

**The Tax Shelter Dilemma:
The Impact of Reportable Transactions
on the Taxpayer and the Tax Return Preparer**

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Introduction

In response to adverse publicity and the perceived loss of tax revenues, the federal government has waged an aggressive campaign to combat the use of abusive tax shelters. As part of this effort, the IRS issued Treas. Reg. §1.6011-4 mandating disclosure of transactions deemed to be tax shelter transactions. These disclosure requirements when combined with the provisions in the Sarbanes-Oxley Act of 2002 (SOA), the American Jobs Creation Act of 2004, and the Small Business and Work Opportunity Act of 2007, create new obligations and risks for corporate controllers, CFOs, CEOs and tax return preparers because of the substantial monetary penalties for noncompliance. This article discusses the evolution of the disclosure requirements from the issuance of the first set of proposed regulations in 2000 through newly-enacted and proposed legislation, recent litigation, and recent IRS guidance found on the IRS website. It is recommended that tax practitioners use a check list to identify potential abusive transactions requiring disclosure.

Treas. Reg. §1.6011-4: Disclosure Requirements

The disclosure requirements of Treas. Reg. §1.6011-4 apply to reportable transactions, the definition of which is discussed below. A reportable transaction must be disclosed to the IRS in each year the taxpayer's tax return reflects the tax consequences or tax benefit of a reportable transaction. Accordingly, a reportable transaction resulting in tax consequences or benefits over more than one year must be disclosed in each tax year.

Reportable transactions are disclosed on Form 8886 (figure 1) which is attached to the tax return. A copy must also be sent to the IRS Office of Tax Shelter Analysis for the first year the taxpayer participates in the transaction. In the event a transaction becomes a reportable transaction after the return was filed (including an amended return), the form is attached to the subsequent year tax return even if the taxpayer did not participate in the transaction that year.¹ In addition to the disclosure requirements, the taxpayer must retain copies of all documents and other records relevant to an understanding of the tax treatment of a reportable transaction until the statute of limitations has run (Treas. Reg. §1.6011-4(g)).

American Job Creation Act of 2004: Penalty Provisions for Failure to Disclose

The American Jobs Creation Act of 2004, P.L. 108-357, (“AJCE”) imposes severe penalties for failure to comply with the disclosure requirements of Treas. Reg. §1.6011-4. The penalties set forth in IRC §6707A(b) are:

- \$10,000 for each reportable transaction and of \$100,000 for each listed transaction not properly disclosed by a natural person.
- \$50,000 and \$200,000 for each reportable transaction and listed transaction, respectively, not properly by a corporation.

While the IRS is vested with the authority to rescind the penalty in certain situations, any determination regarding the rescission of the penalty is not subject to judicial review (§6707A(d)). The penalties apply whenever a taxpayer fails to make a required disclosure, regardless of whether the IRS audits the transaction or whether the taxpayer’s position is ultimately upheld.

The AJCE also imposes an accuracy-related penalty applicable to understatements attributable to “any listed transaction” (§6662A(b)(2)(A)) and “any reportable transaction

¹ Instructions for form 8886, p.3.

(other than a listed transaction) if a significant purpose of such transaction is avoidance or evasion of Federal income tax” (§6662A(b)(2)(B)). If the transaction results in an understatement of tax and was adequately disclosed, a 20% accuracy penalty is imposed. The penalty may be waived if the taxpayer acted in good faith and can demonstrate there is substantial authority for its position. If the transaction was not adequately disclosed, the penalty is 30% and may not be waived under any circumstances (§6662A). Under the Act an understatement of \$10 million or more by a corporation will automatically be considered a substantial understatement (§6662). The AJCE imposes additional disclosure requirements on publicly-traded corporations required to pay (1) a penalty for failure to properly disclose a listed transaction (§6707A), (2) a 30% accuracy-related penalty (§6662A), or (3) a penalty for gross valuation misstatements attributable to a nondisclosed listed transaction or nondisclosed reportable avoidance transaction (§6662). The AJCE also imposes a new SEC reporting requirement that applies without regard to whether the amount of the penalty is material.² The penalty must be reported in the Form 10-K or other similar document once the taxpayer has exhausted its remedies with respect to the penalty, or when the penalty was paid, if earlier. Failure to make the required SEC disclosure is treated as a separate failure to disclose a listed transaction and is subject to a \$200,000 penalty (§6707A(e)(2)).

The Act also requires a “material adviser,” a person who provides material aid, assistance, or advice on a reportable transaction, to file an information return describing

² **6707A(e) PENALTY REPORTED TO SEC.** -A person required to file periodic reports under section 13 or 15(d) of the Securities Exchange Act of 1934 or is required to be consolidated with another person for purposes of such reports, and is required to pay a penalty under this section with respect to a listed or reportable transaction, is required to disclose the payment of the penalty shall in reports as specified by the Secretary.

the transaction and its related tax benefits. The material adviser must also furnish upon request by the IRS a list of tax-shelter investors enabling the IRS to target these investors for audit. Also, a material adviser must file Form 8918 (figure 2) for each reportable transaction for which material aid, assistance or advice was provided.

If the listed transaction is not disclosed on the tax return, the statute of limitations for that transaction will be extended beyond the normal assessment period.³ Thus, it is imperative the person responsible for signing the tax return makes a determination that, should the return be audited, no transactions requiring disclosure will be found.

Sarbanes-Oxley Act of 2002: Its Role in the Disclosure Requirements

Corporate taxpayers are responsible for putting in place a tax compliance strategy which includes documentation of internal controls to support any tax position that meets or is “substantially similar” to a listed transaction. A public corporation subject to the Sarbanes-Oxley Act of 2002 (SOA) must file a written statement certifying that the financial statements filed with the SEC fairly present, in all material respects, the financial condition and results of operations of the company (SOA Sec. 906). Furthermore, SOA Sec. 302 and 404 have a direct impact on tax compliance and tax planning serving as further acknowledgement that management is accountable for information provided to the tax authorities. The responsible party signing the corporate tax return must be fully aware of any tax minimization strategies the IRS may deem to be an “abusive tax shelter” and subject to disclosure requirements under Treasury regulations and SOA.

³ “The period of limitations to assess any tax with respect to the listed transaction will be extended beyond the normal assessment period until one year after the earlier of either: the date you disclose the transaction by filing Form 8886 or the date that a material advisor provides the information required under §6112 in response to a request by the IRS under §6112.” Instructions for Form 8886, p. 3.

Explanation of Provisions of the Tax Shelter Disclosure Regulations

The importance of Treas. Reg. §1.6011-4 lies not only in the requirements for disclosure, but in the very broad view they take of what may constitute an “abusive tax shelter.” Potentially, not only tax minimization strategies but ordinary business transactions and arrangements could come within the purview of what the IRS has declared to be an “abusive tax shelter.” Failure to be aware of such classification may result in inadvertent, but nonetheless punishable, violations of the regulations and SOA.

At the heart of the regulations is the requirement the responsible party is able to identify a proposed transaction as a “listed transaction” one that is the same as or “substantially similar” to one of the types of transactions the IRS has determined to be a tax avoidance transaction and identified by notice, regulation or other form of published guidance. The notion of substantially similar is to be read broadly in favor of disclosure (Treas. Reg. §1.6011-4T(b)(2)). Current listed transactions (Notice 2004-67, 2004-41 IRB, 9/24/2004) and transactions of interest⁴ are found in Table 1 and are summarized in the Appendix.

[Insert Table 1 here]

Not only must taxpayers disclose a listed transaction, they must also disclose transactions that are “substantially similar.” The regulations clarify that “substantially

⁴Recently released final regulations about the disclosure of reportable transactions include the new transaction of interest category as one of the reportable transactions subject to disclosure. In designating a transaction as transactions of interest, Treasury and the IRS believe it has the potential for abuse, but lack sufficient information to determine whether the transactions should be identified specifically as tax avoidance transactions. Treasury and the IRS may take one or more future actions, including designating the transactions as listed transactions, or providing a new category of reportable transaction. The notices also alert persons involved in transactions of interest to certain responsibilities that may arise from their involvement.

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. Transactions especially likely to pose unexpected traps for the unwary include: confidentiality agreements, contingent fee arrangements, tax-loss motivated transactions, and patented transactions. Transactions resulting in significant book-tax differences are disclosed on the Schedule M-3 and no longer require separate disclosure on Form 8886.

Confidentiality Agreements

Before the reportable transaction regulations were enacted, a tax adviser would offer a taxpayer an opportunity to improve cash flow by following a confidential (“proprietary”) tax strategy modified to fit the client’s situation. To assist in the credibility of the tax strategy, the promoter would offer the client an opinion of counsel providing the client with a reasonable assurance that the position would be sustained in a court of law. Should the proposed tax minimization strategy fail, the investor could claim reliance on the advice of a professional to avoid imposition of any penalties. The regulations eliminate this assertion and require taxpayers to understand the risks involved with the proposed tax strategy (Treas. Reg. §1.6011-4(b)(3)). Requiring investors to disclose situations of confidentiality will deter promoters from using their intellectual capacity to manipulate investors into taking positions that may lack economic substance. Furthermore, §6664(d)(3)(B) eliminates the ability of the taxpayer to rely on the opinion of a tax advisor provided by the promoter of the confidential or proprietary tax strategy. In response to public comments, the IRS added an important exception for confidentiality agreements with respect to mergers and acquisitions.

Contingent Fee Arrangements

The IRS identified contingent fees as an important indicator of a tax shelter. Some promoters offered a contingent fee arrangement with a promise to refund the fee should the proposal not pass muster with the IRS. Some taxpayers, especially those with a limited understanding of the tax code, were more willing to engage in risky transactions when adviser fees were contingent. The regulations now require disclosure of fees paid by or on behalf of the taxpayer or a related party to any person who makes or provides a statement, oral or written, to the taxpayer or related party regarding the potential tax consequences that may result from the transaction (Treas. Reg. §1.6011-4(b)(4)). A transaction is not considered to have contractual protection solely because the party to the transaction has the right to terminate the transaction upon the happening of an event affecting the taxation of one or more parties to the transaction. Refundable or contingent fees need not be disclosed if the taxpayer has already entered into the transaction and reported the consequences of the transaction on a tax return filed prior to receiving information regarding the tax consequences of the transaction.

