

## Disclosures Required on 2002 Tax Returns

By: *Elliot Pisem*

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There has been much hoopla in the tax community recently regarding Treasury Regulations that were published in the *Federal Register* on October 22, 2002, relating to "tax shelter disclosure statements." These new Regulations apply to transactions entered into on or after January 1, 2003, and will thus affect primarily tax returns filed during the 2004 filing season. Less attention has been paid to the disclosure rules that will be in effect during the upcoming 2003 filing season, affecting transactions that occurred on or before December 31, 2002. Moreover, the rules applicable to 2002 returns may be difficult to find in commercial tax services and similar sources, as their publishers may already have updated their materials to delete the "old," superseded Regulations. The purpose of this letter is to summarize the rules that will apply during the upcoming filing season.

It is important to note that the term "tax shelter disclosure statements" is something of a misnomer. As will become clear in the discussion below, special disclosures may be required under the Regulations even in the case of transactions that do not fit within any ordinarily accepted definition of a "tax shelter."

1. *Effective Dates.* Over the past few years, several sets of Treasury Regulations dealing with tax shelter disclosure have been published. In this letter, we concern ourselves with the rules (the "June 2002 Regulations") that govern transactions entered into on or after January 1, 2001, but before January 1, 2003, that were not reported on a tax return of the taxpayer filed on or before June 14, 2002 (in other words, in the case of calendar year returns, the rules that applied to 2001 returns filed after June 14, 2002, and that will apply to 2002 returns).

2. *Required Disclosures -- Taxpayers Subject to the Rules.* The June 2002 Regulations distinguish between corporations required to file a return under Internal Revenue Code sections 11 (ordinary C corporations), 594 (mutual savings bank conducting a life insurance business), 801 (life insurance companies), and 831 (insurance companies other than life insurance companies), on the one hand, and individuals, trusts, partnerships, and S corporations, on the other hand. All of these taxpayers are required to disclose their participation in "listed transactions." However, only corporations filing returns under the enumerated sections of the Code are required to disclose other "reportable transactions" in which they may have engaged. It appears that certain limited categories of taxpayers, such as decedents' estates, regulated investment companies, and real estate investment trusts, are exempt from the disclosure requirements of the June 2002 Regulations.

3. *Listed Transactions.* A "listed transaction" is one that is "the same as or substantially similar to one of the types of transactions that the Internal Revenue Service (IRS) has determined to be a tax

avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction for purposes of section 6011," unless the transaction had affected the taxpayer's Federal tax liability as reported on any tax return filed on or before February 28, 2000. A comprehensive enumeration of all "listed transactions" identified by the IRS through December 31, 2002, is annexed to this letter. However, you should bear in mind that additional "listed transactions" may be identified by the IRS at any time, and that such identification may be made with retroactive effect. As noted above, the requirement to disclose participation in "listed transactions" applies to corporations required to file returns under Code sections 11, 594, 801, or 831, as well as to individuals, trusts, partnerships, and S corporations.

4. *Other Reportable Transactions.* Additional disclosure requirements apply to corporations required to file returns under Code sections 11, 594, 801, or 831. Such corporations, in addition to disclosing participation in "listed transactions," must also disclose participation in "other reportable transactions." A transaction is an "other reportable transaction" if it meets all four of the following tests: (a) it was entered into after February 28, 2000; (b) it has at least two of five characteristics ("filters") enumerated in the June 2002 Regulations; (c) at the time the taxpayer entered into the transaction or at any time thereafter, the taxpayer reasonably estimates that the transaction will reduce the taxpayer's Federal tax liability by more than \$5,000,000 in any single taxable year or by a total of more than \$10,000,000 for any combination of taxable years; and (d) certain exceptions do not apply.

*Filters.* The five filters are: (i) that the taxpayer participated in the transaction under "conditions of confidentiality"; (ii) that the taxpayer obtained or was provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction would not be sustained (with a limited exception for certain "customary indemnities"); (iii) that the taxpayer's participation in the transaction was promoted, solicited, or recommended by one or more persons who have received or are expected to receive fees in excess of \$100,000 contingent on the taxpayer's participation in the transaction; (iv) that the expected treatment of the transaction for Federal income tax purposes in any taxable year differed or was expected to differ by more than \$5,000,000 from the treatment of the transaction for purposes of determining "book income" on Schedule M-1 to the taxpayer's income tax return for the same period; and (v) that the transaction involved the participation of a person that the taxpayer knew or had reason to know was in a Federal income tax position that differed from that of the taxpayer (such as a tax-exempt entity) and the taxpayer knew or had reason to know that such difference in tax position permitted the transaction to be structured on terms that were intended to provide the taxpayer with more favorable Federal income tax treatment than it could have otherwise obtained.

