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IRS and States Continue to Crack Down on Tax Shelters

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One year ago, we wrote an article describing steps taken by the IRS, New York and California to crack down on abusive tax shelters and tax advisors engaged in their promotion. There have been a number of developments over the past few months which warrant a fresh look at the issue. Most notably, tax lawyers around the country have been in a tizzy of late, striving to comply with significant new federal disclosure and ethics rules targeting tax shelters. First, beginning April 30, 2005, and quarterly thereafter, attorneys (and other advisors) who are "material advisors" with respect to a "reportable transaction," and who have made after October 22, 2004 any "tax statement" with respect to such transactions, are required to file federal information returns disclosing the tax shelter activities of their clients.[1] The penalties for failing to do so are steep -- $50,000 to $200,000 or more -- and there is little room for forgiveness.

In addition, the Treasury Department has promulgated a series of new ethics rules for persons and firms that practice before the IRS (attorneys, certified public accountants, and enrolled agents) referred to generally as Circular 230.[2] Under these rules the Treasury Department may fine, censure or bar from practice before the IRS practitioners whose behavior (whether towards the IRS or towards their own clients), falls short of Treasury's new standards. Readers who are themselves not tax practitioners may nonetheless have noticed Treasury's new ethics regulations of late, as law firm word processing programs, email footers and other vessels for dispensing written advice are being modified to include the "legend" Treasury requires as an alternative to issuing a full-blown formal opinion, effective June 21, 2005 for certain types of written communications with clients.

The legend for communications that conclude at a confidence level of more likely than not that a significant federal tax issue would be resolved in the taxpayer's favor reads as follows: "This written advice was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer." Additional language must be added to the legend if the practitioner knows or has reason to know that the written advice will be used or referred to by a third party in promoting, marketing, or recommending a partnership or other entity, investment plan, or arrangement to one or more taxpayers. The format of the legend is tightly prescribed by Circular 230, mandating that the font be in a typeface that is the same size or larger than the typeface of any discussion of the facts and law in the written advice and in a separate section (not in a footnote) that is readily apparent to the reader of the written advice.[3]

The federal government is not alone in turning its enforcement eye to the role of tax practitioners. The problem of tax shelters has become so huge, the affected revenues so significant, and certain tax practitioners so complicit that state tax administrators also are beginning to impose new obligations on lawyers (and other advisors) who render tax advice. Some years ago South Carolina adopted legislation to follow the then extant Circular 230 rules;[4] that state has been particularly aggressive in publicizing its efforts to rein in errant advisors. California has in place legislation to disbar from state tax practice any practitioner who has met a similar federal fate.[5] And, just a few months ago New York joined the fray, enacting tax shelter legislation that, among other things, requires tax advisors to disclose their client's activities to the State.[6]

New York's tax shelter legislation includes a variety of other provisions, including tax shelter disclosure rules for taxpayers, list maintenance rules for certain advisors, record-keeping and retention rules, extended statutes of limitations, new penalties, and a six-month[7] voluntary compliance initiative targeted to tax avoidance transactions beginning before 2005. Of particular interest to lawyers, however, are the new "material advisor disclosure" rules; and in particular the "nexus" that is sufficient to subject a practitioner to New York's reporting obligations.

New York's advisor disclosure rules key off the federal rules: "Every person required to make and file a statement or return pursuant to [Code §6111] must file a duplicate of such statement or return, including all documentation submitted to the [IRS] in connection with such statement or return . . . ."[8] The New York filing is due within sixty days of (i) the federal filing or (ii) the advisor's satisfaction of the "nexus conditions" described below. The filing obligation will not be triggered any earlier than September 9, 2005, however, and further is limited to federal disclosures required on or after April 12, 2005 and before July 1, 2007.[9]

Material advisors who fail to satisfy their New York disclosure obligations are subject to penalties, which can range from $20,000 per failure to 75% of the gross income derived from New York attributable to the transaction.[10] These penalties are in addition to any federal penalty and some are applied automatically.

An obligation to copy a federal form and transmit it to New York State does not, at first blush, seem particularly onerous. Given the substantial federal penalties imposed under Code §6111,[11] tax practitioners are already highly motivated to get this compliance right. Moreover, while New York's new *taxpayer* disclosure rules authorize New York to "list" transactions, thus extending the reporting net beyond issues identified by the IRS, New York's material advisor rules confine themselves to federally disclosed transactions. There is, nonetheless, some reason for concern that, as these reporting regimes proliferate, tax lawyers will find themselves obligated to learn and comply with a variety of different state regimes, and risk penalties should their understanding of each state's rules prove wanting.

This is perhaps best illustrated by reviewing the "nexus" rules New York uses to identify those advisors who are obligated to file its Form DTF 664 (Tax Shelter Disclosure Rules For Material Advisors); and by imagining that some other state, say Illinois or Arizona, has enacted a parallel law with which we New York lawyers are obligated to comply, beginning September 9.