Tax-Loss Motivated Transactions

The regulations require disclosure of certain tax-loss transactions exceeding various dollar thresholds for different categories of taxpayers (for corporate taxpayers, \$10 million in any single year, or \$20 million in any combination of years; for partnerships and S corporations, \$10 million in any combination of years; for individuals and trusts, \$2 million in any single year or \$4 million in any combination of years (Reg. Sec. §1.6011-4(b)(5)). A transaction does not become a loss transaction until the losses are actually claimed. A taxpayer who may exceed the applicable loss threshold in any combination of taxable years may want to delay recognition of a loss so that it will fall

outside the general lookback rule in which only losses claimed in the taxable year that the transaction is entered into and the five succeeding taxable years are combined (Reg. Sec. §1.6011-4(b)(5)(ii)). To deter taxpayers from engaging in transactions structured to accumulate losses in foreign investments, thereby escaping US tax, the Regulations require investors to disclose foreign currency losses of \$50,000 or more (Reg. Sec. §1.6011-4(b)(5)(E)). Losses from mark to market accounting, hedging transactions, and losses with a qualifying basis do not require disclosure.

Significant Book-Tax Differences Now Reported on Schedule M-3

Large corporations which minimize taxable income while reporting high GAAP earnings will likely have significant book-tax differences. Corporations with total assets in excess of \$10,000,000 are required to disclose detailed information about book-tax differences for taxable years ending on or after December 31, 2004. Each book-tax difference must be separately stated and adequately disclosed on Schedule M-3 in Columns B and C of Parts II and III in a timely filed original tax return, including extensions (Rev. Proc. 2004-45, Section 4.04(2)). Because book-tax differences are now disclosed on the Schedule M-3, there is no requirement to also disclose them on Form 8886.

Patented Transactions (after September 27, 2007)

The IRS issued proposed regulations adding a new category of reportable transactions for patented transactions entered into or statements made by a material advisor after Sept. 25, 2007.⁵ The new category of patented transactions applies to any transaction for which a taxpayer either directly or indirectly pays a fee in any amount to a

⁵ On July 18, 2007, the House Judiciary Committee approved The Patent Reform Act of 2007 (H. R. 1908) which would make tax planning techniques unpatentable. Similar legislation was introduced in the Senate, S. 2365 on November 15, 2007 and in the House, H.R. 2365, on May 17, 2007.

patent holder (or agent) for the legal right to use a tax planning method the taxpayer knows or has reason to know is the subject of a patent. A patented transaction also includes a transaction for which the patent holder has the right to payment for another's use of a tax planning method that is the subject of the Patent (Prop. Reg. §1.6011-4(b)(7)(i)). A taxpayer is considered to have participated in a patented transaction if the tax return reflects a tax benefit from the transaction, including a deduction for fees paid in any amount to the patent holder. A taxpayer is also considered to have participated in a patented transaction if the taxpayer is the patent holder or the patent holder's agent and the tax return reflects a tax benefit in relation to obtaining a patent for a tax planning method or reflects income from a payment received from another person for the use of the tax planning method that is the subject of the patent (Prop. Reg. §1.6011-4(c)(3)(i)(F)). Patented transactions do not include patent-protected tax preparation software or mathematical calculations (Prop. Reg. §1.6011-4(b)(7)(ii)(F)). Because of the nature of patented transactions and how they are marketed, the threshold amounts described in §6111 with respect to when a taxpayer is a material advisor are reduced from \$50,000 to \$250 and from \$250,000 to \$500.

Everyday Business Transaction vs. Tax Shelters

While the regulations may seem to apply only to "abusive" listed transactions, many everyday business transactions may now require disclosure. For example, post-year end contributions to a qualified cash or deferred arrangement (CODA) that tie CODA contributions to year-end profit figures are no longer deductible and are reportable transactions (Treasury Reg. Sec. 1.404(a)-1(b)). Similarly, by engaging in a lease strip in which a cash-poor entity that shifts a depreciation deduction to an entity in a

higher tax bracket the taxpayer may be engaging in a prohibited transaction (Notice 2003-55, 2003-34 IRB 395). The brief asset holding period regulations deny foreign tax credits when an asset is held by the taxpayer for 45 days or less and is a direct rebuff of the *Compaq Computer Corporation* (277 F. 3d 778 (5th cir. 2001)) decision in which the taxpayer was able to utilize large foreign tax credits when the underlying asset was owned for only a few days (Section 1.6011-4(b)(7)). The Treasury, concerned with the economic substance surrounding similar transactions, now requires disclosure of similar investments (Notice 2004-20, 2004-11 IRB 608).

By providing a list of prohibited transactions and by its recent creation of a list of Transactions of Interest (refer to Table 1), the IRS is putting taxpayers on notice regarding which business transactions it considers abusive. Even so, the list is not exhaustive. The IRS will continue using judicial doctrines such as business-purpose, substance-over form, and the step-transaction doctrine, to determine whether a transaction lacks economic substance or is a sham transaction.

Identifying Potential Abusive Tax Shelter Transactions

To comply with the regulations, the party responsible for signing the tax return must determine if the taxpayer has engaged in any transaction that could be labeled as an abusive tax shelter by the IRS. IRC § 6111 defines a tax shelter as any investment in which the return to the investor in the first five years is greater than two-to-one and is required to be registered under a federal or state law, sold pursuant to an exemption from registration, or a substantial investment with five or more investors with an offering price in excess of \$250,000. However, there are many transactions that may be treated as a tax shelter even though they do not meet the literal definition of Sec. 6111. Table 2 lists the

nine common characteristics of a tax shelter and four judicial responses from a Department of the Treasury study regarding abusive tax shelters. These may be helpful in making a determination of whether a transaction will be classified as a listed transaction.

[Insert Table 2 here]

The economic substance doctrine has been the topic of recent proposed legislation and recent successful appeals of initial taxpayer victories litigating tax shelter cases. For example, H.R. 3970, Tax Reduction and Reform Act of 2007, would clarify, but not change, current standards used by the courts in applying economic substance analysis. Under this provision, the economic substance doctrine would be satisfied only if (1) the transaction changes in a meaningful way the taxpayer's economic position, and (2) the taxpayer has a substantial non-federal tax purpose for entering into the transaction. There would be a 20% penalty on understatements attributable to a transaction lacking economic substance which would be increased to 40% for a transaction in which the relevant facts are not adequately disclosed, presumably indicating that any transaction in which economic substance may be lacking should be disclosed.

Even in the absence of codification of the economic substance test, the IRS has been successful litigating tax-shelter cases based upon the economic substance doctrine.⁶

⁶The first successful litigation of a tax shelter case was Long Term Capital Holdings, Et A., 94 AFTR 2d 2004-5666. 08/27/2994 in which the court found cross-border leasing transactions followed by stock and partnership interest transfers between an offshore intermediary and US taxpayers were shams structured to generate inflated basis and significant tax losses with no economic substance or reasonable non tax-based profit expectation. After unfavorable decisions in the lower courts, the IRS won on appeal an economic substance transaction in Coltec Industries, Inc., US-CT-APP-FC, [2006-2 USTC ¶50,389], vacating and remanding FedCl, 2004-2 USTC ¶50,402 and a contingent liability transaction in Castle Harbour (TIFD III-E, Inc)U.S. Court of Appeals, 2nd Circuit; 05-0064-cv, August 3, 2006, 459 F3d 220). The IRS lost a contingent liability transaction in Black & Decker, US-DIST-CT, [2004-2 USTC ¶50,390], U.S. District Court, Dist. Md, in which the taxpayer argued successfully that the transaction was not a sham and had a real business purpose. The new built-in duplicate loss basis rules included in the American Job Creation

Most recently, the US Court of Federal Claims ruled in Jade Trading LLC that a “Son of Boss” transaction was an abusive effort to avoid paying taxes.⁷

In order to operationalize the somewhat abstract concepts enumerated in Table 2 a checklist (Table 3) may be helpful when determining whether a proposed transaction is likely a reportable transaction. Completing a checklist for each proposed transaction will ensure that the responsible party for signing the tax return is in compliance with the disclosure requirements. Should any question on the checklist be answered YES, then Form 8886 (figure 1) must be attached to the tax return and a copy must be sent to the IRS Office of Tax Shelter Analysis.

[Insert Table 3 here]

Question 6 on the checklist asks if the transaction is a listed transaction that has been identified as such. In answering this question the responsible party should refer to the list of Abusive Shelters and Transactions of Interest from Table 1. A thorough understanding of these listed transactions (each transaction is summarized in the Appendix) is necessary before the responsible party can answer Question 7, which requires a determination of whether a transaction that is not a listed transaction “is substantially similar to a listed transaction.”

Tax Accrual Workpaper Document Requests: Has the IRS Crossed the Line?

Announcement 2002-63 issued by the Office of Chief Counsel, states “the Service may request tax accrual workpapers in the course of examining any return filed on or after July 1, 2002 that claims any tax benefit arising out of a transaction that the Service

Act of 2004 amending §704(c) and §362(e)(1)(C) further limit any potential tax benefit from similar transactions.

⁷ Amir Efrati, “US Prevails in Tax-Shelter Battle,” The Wall Street Journal, December 27, 2007, p. A3.

has determined to be a listed transaction.” If the listed transaction was properly disclosed under Treasury Reg. Sec. 1.6011-4(b)(2), the Service will routinely request the tax accrual workpapers pertaining only to the listed transaction. If the listed transaction was not properly disclosed, the Service will routinely request all tax accrual workpapers. Also, the Public Accounting Oversight Board (PCAOB) has increased its scrutiny of tax shelter involvement. With its power of subpoena, the PCAOB can override the normal accountant-client privileges currently in place and require disclosure.

The Textron Case: One Court Says No to IRS Access

In *United States v. Textron* (C.A. No. 06-198T, 2007 WL 2458325), the United States District Court of Rhode Island was called upon to determine whether the tax accrual workpapers of a taxpayer were protected by the work product privilege. Textron, Inc., a publicly traded conglomerate with approximately 190 subsidiaries, had six tax attorneys and a number of CPAs in its tax department. Textron Financial Corporation (TFC), a subsidiary of Textron provided commercial lending and financial services and relies on the attorneys in its tax department, private law firms, and outside accounting firms for additional assistance and advice regarding tax matters. During the audit of Textron’s 2001 return, the IRS learned that TFC had engaged in nine “sale in, lease out” (SILO) transactions. However, it was not until four years after TFC entered into the SILO transactions that the IRS issued Notice 2005-13, 2005-19 I.R.B. 630, designating SILO transactions as “listed transactions” subject to the tax shelter disclosure requirements and its tax accrual workpaper initiative (Announcement 2002-63).