*Exceptions.* A transaction is not an "other reportable transaction" if any one of four exceptions is satisfied: (i) the taxpayer participated in the transaction in the ordinary course of its business in a form consistent with customary commercial practice, and the taxpayer reasonably determines that it would have participated in the same transaction on substantially the same terms irrespective of the expected Federal income tax benefits; (ii) the taxpayer participated in the transaction in the ordinary course of its business in a form consistent with customary commercial practice, and the taxpayer reasonably determined that there is a generally accepted understanding that the taxpayer's intended tax treatment of the transaction (taking into account any combination of intended tax consequences) is properly allowable under the Code for substantially similar transactions; (iii) the taxpayer reasonably determines that there is no reasonable basis under

Federal income tax law for denial of any significant portion of the expected Federal income tax benefits from the transaction; *or* (iv) the transaction is identified in published guidance as being exempt from disclosure under these rules.<sup>1</sup>

5. *Form, Content, and Time of Disclosure.* The June 2002 Regulations require that disclosure be made on a statement attached to the taxpayer's return. The disclosure must be repeated with each return on which the taxpayer's Federal tax liability is affected by its participation in the transaction. In addition, at the time that disclosure is first made on a taxpayer's return, a copy of the disclosure statement must be mailed to the Office of Tax Shelter Analysis in the IRS National Office. The following items must be included on a disclosure statement:

- (i) the name by which the transaction is known or commonly referred to;
- (ii) a statement indicating whether, to the best of the taxpayer's knowledge, the transaction has been registered as a tax shelter under Internal Revenue Code section 6111 (and, if so, the assigned tax shelter registration number);
- (iii) a brief description of the principal elements of the transaction that give rise to the expected tax benefits, including the manner of the taxpayer's direct or indirect participation in the transaction;
- (iv) a brief description of the expected tax benefits of the transaction;
- (v) an identification of each taxable year in which the transaction is expected to have the effect of reducing the Federal tax liability of the taxpayer, or of any partner or shareholder of the taxpayer, and an estimate of the amount by which the transaction is expected to reduce such liability; and
- (vi) the names and addresses of any parties who promoted, solicited, or recommended the taxpayer's participation in the transaction and who had a financial interest, including the receipt of fees, in the taxpayer's decision.

6. *Record Retention.* Extensive record retention requirements are imposed with respect to "all documents and other records related to a transaction subject to disclosure under this section that are material to an understanding of the facts of the transaction, the expected tax treatment of the transaction, or the taxpayer's decision to participate in the transaction."

7. *Consequences of Failure to Disclose.* In Proposed Regulations issued on December 31, 2002, the Internal Revenue Service warned taxpayers and practitioners that the "IRS, in appropriate circumstances, may consider a taxpayer's failure to disclose a reportable transaction ... as a factor in determining whether the taxpayer has satisfied the reasonable cause and good faith exception under [Internal Revenue Code] section 6664(c) to the accuracy-related penalty."

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<sup>1</sup> No such transactions have yet been identified.

This summary provides general guidance regarding the June 2002 Regulations. Many of the rules summarized above have detailed definitions, examples, exceptions, and special rules, the precise words of the Regulations must be consulted in order to determine their exact scope, and some hard judgment calls may have to be made regarding the application of the rules. Our attorneys are available to consult with you on any questions concerning disclosures required on returns to be filed during the upcoming filing season. Calls may be directed to Elliot Pisem (212-903-8777) or any of our other attorneys.

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## IRS Listed Transactions

- Transactions in which taxpayers claim deductions for contributions to a qualified cash or deferred arrangement or matching contributions to a defined contribution plan where the contributions are attributable to compensation earned by plan participants after the end of the taxable year;
- Trust arrangements purported to qualify as multiple employer welfare benefit funds exempt from the limits of Code sections 419 and 419A;
- Multiple-party transactions intended to allow one party to realize rental or other income from property or service contracts and to allow another party to report deductions related to that income (often referred to as "lease strips");
- Transactions in which the reasonably expected economic profit is insubstantial in comparison to the value of the expected foreign tax credits;
- Transactions involving contingent installment sales of securities by partnerships in order to accelerate and allocate income to a tax-indifferent partner, such as a tax-exempt entity or foreign person, and to allocate later losses to another partner;
- Transactions involving distributions described in Treasury Regulation section 1.643(a)-8 from charitable remainder trusts;
- Transactions in which a taxpayer purports to lease property and then purports to immediately sublease it back to the lessor ("lease-in/lease-out" or "LILO" transactions);
- Transactions involving the distribution of encumbered property in which taxpayers claim tax losses for capital outlays that they have in fact recovered;
- Transactions involving fast-pay arrangements as defined in Treasury Regulation section 1.7701(l)-3(b);
- Transactions involving the acquisition of two debt instruments the values of which are expected to change significantly at about the same time in opposite directions;
- Transactions generating losses resulting from artificially inflating the basis of partnership interests;
- Transactions involving the purchase of a parent corporation's stock by a subsidiary, a subsequent transfer of the purchased parent stock from the subsidiary to the parent's employees, and the eventual liquidation or sale of the subsidiary;
- Transactions purporting to apply Code section 935 to Guamanian trusts;
- Transactions involving the use of an intermediary to sell the assets of a corporation;
- Transactions involving a loss on the sale of stock acquired in a purported Code section 351 transfer of a high basis asset to a corporation and the corporation's assumption of a liability that the transferor has not yet taken into account for federal income tax purposes;
- Certain redemptions of stock in transactions not subject to U.S. tax in which the basis of the redeemed stock is purported to shift to a U.S. taxpayer;
- Transactions involving the use of a loan assumption agreement to claim an inflated basis in assets acquired from another party;
- Transactions involving the use of a notional principal contract to claim current deductions for periodic payments, while disregarding the accrual of a right to receive offsetting payments;
- Transactions involving the use of straddles, tiered partnerships, a transitory partner, and the absence of a Code section 754 election to claim a permanent non-economic loss;
- Transactions designed to use a straddle, one or more transitory shareholders, and the rules of subchapter S to claim an immediate loss while deferring an offsetting gain;
- Transactions that use a reinsurance arrangement to divert income properly attributable to a taxpayer to the taxpayer's wholly-owned reinsurance company; and
- Certain transactions involving ESOP's purportedly established by S corporations on or before March 14, 2001.