A material advisor must file in New York if he, she or it (i) is organized in New York; (ii) is doing business in New York; (iii) is deriving income in New York; or (iv) provides, in New York, "any material aid, assistance or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction," and maintains a list under Code §6112 which identifies *any* New York taxpayer.[12] While test (i) is simple, (ii), (iii) and (iv) can present numerous issues, and require advisors to review very carefully their activities, and those of their firm, to establish whether the nexus threshold has been crossed. If three paralegals spend a week reviewing boxes in a warehouse, is the firm "doing business" in New York?[13] If a partner bills for time spent in meetings in New York, has the firm "derived income" in New York? How is a law firm to know in which state its clients file tax returns? These are not easy questions to resolve in many cases. And while one's sympathies may lie with the administrators who are trying to stem the hemorrhage of state and local revenues brought on by sly tax avoidance, at the same time one must recognize the concerns that tax advisors may not be readily able to track their disclosure obligations, particularly if similar (but not identical) rules start to proliferate.

Once a practitioner falls within New York's "material advisor" nexus requirements, certain long-term recordkeeping requirements obtain. The advisor must "retain *all* ... records or documents related to the disclosure, filing and list maintenance requirements" mandated under the new legislation for a period of six years. [14] In addition, any practitioner required to maintain a list of persons under Code §6112, must maintain a duplicate of this list and provide a copy of the list to New York State within 20 days after written request is made for the list.

Over the next several months, practitioners will likely receive telephone calls from clients concerning the State's Voluntary Compliance Initiative ("VCI"), which begins in October. The VCI allows taxpayers to report and pay underreported tax liabilities and interest attributable to abusive tax avoidance transactions for tax years prior to 2005. The term "abusive tax avoidance transaction" includes, but is not limited to, "listed transactions."[15] A "listed transaction" includes any transaction designated as a tax avoidance transaction by the IRS or the Commissioner of Taxation and Finance. Currently, no transactions have been designated by the Commissioner as New York listed transactions. Any such designation of a specific transaction as a New York listed transaction is not subject to the rulemaking provisions of the State Administrative Procedures Act; however, it must be made through public guidance. Accordingly, practitioners now have a duty to periodically check New York's published tax guidance to determine if any transaction has become a New York "listed transaction".

A significant feature of the State's recent tax shelter legislation is the extension of the statute of limitations for assessment of tax from three years to six years from the filing date of a return that involves a deficiency attributable to an "abusive tax avoidance transaction".[16] Thus, if a client fails to participate in the VCI and has engaged in an abusive tax avoidance transaction, practitioners should advise the client that the State now has an additional three-year period of time to assess any tax attributable to the transaction. Further, if a client is eligible for VCI participation but fails to apply, then the State will add to the amount of tax due, a penalty equal to 100% of the interest payable. Practitioners should also be aware that a client must be willing to file amended tax returns for the years involved and pay in full the tax and interest due for each year attributable to the transaction.

Depending upon whether the taxpayer waives its right to appeal liability for any taxes paid under VCI, some or all of the potentially applicable negligence, substantial understatement of tax, and reportable transaction understatement penalties are waived. The State plans on issuing additional guidance regarding the VCI. Practitioners should stay tuned for this information.

For now, the message is that New York practitioners filing disclosure forms under Code §6111 must begin copying New York State on such filings, effective September 9. Over the longer term and wider horizon, however, the message is that the years of irresponsible tax shelter advising, which went largely unchecked by the professions themselves, have left all of us with yet another responsibility—and not likely the last.

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1 Internal Revenue Code §6111, as amended by American Jobs Creation Act of 2004. See also the regulations thereunder (Treas. Reg. §1.6011-4 et seq.). Reporting is generally done on federal form 8264.

2 31 U.S.C. §330; 31 CFR part 10.

3 With respect to certain transactions, legending a document will not be sufficient.

4 S.C. Code §12-60-90.

5 Cal. Franchise Tax Board's Proposed Amendments to Section 19523.5 of Cal. Rev. & Tax Code, MR 04-12, available at http://www.ftb.ca.gov/law/meetings/attachments/061004/2b.pdf.

6 Ch. 61 Laws of 2005, Part N. These provisions took effect April 12, 2005, and are scheduled to sunset on July 1, 2007.

7 The initiative will be operative from October 1, 2005 to March 1, 2006.

8 N.Y. Tax Law §25(b)(1).

9 The manner in which covered advisors are to submit their federal disclosures to New York state is by appending federal forms 8264 (Application For Registration of a Tax Shelter) to New York's new Form DTF-664 "Tax Shelter Disclosure for Material Advisors." New York's form identifies the "material advisor," appends a copy of the federal disclosure, and certifies that the return and attachments are true, correct and complete. See Also TSB-M-05(2)C, June 1, 2005, for further filing instructions.

10 Tax Law §§685, 1085.

11 $50,000 to $200,000 or more.

12 That is, a person subject to tax under Article 9, 9-A, 22, 32 or 33.

13 N.Y.S. Dep't of Tax'n & Fin., TSB-A-05(6)C (Mar. 10, 2005) (explaining that temporary employees in New York placed by a foreign corporation at a client's facilities is sufficient presence for the foreign corporation to be considered "doing business" in New York).

14 N.Y. Tax Law §25(d).

15 The term "tax avoidance transaction", is defined broadly as "a plan or arrangement devised for the principal purposes of avoiding tax." N.Y. Tax Law §25(h).

16 N.Y. Tax Law §683(c)(11).