Despite Textron’s full compliance with 522 previous requests for information issued by the IRS, 101 of them dealing with the SILO transactions entered into by TFC,

and the fact that the IRS had been provided with all of the documents relating to the SILO transaction, the IRS issued an administrative summons for all of the tax accrual workpapers not only of TFC, the entity that entered into the SILO, but for Textron (the parent company) and all of its other subsidiaries (none of which entered into listed transactions). The IRS insisted that all of the tax accrual workpapers for Textron and its 190 subsidiaries be produced, including portions not related to the SILO transactions, rejecting an offer by Textron to produce only the tax accrual workpapers related to the SILO transactions.⁸

Textron objected to the production of its tax accrual workpapers on the basis that they were protected by the attorney-client privilege, the tax practitioner client privilege and the work product privilege. The tax accrual workpapers consisted of a spreadsheet containing (1) a list of items on Textron's return which in the opinion of Textron's attorneys involve issues of tax law that are unclear, (2) estimates by Textron's attorneys in percentage terms of the chance of Textron prevailing in any litigation over those issues, and (3) the dollar amount reserved to reflect the possibility that Textron might not prevail in such tax litigation with the IRS. In addition, the tax accrual workpapers included the previous year's spreadsheet and earlier drafts of the spreadsheets together with notes and memoranda written by Textron's in-house tax attorneys reflecting their opinions as to the items that should be included on the spreadsheet and the hazard of litigation percentages. From the description of the tax accrual workpapers Textron's attorneys played a central role in their preparation.⁹

⁸ Brief in Support of Petition to Enforce Summons, p. 12, filed in *United States v. Textron*, Docket No. CA 06-198T, United States District Court, District of Rhode Island

⁹ *United States v. Textron*, C.A. No. 06-198T, 2007 WL 2458325, page 2 (D. R.I. 2007)

The IRS asserted Textron's tax accrual workpapers were not protected by the work product doctrine because they were prepared in the ordinary course of business to comply with federal securities laws requiring publicly traded companies to prepare financial statements in compliance with GAAP which requires the creation of reserves to meet contingent liabilities such as taxes. Textron argued the tax accrual workpapers were prepared based on its anticipation of litigation with the IRS regarding various items on its return and thus were protected by the work product doctrine.

A federal district court applies one of two tests in determining whether a document has been prepared by or for an attorney "in anticipation of litigation," and the district court must apply the test adopted by the U.S. Court of Appeal in which it resides. The tests are referred to as the "because of" test and the "primary purpose" test. The "because of test" merely requires that the document in question be prepared due to the anticipated litigation whereas under the "primary purpose" test the primary motivation for the creation of the document must be in anticipation of litigation. The "because of" test is broader and more inclusive than the "primary purpose" test.

The federal district court that heard the Textron case is within the First U.S. Circuit Court of Appeal and applied the "because of" test adopted in that circuit. The Court in Textron held the "... estimated hazards of litigation percentages and the (Textron's) calculation of tax reserve amounts would not have been prepared at all 'but for' the fact that Textron anticipated the possibility of litigation with the IRS."¹⁰ The Court in Textron noted one reason for the work product doctrine is to prevent an opponent from freeloading on the research and work of its opponent's lawyer. The Court observed that, like other large corporations, Textron's federal tax returns are

¹⁰ United States v. Textron, C.A. No. 06-198T, 2007 WL 2458325, at page 8 (D. R.I. 2007)

audited periodically at which time the IRS examines the returns that are part of the audit cycle. In seven of the past eight audit cycles between 1980 and 2001, Textron appealed disputed matters raised on audit with three of these disputes resulting in litigation.¹¹ Given a history of litigation, it is certainly arguable the legal analysis and opinions contained in the tax accrual workpapers met the more stringent “primary purpose” test especially if it can be established that the legal analysis in the tax accrual workpapers would be used (or have been used in the past) by Textron’s counsel to prepare for trial with the IRS in the event of litigation arising out of the audit or negotiations.¹² While Textron, “won” in this case because of the work-product doctrine, preparation of tax accrual workpapers not in anticipation of litigation would not be protected from subpoena by the IRS. Additionally, the Textron tax accrual workpapers were not protected by either the attorney-client privilege or the tax practitioner client privilege since they had been disclosed to the outside auditors resulting in a waiver of confidentiality and the respective privilege.¹³

IRS Response to Textron Decision

Chief Counsel Donald Korb indicated the IRS is “not going to change anything as a result of this decision.”¹⁴ On August 28, 2007, the IRS filed a notice of appeal (*United States v. Textron, Inc.*, No. 06-198 (D.R.I. Aug. 28, 2007)), but an IRS spokesperson indicated the notice was intended as a placeholder protecting the government’s right to

¹¹ *United States v. Textron, C.A. No. 06-198T*, 2007 WL 2458325, at page 1 (D. R.I. 2007)

¹² *United States v. ElPaso*, 682 F.2d at 543

¹³ Textron predates FASB Interpretation No. 48 which now requires additional disclosure of uncertain tax positions. Under FIN 48, a company’s determination of its income tax provision may not take audit risk into account. “It shall be presumed that the tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information” (FIN 48, ¶ 7a). FIN 48 may undermine the Textron determination that tax accrual workpapers would not be prepared but for the possibility of litigation (Kimmelfield and Hsu, “Textron, the Work Product Doctrine, and the Impact of FIN 48, Tax Notes, November 26, 2007, p. 872.)

¹⁴ BNA Daily Tax Report, Aug. 31, 2007, p. K-1.

appeal.¹⁵ It is the intent of the IRS to continue its policy of requesting the tax accrual workpapers when a taxpayer has engaged in more than one listed transaction, first with an Information Document Request (IDR), then with a summons if the workpapers are not forthcoming. If the taxpayer fails to honor the summons, the IRS can go to court for enforcement of the summons.¹⁶

To clarify its position on when and how tax accrual workpapers will be requested during an Exam, the IRS created a Tax Accrual FAQ Website (www.irs.gov) on April 24, 2007, which has sixteen Q & A's. It is interesting to note that an exam team must seek permission from the Director, Field Operations, to NOT seek the tax accrual workpapers when the taxpayer has more than one listed transaction or the exam team has a reasonable belief the taxpayer engaged in a listed transaction or a transaction substantially similar to a listed transaction. The taxpayer may not assert that disclosure of listed transaction was only a "protective" disclosure and as such should be ignored (Q&A2). Furthermore, multiple listed transactions can result from similar transactions that occurred on different dates, or on the same date but with different parties (Q&A5). Entering into a closing agreement on the issue underlying the listed transaction will not limit the ability of the exam team to request the tax accrual workpapers (Q&A7). The IRS also exerts its right to request tax-accrual workpapers for tax years not under examination if they would be relevant to the open year, or if the questionable item was reported on a claim for refund or an amended return, or if there were "reported financial irregularities," such as a restatement of earnings resulting from what may be earnings manipulation (Q&A12).

¹⁵ BNA Daily Tax Report, Sept. 24, 2007, p. K-1.

¹⁶ Another tax accrual summons case is going to trial in the Northern District of Alabama, *Regions Financial Corp. v. United States*, Dkt. No. 2:06-CV-0895-RDP. On May 9, 2006, the taxpayer filed a petition to quash the summons for three years' worth of tax accrual workpapers and supporting documents. Regions engaged in at least one SILO transaction.

However, the Service also cautions its examiners to NOT use a request for the tax accrual workpapers as an inducement to encourage the taxpayer to settle disputed issues or as any other type of bargaining tool (Q&A15).

Small Business and Work Opportunity Tax Act of 2007: Beware Tax Preparers

The Small Business and Work Opportunity Tax Act of 2007 (“SBWOT”) increased the preparer penalties under IRC §6694 when a tax advisor signs a tax return that includes an “unreasonable position.”¹⁷ The SBWOT creates something of an anomaly in that the standards for taking an aggressive position on a tax return are higher for the tax preparer than for the taxpayer.¹⁸ Additionally, the IRC §6694 preparer penalty sets a higher disclosure standard for tax professionals than currently is the case in the various applicable professional codes of conduct and ethics, such as the AICPA Statements on Standards for Tax Services. Failure to comply with the law could result in being barred from practice before the IRS. The Act increases the potential for imposition of penalties on a tax professional in three ways.

- The penalties apply to a larger group of tax professionals.
- The standards of conduct that apply to tax professionals have been raised.
- The dollar amounts of the penalties have increased.

These provisions will likely reduce the aggressiveness of the tax professional when advising the taxpayer to take return positions that may challenge the boundaries of existing tax law.¹⁹ The most significant conduct penalty for tax return preparers now includes higher standards which must be met for nondisclosed positions taken on returns.

¹⁷ Presumably, an “unreasonable position” would include a listed transaction that has not been disclosed.

¹⁸ To avoid the substantial understatement of tax penalty the taxpayer need only meet the “substantial authority” standard which is less stringent than the §6694 “more likely than not” requirement but more stringent than the “reasonable basis” standard. The taxpayer’s position need only be stronger than one that is arguable but fairly unlikely to prevail in court (Reg. §1.6662-3) while the tax return preparer must have a >50% likelihood the position will be upheld.

¹⁹ Proposed legislation, H.R. 4318, would return to the “substantial authority” requirement for non-tax shelter positions when imposing a tax preparer penalty.

The penalty applies where the tax liability is understated due to the taking of an “unreasonable position,” one that is either:²⁰

- not disclosed on the return (Forms 8275 or 8275-R), and for which there was not a reasonable belief that the position was “more likely than not (MLTN)” (a greater-than-fifty-percent likelihood) to be sustained by its merits upon review, a strengthening of the prior “realistic possibility” one-in-three likelihood standard; or,
- disclosed on the return, and for which there was not a “reasonable basis,” one-in-four likelihood for the position, a strengthening of the prior “non-frivolous” probably a one-in-twenty standard.

On December 31, 2007 the IRS issued Notice 2008-13 (I.R.B. 2008-3), clarifying the signing preparers disclosure requirements. The disclosure requirements can be met by *advising* the taxpayer of the differences between the taxpayer’s substantial authority requirement (§6662(d)(2)(B)(i)) and the preparer’s more likely than not requirement (§6694) and *contemporaneously documenting* in the taxpayer’s file the advice was provided. This relaxation of the need to actually file the disclosure form applies only to a tax position for which there is a reasonable basis, but not a more likely than not level of confidence. Thus, the preparer may meet the disclosure requirement by simply informing the taxpayer of how to avoid the penalties for nondisclosure and contemporaneously documenting the file the date the advice was given.

The penalty is waived if the tax professional acted in good faith and had reasonable cause for taking the unreasonable position.²¹ If the preparer’s office practices include systems that promote accurate and consistent reporting, the good-faith standard probably is met.²² The likely result is that more aggressive return positions will be disclosed by the taxpayer and/or fewer aggressive return positions will be taken. The

²⁰ §6694(a)(2).

²¹ §6694(a)(3).

²² Reg. §1.6694-2(d)(4).

amount of the penalty is not tied to the amount of the understatement or the tax but is the greater of:²³

- \$1,000; or,
- One-half of the income of the tax return preparer that is attributable to the return or claim that violated the conduct standard.

Example: A corporate tax return included a deduction that had a 40 percent chance of being sustained on its merits because it was a listed transaction that was not disclosed. The paid tax return preparer may be assessed a §6694 penalty, equal to the greater of \$1,000 or one-half of the fees for preparing the tax return.

