOSES[61]

Book-tax differences arising by reason of the following items are not taken into account in determining whether a transaction has a significant book-tax difference under Treas. Reg. § 1.6011-4(b)(6):

(1) Items to the extent a book loss or expense is reported before or without a loss or deduction for federal income tax purposes.

(2) Items to the extent income or gain for federal income tax purposes is reported before or without book income or gain.

(3) Depreciation, depletion under section 612, and amortization relating solely to differences in methods, lives (for example, useful lives, recovery periods), or conventions as well as differences resulting from the application of sections 168(k), 1400I, or 1400L(b).

(4) Percentage depletion under section 613 or section 613A, and intangible drilling costs deductible under section 263(c).

(5) Capitalization and amortization under sections 195, 248, and 709.

(6) Bad debts or cancellation of indebtedness income.

(7) Federal, state, local, and foreign taxes.

(8) Compensation of employees and independent contractors, including stock options and pensions.

(9) Charitable contributions of cash or tangible property.

(10) Tax exempt interest, including municipal bond interest.

(11) Dividends as defined in section 316 (including any dividends received deduction), amounts treated as dividends under section 78, distributions of previously taxed income under section 959 and section 1293, and income inclusions under sections 551, 951, and 1293.

---

[61] As set forth in Rev. Proc. 2003-25, 2003-11 IRB.

(12) A dividends paid deduction by a publicly-traded REIT.

(13) Patronage refunds or dividends of cooperatives without a section 267 relationship to the taxpayer.

(14) Items resulting from the application of section 1033.

(15) Items resulting from the application of sections 354, 355, 361, 367, 368, or 1031, if the taxpayer fully complies with the filing and reporting requirements for these sections, including any requirement in the regulations or in forms.

(16) Items resulting from debt-for-debt exchanges.

(17) Items resulting solely from the treatment as a sale, purchase, or lease for book purposes and as a financing arrangement for tax purposes.

(18) Treatment of a transaction as a sale for book purposes and as a nontaxable transaction under section 860F(b)(1)(A) for tax purposes, not including differences resulting from the application of different valuation methodologies to determine the relative value of REMIC interests for purposes of allocating tax basis among those interests.

(19) Items resulting from differences solely due to the use of hedge accounting for book purposes but not for tax purposes, the use of hedge accounting under Treas. Reg. § 1.446-4 for tax purposes but not for book purposes, or the use of different hedge accounting methodologies for book and tax purposes.

(20) Items resulting solely from (i) the use of a mark-to-market method of accounting for book purposes and not for tax purposes, (ii) the use of a mark-to-market method of accounting for tax purposes but not for book purposes, or (iii) in the case of a taxpayer who uses mark-to-market accounting for both book purposes and tax purposes, the use of different methodologies for book purposes and tax purposes.

(21) Items resulting from the application of section 1286.

(22) Inside buildup, death benefits, or cash surrender value of life insurance or annuity contracts.

(23) Life insurance reserves determined under section 807 and non-life insurance reserves determined under section 832(b).

(24) Capitalization of policy acquisition expenses of insurance companies.

(25) Imputed interest income or deductions under sections 483, 1274, 7872, or Treas. Reg. § 1.1275-4.

(26) Gains and losses arising under sections 986(c), 987, and 988.

(27) Items excluded under section 883, section 921, or an applicable treaty from a foreign corporation's income that would otherwise be subject to tax under section 882.

(28) Section 481 adjustments.

(29) Inventory valuation differences whether attributable to differences in last-in, first-out (LIFO) computations or obsolescence reserves.

(30) Section 198 deductions for environmental remediation costs.

SIMPSON THACHER & BARTLETT