If it can be shown that the preparer's conduct was willful, or that it entailed a reckless disregard of tax rules or regulations, such as advising the taxpayer in the above example to not file a disclosure form, the penalty is the greater of:²⁴

- \$5,000; or,
- One-half of the income of the tax return preparer that is attributable to the return or claim that violated the conduct standard.

The MLTN standard matches that required for recognizing a tax return benefit under FIN 48 rules for generally accepted accounting principles but is higher than the one-in-three substantial-authority standard applicable to taxpayers.²⁵ As a result of this legislation, tax return preparers must be more diligent than ever to prevent signing a tax return that includes an undisclosed listed transaction or a transaction substantially similar to a listed transaction.

Conclusion

The Department of the Treasury with legislative support from the Congress is waging an all out war against abusive tax shelters.²⁶ As part of the tax compliance

²³ §6694(a)(1).

²⁴ §6694(b).

²⁵ §6662(d).

²⁶ Professional organizations, such as the AICPA, are also concerned about the proliferation of tax shelters. "The AICPA has a clear position on abusive transactions - they should be eradicated. Tax shelters insult the

process, tax advisers and their clients may find a checklist useful to verify compliance with the disclosure regulations contained in Treas. Regs. §1.6011-4. The IRS website contains the current listed abusive shelters and transactions and transactions of interest with hypertext links to their source documents.

Tax shelter disclosure regulations are an increasing area of concern for businesses, investors, regulators, tax return preparers and material advisors. Tax professionals must work closely with the audit staff of their corporate clients to implement the necessary internal controls to comply with the Treasury Regulations as well as SOA. By completing a checklist for each potential reportable transaction, the person responsible for signing the corporate tax return will be able to distinguish between a reportable transaction and an everyday business transaction not subject to the disclosure requirements. Paid tax return preparers and material advisors risk imposition of significant penalties, including sanctions under Circular 230, when a client takes a tax position that does not meet the MLTN standard and is not separately and adequately disclosed on the tax return.

large majority of honest taxpayers and their CPA advisors, who strive every day to obey the increasingly complex tax laws.” (<http://www.aicpa.org/members/div/tax/index.htm>)

Table 1

Listed Abusive Tax Shelters and Transactions of Interest, November 1, 2007.
<http://www.irs.ustreas.gov/businesses/corporations/article/0,,id=120633,00.html>

1. [Revenue Ruling 90-105](#) – Certain Accelerated Deductions for Contributions to a Qualified Cash or Deferred Arrangement or Matching Contributions to a Defined Contribution Plan
 - a. [Lead Executive Memorandum](#) -- Advises that settlements will not be offered on these issues
 - b. [Revenue Ruling 2002-46](#)– §401k Accelerators
 - c. [Revenue Ruling 2002-73](#) - modifies RR 2002-46 for taxpayers electing to change method of accounting.
2. [Notice 95-34](#) – Certain Trusts Purported to be Multiple Employer Welfare Funds Exempted from the Lists of §§ 419 and 419A. See also Reg. 1.419A(f)(6)-1.
3. [ASA Investing Partnership v. Commissioner](#) -Transactions similar to that described in the ASA Investing litigation and in [ACM Partnership v. Commissioner](#), 157 F.3d 231 (3rd Cir. 1998)
4. [Treasury Regulation § 1.643\(a\)-8](#) – Certain Distributions from Charitable Remainder Trusts
5. [Notice 99-59](#) – BOSS Transactions. See also Reg. 1.301-1(g).
6. [Treasury Regulation § 1.7701\(T\)-3](#) – Fast Pay or Step-Down Preferred Transactions
7. [Revenue Ruling 2000-12](#) – Debt Straddles
8. [Notice 2000-44](#) – Inflated Partnership Basis Transactions (Son of Boss)
 - a. Son of Boss Settlement Initiative
 - b. [IRS News Release Announcing Settlement Initiative](#)
 - c. [IRS Fact Sheet, Son of Boss Settlement Initiative](#)
 - d. [Announcement 2004-46, Son of Boss Settlement Initiative](#)
 - e. [FAQs](#) (updated 5-28-04 with eligibility information)
 - f. [Notice of Election to Participate in Settlement Initiative](#)
 - g. [Initial RA Letter to Taxpayer](#)
 - h. [Rejection Letter](#)
 - i. [Temporary Income Tax Regulation §1.752-6T](#)
 - j. [Proposed Income Tax Regulations § 1.752-1\(a\) and § 1-752-7](#)
 - k. [CCN 2003-20](#) - Chief Counsel Guidance
9. [Notice 2000-60](#) – Stock Compensation Transactions
10. [Notice 2000-61](#) – Guam Trust
11. [Notice 2001-16](#) – Intermediary Transactions
 - a. [Coordinated Issue Paper - Intermediary Transactions](#)
12. [Notice 2001-17](#) - §351 Contingent Liability.
13. [Notice 2001- 45](#) – §302 Basis-Shifting Transactions
14. [Notice 2002-21](#) – Inflated Basis "CARDS" Transactions
15. [Notice 2002-35](#) – Notional Principal Contracts
16. [Notice 2002-50](#)– Partnership Straddle Tax Shelter
 - a. [Notice 2003-54](#) - Common Trust Fund Straddle Tax Shelter
 - b. [Notice 2002-65](#)– Pass-through Entity Straddle Tax Shelter
17. [Revenue Ruling 2002-69](#) – Lease In / Lease Out or LILO Transactions
 - a. [Revenue Ruling 99-14](#) – Lease-In / Lease-Out or LILO Transactions
 - b. [Coordinated Issue Paper - Losses Claimed and Income to be Reported from Lease In / Lease Out transactions](#)
18. [Revenue Ruling 2003-6](#) - Abuses Associated with S Corp ESOPs
19. [Notice 2003-22](#) - Offshore Deferred Compensation Arrangements
20. [Notice 2003-24](#) - Certain Trust Arrangements Seeking to Qualify for Exception for Collectively Bargained Welfare Benefit Funds under § 419A(f)(5)
21. [Notice 2003-47](#) - Transfers of Compensatory Stock Options to Related Persons
22. [Notice 2003-55](#) - Accounting for Lease Strips and Other Stripping Transactions

- a. [Notice 95-53](#) – Lease Strips - Modified and superseded.
- 23. [Notice 2003-77](#) - Improper use of contested liability trusts to attempt to accelerate deductions for contested liabilities under IRC 461(f). See also Reg. 1.461-2.
 - a. [Lead Executive Memorandum](#) -- Advises that settlements will not be offered on these issues
 - b. [Department of Treasury News Release](#)
 - c. [TD 9095](#)
 - d. [Regulation 136890-02](#)
 - e. [Revenue Procedure 2004-31](#) - Change of accounting methods for improper contested liability trust transactions described in Notice 2003-77.
 - f. [Treasury News Release](#) - Announcing Revenue Procedure 2004-31
- 24. [Notice 2003-81](#) – Tax Avoidance Using Offsetting Foreign Currency Option Contracts.
- 25. [Notice 2004-8](#) - Abusive Roth IRA Transactions
 - a. [Treasury Department News Release](#)
- 26. [Revenue Ruling 2004-04](#), Situation 2—Prohibited Allocations of Securities in an S Corporation.
 - a. [Treasury Department Press Release](#)
- 27. [Revenue Ruling 2004-20, Situation 2](#)—Abusive Transactions Involving Insurance Policies in IRC 412(i) Retirement Plans. See also Reg. 1.79-1(d)(3), Reg. 1.83-3(e) and Reg. 1.402(a)(1) and (2).
 - a. [Revenue Ruling 2004-21](#)
 - b. [Proposed Regulation 126967-03](#)
 - c. [Revenue Procedure 2004-16](#)
 - d. [News Release IR-2004-21](#)
- 28. [Notice 2004-20 -- Abusive Foreign Tax Credit Transactions](#)
 - a. [Treasury Department Press Release](#)
 - b. [Notice 2004-19](#) -- Withdraws transactions described in Part II of [Notice 98-5](#) and describes strategy to address abusive FTC transactions
- 29. [Notice 2004-30](#) -- S Corporation Tax Shelter Involving Shifting Income to Tax Exempt Organization
 - a. [IRS Press Release 2004-44](#)
- 30. [Notice 2004-31](#) -- Intercompany Financing Through Partnerships [Treasury Press Release 4/1/04](#),
- 31. [Notice 2005-13, Sale-In Lease-Out transactions](#) [Treasury Press Release Coordinated Issue Paper](#) - Losses Claimed and Income to be Reported from Sale In/Lease Out (SILO)
- 32. [Notice 2007-57](#) - **Loss Importation Transaction** (IRB 2007-29)

Transactions of Interest

<http://www.irs.gov/newsroom/article/0,,id=173075,00.html>

- 1. [Notice 2007-73](#), Transaction of Interest – Toggling Grantor Trust.
- 2. [Notice 2007-72](#), Transaction of Interest – Contribution of Successor Member Interest.

Table 2	
Abusive Tax Shelters and Transactions	
Characteristics of A Tax Shelter	
1	Lacks economic substance: Through hedges, circular cash flows, defeasements and similar devices, the participant in a shelter is insulated from virtually all economic risk.
2	Inconsistent financial and tax accounting treatment: The presence of a large book-tax difference or engaging in a transaction that reduces both book and taxable income and the corporation's tax liability but does not affect the effective tax rate.
3	Presence of Tax-indifferent parties: Tax-indifferent parties are accommodation parties who are paid a fee or an above-market return on investment for the service of absorbing taxable income or otherwise permitting their tax-advantaged status to be used by the taxpayer. Tax-indifferent parties include tax-exempt organizations, such as charities and pension plans, foreign persons, Native American tribal organizations, and domestic corporations with unused net operating losses or tax credit carryforwards.
4	Complexity: Complex transactions using sophisticated or innovative financial instruments that exploit tax law inconsistencies.
5	Unnecessary steps or novel instruments: Steps that are unnecessary to achieve the corporation's purported business purpose, or involve property or transactions that the corporate participant has either little or no experience with or which lack a bona fide business purpose.
6	Promotion or marketing: A tax shelter designed to be replicated multiple times for use by different taxpayers rather than addressing the tax planning needs of a single taxpayer.
7	Confidentiality: Promoters of a tax shelter who require a nondisclosure agreement to protect their "proprietary" advice.
8	High transaction costs: Transaction costs for fees paid to the promoter, the tax-indifferent party, for legal services and financial instruments, tax opinions, and other expenses incurred in connection with the shelter activity.
9	Risk reduction agreement: Corporate tax shelters involving contingent or refundable fees in which the promoter receives a percentage of any tax savings realized by the corporate participant.
Judicial Responses to Abusive Tax Shelters	
1	Economic substance doctrine: The economic substance doctrine denies tax benefits if the economic substance of a transaction is insignificant relative to the tax benefits obtained. The test has 3 components: 1) the benefits arise from a set of discrete tax-motivated transactions, 2) these transactions do not meaningfully alter the taxpayer's net economic position, 3) the tax benefits are unreasonable and unwarranted in light of the objective rules which give rise to them.
2	Business Purpose Doctrine: Requires the taxpayer to have a reason, other than the avoidance of federal taxes, for undertaking a transaction.
3	Step transaction doctrine: Separate steps may be treated as one transaction for tax purposes, if integration of the steps more accurately reflects the underlying substance of the transaction. The three tests used to apply the step transaction doctrine are: 1) the binding commitment test, 2) the end result test, and 3) the mutual interdependence test.
4	Substance over form doctrine: The substance of a transaction should not produce tax results that are inconsistent with its form.
Source: Department of the Treasury, July 1999, "The Problem of Corporate Tax Shelters. Discussion, Analysis and Legislative Proposals."	

Table 3		
Abusive Tax Shelters and Transactions Check List		
Treas. Reg. 1.6011-4(b)		
If one or more of the following questions are answered YES, the transaction is a reportable transaction and Form 8886 must be attached to the tax return.		CIRCLE ONE
1	Is the transaction offered to the taxpayer under a condition of confidentiality?	YES NO
2	Is the transaction offered to the taxpayer with the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained?	YES NO
3	Does the transaction generate a Sec. 165 loss of (Rev. Proc. 2003-24):	
	a. If taxpayer is a corporation, a loss of at least \$10,000 in any single year of \$20,000 in any two or more years?	YES NO
	b. If the taxpayer is an individual, an S corporation, or a trust, a loss of at least \$2,000,000 in any single year, or \$4,000,000 in any two or more years?	YES NO
	c. If the taxpayer is an individual or a trust, a loss of \$50,000 in any single year if the loss arises with respect to a foreign currency transaction?	YES NO
4	Does the transaction involve an asset with a holding period of 45 days or less and result in a tax credit (including a foreign tax credit) exceeding \$250,000?	YES NO
5	Is the transaction a "patented transaction" for which the taxpayer has paid a fee (directly or indirectly) in any amount to a patent holder or the patent holder's agent for the legal right to use a tax planning method the taxpayer knows or has reason to know is the subject of a patent?	YES NO
6	Is the transaction a listed transaction the IRS has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance? (http://www.irs.ustreas.gov/businesses/corporations/article/0,,id=120633.00.html)	YES NO
7	Is the transaction substantially similar to one of the listed transactions because: (Refer to description of listed transactions and transactions of interest in the appendix.)	
	a. the transaction lacks economic substance related to the purported tax benefits?	YES NO
	b. if the transaction is a financing transaction, the deductions exceed the economic return on the investment?	YES NO
	c. if the transaction generates a loss, deduction, or credit, the present value of the tax benefits for the deduction, loss, or credit exceed the present value of the income?	YES NO
	d. the transaction is dependent upon the participation of a tax-indifferent party, such as a foreign person, a tax-exempt organization, a Native American tribal organization, or another taxable person with expiring tax attributes such as loss or tax credit carryovers?	YES NO
	e. Subsequent to the filing of the tax return reflecting the transaction but before the end of the statute of limitations for that return, has the transaction become a Listed Transaction?	YES NO

Appendix

Summary of Listed Transactions and Transactions of Interest

1. Certain Accelerated Deductions for contributions to a qualified cash or deferred arrangement (CODA) or Matching Contributions to a Defined Contribution Plan. Rev. Rul. 90-105, Rev. Rul. 2002-46, Rul. 2002-73, and Lead Executive Memorandum, April 15, 2004.

The Board of Directors adopted a resolution prior to the end of the taxable year setting a minimum contribution of \$8.0x to a qualified Sec. 401(k) plan. Taxpayer deducted the \$8.0x contribution, which consisted of \$3.8x for elective deferrals and matching contributions attributable to compensation earned by plan participants before the end of taxpayer's taxable year, and \$4.2x attributable to compensation earned by plan participants after the end of taxpayer's taxable year.

The Service held that contributions attributable to compensation earned by plan participants after the end of the taxable year are not deductible notwithstanding the Board of Directors' resolution. Compensation cannot be deferred and contributed to a plan as elective deferrals and matching contributions cannot be made to a plan with respect to such elective deferrals, until the underlying compensation has actually been earned.

2. Certain Trusts Purported to be Multiple Employer Welfare Funds Exempted from the Lists of Sec. 419 and 419A. Notice 95-34, Reg. 1.419A(f)(6)-1.

In general, contributions to a welfare benefit fund are deductible when paid, but only if they qualify as ordinary and necessary business expenses and only to the extent allowable under Sec. 419 and 419A, which impose strict limits on the amount of tax-deductible prefunding permitted for contributions to a welfare benefit fund. Promoters have offered trust arrangements that they claim satisfy the requirements for a current deduction of contributions to a welfare benefit fund by businesses that have had no prior involvement with labor organizations or other aspects of the collective bargaining process. Typically, the arrangements are used to provide benefits to owner/employees that are more favorable than those provided to non-owner/employees.

These transactions lack the good faith bargaining required to satisfy the conditions for a welfare benefit trust and may be recast as either deferred compensation or constructive dividends to the employee/owners.

3. ASA Investing Partnership v. Commissioner - Transactions similar to that described in the ASA Investing litigation and in ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir. 1009) ASA Investing Partnership, 76 TCM 325, ACM Partnership, 73 TCM 2189.

A Contingent Installment Note Sale (CINS) was designed to allow US corporate taxpayers, through use of a tax-indifferent party, to have a high and overstated basis in a relatively liquid asset. When the US corporate taxpayer sells the asset, a tax loss is generated that can be used to shelter other income from tax. These transactions are designed to over allocate taxable income to a tax-indifferent participant in the transaction with a corresponding under allocation of taxable income to a US corporate taxpayer. In a CINS transaction, a US taxpayer, a tax-indifferent party and a promoter create a partnership. The partnership acquires privately offered notes and then exchanges the notes for cash and contingent notes in a transaction designed to qualify as a contingent installment sale. Because the contingent installment sale rules limit the amount of basis that can be allocated to the first year of the sale, the cash consideration received in the first year produces a large gain which is allocated to the tax-indifferent partner who is then redeemed out of the partnership, leaving only the US taxpayer and the promoter to benefit from the future losses.

The Court denied the tax benefits on economic substance grounds by recharacterizing the transactions in a manner that eliminated the intended tax benefits.

4. Certain Distributions from charitable remainder trusts, Reg. 1.643(a)-8.A

A charitable remainder trust shall be treated as having made a deemed sale in the year in which a distribution of an annuity or unitrust amount is made from a pro rata portion of the trust assets.

Donor contributes stock with a FMV of \$2,000,000 and an adjusted basis of \$400,000 to a charitable remainder unitrust. The unitrust is required to make a distribution of 50% of the net FMV of the trust assets over 2 years. In year 1 the trust receives dividend income of \$20,000. The trustee borrows \$990,000 using the stock as collateral and distributes \$1,010,000 to the beneficiary. Prior to enactment of Reg. 1.643(a)-8, the distribution is characterized as \$20,000 in dividend income, and \$990,000 as a return of corpus.

After enactment of the regulation, the entire loan has been recharacterized as a deemed sale and no part of the loan is treated as acquisition indebtedness. The trust is treated as having sold stock for \$990,000 and realizes a capital gain of \$792,000. Thus, \$792,000 of the \$990,000 distribution is characterized as a capital gain and only \$198,000 is a return of corpus.

5. Boss Transactions. Notice 99-59, Reg. 1.301-1(g)

P, a partnership, contributes cash to F, a foreign corporation in exchange for the common stock of F. X contributes securities to F in exchange for the preferred stock of F. F borrows cash from a bank using the securities as collateral. F then distributes the securities to P. After the distribution, the stock of F has a fair market value of \$0 since the cash on hand approximates the unpaid balance of the loan. P takes the position that the distribution of the securities is neither taxable nor a reduction in P's basis in its F stock since the securities distributed to P are encumbered by the bank loan. P then

disposes of its stock in F and claims a capital loss equals to its initial investment in F. When F repays the bank loan, the repayment is not treated as a distribution on its common stock.

A loss is allowable as a deduction for federal income tax purposes only if it is bona fide and reflects actual economic consequences. An artificial loss lacking economic substance is not allowable. The above arrangement does not produce an allowable loss because through a series of contrived steps, P is claiming a tax loss for a capital outlay that has in fact been recovered.

6. Fast pay or Step-Down Preferred stock transactions, Reg. 1.7701(i)-3.

Fast-pay stock transactions, also known as step-down preferred transactions, were intended to allow a US taxpayer to avoid tax on substantial amounts of economic income by using a conduit entity whose income tax treatment artificially allocated the income to a tax-indifferent party. The effect was purportedly to allow a US taxpayer to deduct both principal and interest. A US corporate taxpayer would form a closely held REIT with tax-exempt investors. The REIT would issue common stock to the US taxpayer and fast-pay stock to the tax-exempt investors. The stock had an above-market dividend rate for a number of years after which the dividend stepped down to a de minimis amount. The fast-pay stock would then be redeemed for a fraction of its issue price. For federal income tax purposes the dividends on the fast-pay stock were distributions of income effectively allowing the REIT to over allocate taxable income to the tax-exempt investors.

US Corporation forms a REIT by contributing \$1,000 for all of the common stock. A tax-exempt party contributes \$1,000 for fast-pay stock with a dividend rate of 14%. The \$2,000 is invested in a 10-year 7% balloon mortgage, providing for 10 annual interest payments of \$140 and a single \$2,000 principal payment at the end of the term. The fast-pay stock dividend equals the interest income earned by the REIT for the first 10 years declining to 1% in the 11th year. The REIT then redeems the fast-pay stock for its fair market value of \$100 (\$1,000 x 1%). The corporation makes a Sec. 332 liquidation election and receives cash of \$1,900 tax-free.

Under regulations issued in 1999, the fast-pay stock will be treated as if it were a security issued by the US Corporation instead of the REIT. This recharacterization will ensure that the corporation is taxed on its economic income from the transaction.

7. Debt Straddles. Rev. Rul. 2000-12.

X, a corporation, purchases two debt instruments. Note 1 has a 10-year term, a stated principal amount of \$1x and provides for quarterly interest payments of 5.9%. It provides that the interest rate will double to 11.8% based on a contingent event with a 50% probability of occurring on a specified date. If the reset event does not occur, the interest rate is reset at 0%. Note 2 has the same terms as Note 1 except that the consequences of the contingency are reversed. If the reset event occurs, the interest rate

is reset at 0%. If the reset event does not occur, the interest rate doubles to 11.8%. It is expected that one note will increase significantly in value and the other note will decrease in value by the same amount. The reset event does not occur on the specified date. Thus, the interest rate on Note 1 is reset at 0% and the interest rate on Note 2 doubles to 11.8%. X then sells Note 1 for its fair market value and claims a loss.

The courts have held that a loss is allowable as a deduction for federal income tax purposes only if it is bona fide and reflects actual economic consequences. An artificial loss lacking economic substance is not allowable. The ruling holds that when X sells Note 1 before its maturity date while retaining Note 2, X does not realize an actual economic loss because the purported loss on the sale of Note 1 is substantially offset by the unrealized gain in Note 2. Such an artificial loss is not allowable for federal income tax purposes.

8. Inflated Partnership Basis Transactions (Son of Boss). Notice 2000-44, which is a variation on Notice 99-59, IR 2004-64 May 5, 2004, IRS Fact Sheet, Son of Boss Settlement Initiative, Ann. 2004-46, FAQs May 28, 2004, Form 13585 Notice of Election to Participate in Announcement 2004-46 Settlement Initiative, TD 9062, Temp. Reg. 1.752-6T, REG-106736-00 Prop. Reg. 1.752-1(a) and 1.752-7.

T borrows \$3x under a loan agreement that provides for an inflated stated rate of interest and a stated principal amount of \$2x. T contributes the \$3x cash and the loan to P, a partnership. On disposition of his partnership interest, T claims a loss of \$1x arguing that his basis in the partnership interest is \$1x, the excess of the cash contributed of \$3x over the stated principal amount of \$2x.

The purported loss does not represent a bona fide loss reflecting actual economic consequences as required by Sec. 165.

9. Stock compensation Transactions. Notice 2000-60.

P is a domestic corporation and X is a third party that is not an includible corporation. P transfers cash to S in exchange common stock, which constitutes less than 80% of the voting power of S stock. X transfers cash to S in exchange for preferred stock. S uses the cash to purchase stock of P from P's shareholders. S periodically transfers a portion of its P shares to P's employees in satisfaction of P's employee stock compensation plan. These transfers are treated as capital contributions by S to P and as a result P does not reduce its basis in its S stock. P takes a Sec. 83(h) deduction equal to the amount the P employees include in income upon receipt of the P stock from S. S is liquidated once it has distributed all of its P stock and P claims a capital loss for its basis in its S stock.

The Notice asserts that P's loss is not deductible since the distributions of P's stock by S reduces P's basis in its stock under sec. 301(c)(2). Alternatively, the IRS may disregard the described steps when that transaction lacks a legitimate business purpose and is undertaken solely for tax avoidance purposes (Gregory v. Helvering).

10. Guam Trusts. Notice 2000-61.

Under sec. 935, individuals who are resident in Guam and individuals who are citizens of Guam are required to file an income tax return only in Guam and not in the US. Certain promoters claim that Sec. 935 also applies to a trust as part of a scheme in which the trust seeks to avoid any tax liability in either the US or Guam.

The Service has taken the position that nothing in the language of Section 935 indicates that a trust is to be considered an individual for purposes of sec. 935.

11. Intermediary Transactions. Notice 2001-16, Coordinated Issue Paper, UIL 9300.16-00 Dec. 19, 2002.

X desires to sell his stock in corporation T. Y wants to purchase the assets of T. M purchases the T stock from X. Y purchases the assets of T taking a basis in the T assets equal to their purchase price. M and T file a consolidated return and the gain on the sale of the T assets is offset by losses incurred by M. M then liquidates T and reports no gain since the cash from the sale of the T assets equals M's basis in its T stock.

The IRS will challenge the tax result of this transaction by arguing that: 1) M is an agent for X and that consequently for tax purposes T sold the assets while T is still owned by X., 2) M is an agent for Y and consequently for tax purposes Y has purchased the stock of T from X, or 3) the transaction is recharacterized to treat X as having sold the assets while T is still owned by X. Alternatively, the Service may determine that M cannot use its loss to offset T's gain on the sale of its assets.

12. Sec. 351 Contingent Liability. Notice 2001-17.

Situation 1. T transfers a high basis asset to X in exchange for the stock of X. X agrees to assume T's obligation for deferred employee benefits, which have not been deducted by T. T remains liable for payment of the benefits. The fair market value of the X stock received by T is minimal. T argues that under Sec. 357(c) its basis in the X stock is equal to its basis in the asset contributed to X without any offset for the obligation assumed by X. T then sells its stock in X and claims a tax loss.

Situation 2. Foreign parent has three US subsidiaries and three \$0 basis assets subject to a single \$100x liability. The foreign parent separately transfers to each subsidiary one asset subject to the same liability. Through an aggressive reading of Sec. 357(c), each subsidiary takes the position that it can step-up the basis of its asset by the full \$100x amount of the liability on the theory that each asset is transferred "subject to" the entire liability. The sale of the assets would then generate a \$100x tax loss.

13. Sec. 302 Basis-Shifting Transactions. Notice 2001-45.

Stock in C owned by T, a tax-indifferent entity, is redeemed. As a result of application of the Sec. 318 attribution rules, the redemption is deemed to be a dividend under Sec. 301 rather than a redemption under Sec. 302(a). T's basis in its remaining C stock is increased. T then sells the stock and claims a loss.

The Service intends to disallow the loss by arguing: 1) the redemption does not result in a dividend because viewing the transaction as a whole, the redemption results in a reduction of T's interest in the corporation, 2) the basis shift is not a "proper adjustment" as contemplated by Reg. 1.302-2(c), and 3) there is no attribution of stock ownership or basis shift because the steps taken to achieve those results are transitory and serve no purpose other than tax avoidance.

14. Inflated Basis "CARDS" Transactions. Notice 2002-21.

T, transferor, borrows money from L, lender, on a long-term basis. Interest is payable at regular intervals and principal is due at maturity. T uses the proceeds to purchase Assets, which serve as collateral for the loan. As each interest payment becomes due, the collateral is used to satisfy the interest payments. T transfers a portion of the assets to X in consideration for X's agreement to pay a portion of the loan and become jointly and severally liable to lender. The fair market value of the assets transferred to X equals the present value of the loan's principal payment at maturity. Thus, the fair market value of the conveyed assets is substantially less than the loan's stated principal amount. T agrees to make all interest payments on the loan and X agrees to pay the principal due at maturity. X disposes of the assets for their fair market value and claims a loss in an amount equal to the excess of the stated principal amount of the loan over the fair market value of the assets.

The Service will hold that X's basis in the assets is equal to the fair market value of the assets upon their acquisition. The losses purportedly resulting from the transaction are not allowable to the extent X derives a tax benefit that is attributable to a basis in excess of the fair market value of the assets.

15. Notional (imaginary) principal contracts (NPC), Notice 2002-35.

A NPC is used to claim current deductions for periodic payments made by a taxpayer (T) while disregarding the accrual of the right to receive offsetting future payments. T is required to make periodic payments at regular intervals of one year or less based on a fixed or floating rate index. In return T will receive a single payment at the end of the term that consists of a noncontingent and a contingent component. The noncontingent component is relatively large in comparison to the contingent component and may be based upon a fixed or floating interest rate. The contingent component may reflect changes in the value of a stock index or currency. T funds its obligation to make periodic payments by borrowing funds from a lender. T deducts the interest paid but does not recognize any income until the year the payment is received. T reports as capital gain any gain it realizes upon termination of the NPC.

The Service intends to hold that the nonperiodic payment must be accrued ratably over the term of the NPC. Alternatively the Service may disregard the combination of the loans and the periodic payments as circular cash flows or may apply the doctrine of substance-over-form.

16. Partnership Straddle Tax Shelter. Notice 2002-50, Notice 2002-65 and Notice 2003-54.

Facts: Corporation acquires a majority interest in an upper tier partnership (UTP) at fair market value. UTP acquires a majority interest in a lower tier partnership (LTP) at fair market value. LTP enters into straddles on foreign currencies and may acquire other assets. LTP terminates the gain leg of a foreign currency straddle. LTP allocates a pro rata share of the gain to UTP, which in turn allocates a pro rata share of the gain to corporation. This gain increases the basis of each partnership interest. Corporation sells its interest in UTP to Taxpayer at fair market value. This results in a loss to Corporation sufficient to offset the gain that was allocated to Corporation. Taxpayer purchases UTP's interest in LTP at fair market value. UTP realizes a loss on this sale, but the loss is disallowed under Sec. 707 because Taxpayer owns more than 50% of UTP. LTP engages in a transaction that is intended to increase Taxpayer's basis in the LTP interest. Taxpayer sells the interest in LTP at its fair market value and realizes gain. Taxpayer then claims that this gain is offset by the amount of the loss that was disallowed to UTP.

This transaction uses a straddle, a tiered partnership structure, a transitory partner, and the absence of a Sec. 754 election to allow Taxpayer to claim a permanent non-economic loss.

The Service may challenge the allowance of the loss deduction based on other statutory provisions and judicial doctrines, including the step transaction doctrine and the doctrine of economic substance, business purpose and substance over firm. Also, the Service may assert that where a loss is disallowed on the sale of a partnership interest, Sec. 267(d) must be applied under an aggregate approach rather than an entity approach. Because the gain realized by Taxpayer on the sale of its interest in LTP does not correspond to any increase in the value of the assets within LTP, the disallowed loss realized on the sale of LTP by UTP cannot be used to offset the gain under an aggregate approach.

17. Lease-in, Lease-out (LILO) transactions: Creating tax deferral through improper tax accounting and the use of tax-indifferent parties, Rev. Rul. 2002-69, which supersedes Rev. Rul. 99-14. Coordinated Issue Paper, October 17, 2003.

In the basic LILO transaction, a US corporation leases long-lived property, such as a building, from a tax-indifferent party and immediately subleases the property back to the same party. The US Corporation generates significant net deductions in the early years of the lease that reverse in later years. Although the US Corporation is taxed on the proper economic income over the entire term of the lease, there is a positive net present value of the tax savings. The tax benefit comes from the unusual payment structure in which the US taxpayer is obligated to prepay its rental obligations producing significant

tax benefits in the early years of the lease with little or no real business risk. In Rev. Rul. 2002-69, the Service disallowed the tax benefits claimed in connection with LIFO transactions by holding that the substance over form doctrine requires their recharacterization as financing arrangements and that LIFO transactions are to be disregarded for lack of economic substance.

18. Abuses Associated with S Corp. ESOPs. Rev. Rul. 2003-6.

An ESOP formed for the purpose of claiming eligibility for the delayed effective date of Sec. 409(p) is a tax avoidance transaction subject to the disclosure requirements of Sec. 6011 and is not eligible for the delayed effective date.

Sec. 409(p) is effective for plan years beginning after December 31, 2004. An ESOP is subject to a 50% excise tax when a disqualified person owns at least 50% of the shares in the S corporation. A disqualified person is one for whom the aggregate number of deemed-owned shares of such person and the members of such person's family is at least 20% of the number of deemed-owned shares of stock in the S corporation or the number of such deemed-owned shares is at least 10% of the number of deemed-owned shares of stock in the S corporation.

However, there is an exception for ESOPs established on or before March 14, 2001. To take advantage of this exception, a person in the business of providing advice establishes multiple S corporations with no substantial assets or business purpose. An ESOP is formed for each S corporation to hold substantially all the stock in the S corporation. Sometime after March 14, 2001, a taxpayer restructures his business so that the ESOP of one of these S corporations receives substantial income from taxpayer's business. After the restructuring, the S corporation is wholly or substantially owned by the ESOP and one or more individual shareholders in the S corporation are disqualified persons.

19. Offshore deferred compensation arrangements. Notice 2003-22.

Taxpayer, in individual, purports to terminate Taxpayer's existing employment relationship with a domestic Service Recipient Corporation (SRC) that is owned either directly or indirectly by the Taxpayer. Taxpayer then purports to enter into an employment relationship with a Foreign Leasing Corporation (FLC), which purports to lease the right to Taxpayer's services in the US to a Domestic Leasing Corporation (DLC), which then purports to lease Taxpayer's services to Service Recipient Corporation. After entering into the arrangement, Taxpayer continues to provide substantially the same services for SRC that Taxpayer provided before entering into the arrangement with the interposition of FLC and DLC having no significant effect on Taxpayer's performance of services. SRC makes payments to DLC for Taxpayer's services, which in turn makes payments to Taxpayer in an amount that is substantially less than the amount paid to DLC. After deducting a fee for its participation in the arrangement, DLC remits to FLC, the remainder of the amount paid to it. After deducting a fee, FLC credits the remainder to notional account maintained on behalf of Taxpayer. Taxpayer reports as income only the compensation actually paid by DLC,

while SRC takes the position that the entire amount paid to DLC is currently deductible. DLC takes the position that it has no net income from the transaction. FLC take the position that it is not subject to US taxes because it has no permanent establishment in the US.

Under the step transaction doctrine, the series of steps described above to not reflect the underlying economics of the arrangement and have been designed to circumvent longstanding legal principles to enable Taxpayer and SRC to avoid or evade income and employment taxes. Thus, the IRS will hold that Taxpayer continues to be an employee of SRC and that amounts paid to DLC are currently includible in Taxpayer's gross income as compensation for services rendered. Alternatively, the IRS may assert that such amounts are currently includible in Taxpayer's gross income under Sec. 83(a), the economic benefit doctrine, the cash equivalency doctrine, or the assignment of income doctrine.

20. Certain Trust Arrangements Seeking to Qualify for Exception for Collectively Bargained Welfare Benefit Funds under Sec. 419A(f)(5).

Sham labor negotiations took advantage of a special tax rule allowing deductions for contributions made to welfare benefit funds set up through good-faith bargaining by labor unions legitimately representing their member's interests. The owner of a company purported to bargain on behalf of employees, but the arrangement actually benefited the owner and provided little benefit to the other employees.

Sec. 419A imposes strict limits on the deduction for contributions to a retirement plan in excess of current costs. An exception to some of the limits is provided in Sec. 419A(f)(5) for contributions to a separate welfare benefit fund under a collective bargaining agreement. The exception is based in part on the premise that deductions will not be excessive because of arms' length negotiations between adversary parties inherent in the collective bargaining process.

If an employer bargains for benefits to be provided to employees, including the owners of that employer and the benefits to be provided to the owners are more favorable than those provided to other employees, the circumstances of that bargaining process strongly indicate a lack of good faith bargaining required to satisfy the exception in Sec. 419A(f)(5).

21. Transfer of compensatory stock options to related persons. Notice 2003-47.

An employee transfers a nonstatutory compensatory stock option to a related person who pays an amount purportedly equal to the option's value. The payment is often in the form of a long-term, unsecured and non-negotiable note with a balloon payment at the end of the term of the note. Promoters contend that this constitutes a sale of the option with the result that the employee will not recognize compensation income when the stock option is exercised. Furthermore, the promoters argue that the employee does not recognize compensation income for the purchase price until the note is paid.

The Service will challenge this transaction as not satisfying the arm's length transaction requirement. In addition, the Service will not respect this transaction where the related person is not bona fide, lacks substance, or lacks a business purpose.

22. Accounting for Lease Strips and Other Stripping Transactions. Notice 2003-55, superseding Notice 95-53.

Stripping transactions are multiple-party transactions designed to permit one party to realize rental or other income from property while another party claims the deductions related to that income, such as depreciation or rental expenses.

In exchange for consideration, a corporation sells, or otherwise assigns the right to receive future payments under a lease of tangible property to a tax-exempt entity. The amount realized from the assignment is treated as current income and is offset by available loss carryovers. In a Sec. 351 transaction, the corporation transfers the property subject to the lease to a corporation that uses the depreciation deductions to reduce its taxable income.

The Service held in Notice 2003-55 that the lease strip improperly separates income from its related deductions. It may recast the transactions to void the tax savings by applying the doctrines of: assignment-of-income, business purpose, substance-over-form, step transaction or sham transaction. In addition, it may challenge the assignment of future income as financings.

23. Improper use of contested liability trusts to attempt to accelerate deductions for contested liabilities. Notice 2003-77, Lead Executive Memorandum April 15, 2004, Department of the Treasury Release May 6, 2004, TD 9095, Reg-136890-02, Rev. Proc. 2004-31, Treasury News Release May 6, 2004.

Under Sec. 461(f), a taxpayer is allowed a deduction for a contested liability in a year prior to the resolution of the contest provided the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability and but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer determined in accordance with the application of the economic performance rules. Since the regulations did not define "money or other property," some taxpayers were transferring their own stock or the stock or note of a related party to a contested liability trust to satisfy the requirements of Sec. 461(f). The proposed and temporary regulations now provide that such a transfer does not satisfy either the requirements of Sec. 461(f) or the economic performance test.

24. Using foreign currency option/straddles to generate non-economic losses. Notice 2003-81.

A taxpayer pays premiums to purchase a call option and a put option on a foreign currency. The currency is one in which positions are traded through regulated futures

contracts. The purchased options are reasonably expected to move inversely in value to one another over a relevant range, thus ensuring that, as the value of the underlying foreign currency changes, the taxpayer will hold a loss position in one of the two sec. 1256 contracts. The taxpayer also receives premiums for writing a call option and a put option on a different foreign currency in which positions are not traded through regulated futures contracts. Thus, the written options are not foreign currency contracts. The written options are reasonably expected to move inversely in value to one another over a relevant range, as the value of the underlying foreign currency changes, the taxpayer will hold a gain position in one of the two non-section 1256 contracts.

This transaction is a tax avoidance transaction because the taxpayer claims a loss upon the assignment of a sec. 1256 contract to a charity but fails to report the recognition of gain when the taxpayer's obligation under an offsetting non-section 1256 contract terminates.

25. Abusive Roth IRA Transactions. Notice 2004-8.

Taxpayers are avoiding the limitations on contributions to Roth IRAs by having the Roth IRA own a corporation which acquires property, such as accounts receivable from the taxpayer's business for less than their fair market value. Since the taxpayer controls the business and is the beneficial owner of substantially all of the assets in the corporation owned by the Roth IRA, the taxpayer is in the position to shift value from the business to the Roth IRA.

In substance, the transaction shifts value from the business to the corporation owned by the Roth IRA. The service may require the business to recognize gain on the transfer under Sec. 311(b) and may require the taxpayer to report dividend income on the transfer. Alternatively, the IRS may apply Sec. 482 to clearly reflect income.

26. Prohibited Allocations of Securities in an S Corporation. Rev. Rul. 2004-4.

Ownership structure of an S corporation was designed to allow the taxpayer to take advantage of the tax-exempt status of an S corporation whose stock is owned by an ESOP. When a disqualified person benefits from the ESOP, the Sec. 4979A excise tax applies.

27. Abusive Transactions Involving Insurance Policies in Sec. 412(i) Retirement Plans. Rev. Rul. 2004-20, Rev. Rul. 2004-21, Prop. Reg. 126967-03, Rev. Proc. 2004-16, News Release IR-2004-21.

Rev. Rul. 2004-20: Sec. 412(i) describes certain insurance contract plans that are exempt under Sec. 412(h)(2) from these minimum-funding requirements. To qualify, a Sec. 412(i) plan must be funded by the purchase of individual or group insurance contracts. Under Reg. 1.412(i)-1(b)(2)(iii) the benefits for each participant provided under a Sec. 412(i) plan that holds individual insurance contracts must be equal to the benefits provided under the participant's individual contracts at the participant's normal retirement

age. Sec. 404(a)(1)(A)(i) provides that the amount necessary to satisfy the minimum funding requirement is deductible even if it is greater than the amount determined under Sec. 404(a)(1)(A)(ii) or (iii).

A qualified pension plan cannot be a Sec. 412(i) plan if the plan holds life insurance and annuity contracts for the benefit of a participant that provide for benefits at normal retirement age in excess of the participant's benefits at normal retirement age under the terms of the plan.

Employer contributions under a qualified defined benefit plan that are used to purchase life insurance coverage for a participant in excess of the participant's death benefit provided under the plan are not fully deductible when contributed but are deductible in future years when other contributions are less than the maximum deductible amount.

Rev. Rul. 2004-21. When a plan is funded in whole or in part with life insurance contracts and highly compensated employees are permitted prior to distribution of retirement benefits to purchase the life insurance contracts at their cash surrender value does not satisfy the requirements of Sec. 401(a)(4) prohibiting discrimination in favor of highly compensated employees.

Rev. Proc. 2004-16: The proposed regulations clarify that the amount includible in income upon the distribution of life insurance contracts is based upon their fair market value rather than their cash surrender value.

28. Abusive Foreign Tax Credit Transactions. Notice 2004-20. Treasury Department Press Release Feb. 17, 2004, Notice 2004-19, Notice 98-5 withdrawn.

Situation 1. US Corporation purchases rights to a copyright for \$75x. The copyright is expected to generate a royalty of \$100x, which is subject to a 30% withholding tax in country X. US Corporation expects to receive only \$70x and has a \$5x economic loss, but will be entitled to a \$30x foreign tax credit.

Situation 2. F, an entity that does not receive a tax benefit from foreign tax credits, acquires a foreign bond with a value of \$1,000 that provides for annual interest payments of \$100. The interest payments are subject to a 4.9% country X withholding tax. Instead of purchasing the bond, F invests its \$1,000 elsewhere and enters into a 3-year notional principal contract (NPC) with US, an unrelated domestic corporation. Under the terms of the NPC, US agrees to make an annual payment to F of \$95 and F agrees to make an annual payment to US equal to the product of \$1,000 and a rate calculated based on LIBOR. In addition, the parties agree that upon termination of the NPC, US will make a payment to F based on the appreciation, if any, in the value of the foreign bond, and F will make a payment to US based on the depreciation, if any, in the value of the foreign bond. In order to hedge its obligations under the NPC, US purchases the bond for \$1,000 and incurs an additional \$1,000 of borrowing at an interest rate equal to the LIBOR-based rate provided for in the NPC. US reasonably expects to incur an annual \$0.90 economic loss, which is the \$95.10 net interest payment on the bond plus the bond plus the LIBOR-

based amount received from F under the NPC, less the \$95 payment to F. US has effectively purchased foreign tax credits in a transaction that was reasonably expected to result in an economic loss. The Treasury intends to issue regulations, which will disallow foreign tax credits for taxes generated in abusive arrangements such as those described above. From which the reasonably expected economic profit is insubstantial compared to the value of the foreign tax credits expected to be obtained as a result of the arrangement.

Note: The regulations will overturn the Compaq Computer Corporation decision in the 5th US Court of Appeals on 12/28/2001 which reversed the decision in 113 TC 214. In the Compaq case, the company was entitled to foreign tax credits in connection with its purchase and resale of a foreign company's American Depository Receipts (ADRs). On Sept 17, 1992 the company purchased \$888 million ADRs cum dividend and on September 21 resold the ADRs ex dividend for approx \$868 million. Since Compaq was the shareholder of record on the ADRs dividend record date, it was entitled to a gross dividend of approx \$22 million, less approx \$3 million withheld in Netherlands tax. Compaq reported the capital loss, which offset part of a capital gain from an unrelated transaction. The court found that the transactions had economic substance and a business purpose other than to reduce taxes. The taxpayer realized an economic benefit equal to the gross dividend before the foreign taxes were paid. Because the company was the legal owner of the ADRs on the record date of the dividend, it was legally entitled to the benefits of ownership, including the right to receive dividends and a foreign tax credit for the taxes withheld at source. There was no indication that the ADR transaction was motivated solely by the tax consequences of the transaction.

29. S Corporation Tax Shelter Involving Shifting Income to Tax Exempt Organization. Notice 2004-30, IRS Press Release 2004-44.

In a typical transaction, an S corporation uses nonvoting stock and warrants to shift the bulk of an S corporation's income to a Sec. 501(c)(3) tax-exempt organization shareholder with the original shareholders avoiding paying income tax on most of the S corporation's income.

These transactions will be challenged under the substance over form doctrine. In addition, the IRS may argue that the issuance of warrants may violate the single class of stock requirement and terminate the corporation's status as an S corporation.

In an IRS Press Release IRS Commissioner Everson stated "participation of tax-exempt entities in these abusive transactions is a worrisome trend."

30. Intercompany Financing Through Partnerships, Notice 2004-31, Treasury Press Release 4/1/04.

A partnership between a domestic corporation and a foreign person is formed. The foreign person is the common foreign parent and the domestic corporation and a second domestic corporation are part of the affiliated group. The foreign corporation and the second domestic corporation contribute property to the partnership which in turn

contributes a substantial portion of the assets to the domestic corporation for preferred stock. Under the partnership agreement, the foreign person is entitled to a substantial guaranteed payment for the use of capital and the second domestic corporation is entitled to a disproportionately large share of the gross dividend from the domestic corporation (eligible for the 100% dividends received deduction) and the partnership's deduction for the guaranteed payment.

This transaction lacks the requisite non-tax business purpose to form a valid partnership and may be subject to the partnership anti-abuse regulations. In addition the IRS may argue that the allocations lack economic effect since under the partnership agreement the second domestic corporation is entitled to a disproportionately large share of both the gross dividend income and the deductions for the guaranteed payments.

Press Release: These transactions are structured to avoid rules limiting the deduction of interest on certain debt issued to related persons that are exempt from tax (foreign corporations).

31. SILO Transactions, Notice 2005-13, Notice 2007-57.

Taxpayer enters into a sale-leaseback arrangement with a tax-indifferent person in which substantially all of that person's payment obligations are economically defeased and the taxpayer's risk of loss from a decline and opportunity for profit from an increase in the value of the leased property are limited. The arrangement is designed to shift tax benefits from a tax indifferent party to a taxpaying entity that can use the benefits. The American Jobs Creation Act of 2004 now imposes limitations on the deductibility of losses for certain leases of property to tax-exempt entities entered into after March 12, 2004.

32. Loss Importation, Notice 2007-57.

A US taxpayer uses offsetting positions with respect to foreign currency for the purpose of importing a loss, but not gain in the computation of US taxable income. For example, an S corporation purchases a foreign entity from a foreign shareholder and the foreign entity enters into offsetting foreign currency positions, closing out the gain positions and retaining the loss positions which subsequently flow through to the US shareholder by making an election to treat the foreign entity as a disregarded entity.

Transactions of Interest

IR-2007-143, Aug. 14, 2007

"These are the first two transactions of interest we have published under the new regulatory scheme," said IRS Chief Counsel Don Korb. "Hopefully, the notices released today will give taxpayers and practitioners a better idea of the types of transactions that we will be identifying as transactions of interest in the future."

1. [Notice 2007-73](#), Transaction of Interest – Toggling Grantor Trust. “Toggling” grantor trust transactions are utilized by grantors of these trusts in an attempt to avoid recognizing gain or to claim a tax loss greater than any actual economic loss by purportedly terminating and then reestablishing the grantor status of the trust. These grantor trust transactions usually occur within a short period of time (typically within 30 days).
2. [Notice 2007-72](#), Transaction of Interest – Contribution of Successor Member Interest. Transactions involving contributions of a successor member interest are utilized by persons to claim charitable contributions that may be excessive. These transactions arise when a taxpayer acquires a successor member interest, directly or indirectly, in real property, transfers the interest to a tax-exempt organization, and claims a charitable contribution deduction that is significantly higher than the amount that the taxpayer paid for the interest.

Reportable Transaction Disclosure Statement

CMB No. 1545-1800

- ▶ Attach to your tax return.
- ▶ See separate instructions.

Attachment
Sequence No. 137

Name(s) shown on return

Identifying number

Number, street, and room or suite no.

City or town, state, and ZIP code

A Enter the form number of the tax return that this form is attached to
Enter the year of the tax return with which this form is filed

B Check the box(es) that apply (see instructions).

- Initial year filer
- Protective disclosure

1a Name of reportable transaction

1b Initial year participated in transaction

1c Material advisor or tax shelter registration number
(9 digits or 11 digits)

2 Identify the type of reportable transaction. Check all the box(es) that apply (see instructions).

- a** Listed transaction
- b** Confidential
- c** Contractual protection
- d** Loss
- e** Significant book-tax difference
- f** Brief asset holding period

3 If the transaction is a "listed transaction" or substantially similar to a listed transaction, identify the listed transaction (see instructions) ▶

4 Enter the number of transactions reported on this form

5 If you invested in the transaction through another entity, such as a partnership, an S corporation, or a foreign corporation, provide the information below for the entity.

- a** Name
- b** Type of entity
- c** Form number of tax return filed
- d** Employer identification number (EIN)

6 Enter below, the name and address of each person to whom you paid a fee with regard to the transaction if that person promoted, solicited, or recommended your participation in the transaction, or provided tax advice related to the transaction. (Attach additional sheet, if necessary.)

a Name

Number, street, and room or suite no.

City or town, state, and ZIP code

b Name

Number, street, and room or suite no.

City or town, state, and ZIP code

Material Advisor Disclosure Statement

OMB No. 1545-0055

▶ See separate instructions.

FOR IRS USE ONLY

Note: The reportable transaction number will be sent to the material advisor's address below.

Material Advisor's Name (see instructions)	Identifying number	Telephone number () -
--------------------------------------------	--------------------	---------------------------

Number, street, and room or suite no.

City or town, state, and ZIP code

A Contact person name (last name, first name, middle initial)	Title	Telephone number () -
---------------------------------------------------------------	-------	---------------------------

B Is this a protective disclosure? (see instructions) Yes No If "Yes," see line 6a instructions.

C Is this the original Form 8918 for this reportable transaction? Yes No

If "Yes," go to line 1. If "No," enter the reportable transaction number previously issued for this reportable transaction or tax shelter.

Reportable Transaction Number ▶

1 Name of reportable transaction (see instructions)

2 Identify the type of reportable transaction. Check all the box(es) that apply (see instructions).

- a Listed c Contractual protection e Transaction of interest
 b Confidential d Loss f Brief asset holding period

3 If you checked box 2a or 2e, enter the published guidance number for the listed transaction or transaction of interest ▶

4 Enter the date the Material Advisor became a material advisor with respect to the reportable transaction (see instructions) ▶

5 If you are a party to a designation agreement, identify the other parties (see instructions).

Name	Identifying number (if known)
------	-------------------------------

Address (Number, street, and room or suite no.)

City or town, state, and ZIP code

Contact name	Telephone number () -
--------------	---------------------------

6a Provide a brief description of the type of material aid, assistance, or advice you provided (see instructions).

b Describe the role of any other entity(ies) or individual(s) who you know or have reason to know provided material aid, assistance, or advice to this transaction and include each entity's and individual's complete name, identifying number (if known), and address.

7a To obtain the intended tax benefits generated by the transaction:

- Is a related entity(ies) or individual(s) needed? Yes No
 Is a foreign entity(ies) or individual(s) needed? Yes No
 Is a tax-exempt entity(ies) needed? Yes No

b If you answered "Yes" to any of the above questions, describe the role of each individual or entity. Also identify the individual's or entity's country of existence if a particular country is required to obtain the intended tax benefits.

8a To obtain the intended tax benefits generated by the transaction, is income or gain from the transaction allocated directly or indirectly to an individual(s) or entity(ies) that has a net operating loss and/or unused loss or credits? Yes No

b If "Yes," describe the role of each individual or entity in the transaction.

7 Facts. Describe the facts of the transaction that relate to the expected tax benefits, including your participation in the transaction. For listed transactions identified in item 2a, also provide the complete name, address, and nature of involvement of all parties to the transaction (see instructions).

8 Expected tax benefits. Describe the expected tax benefits, including deductions, exclusions from gross income, nonrecognition of gain, tax credits, adjustments (or the absence of adjustments) to the basis of property, etc. (see instructions for more details).

9 Estimated tax benefits. Provide a separate estimate of the amount of each of the expected tax benefits described above for each affected tax year (including prior and future years).

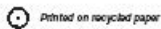


Figure 2