

NEW IRS DISCLOSURE AND “LIST MAINTENANCE” TAX SHELTER REGULATIONS

by Alan M. Valade

In February 2003, the U.S. Department of Treasury issued new regulations concerning certain “tax shelter” disclosure and “list maintenance” requirements. Among other things, the new List Maintenance Regulations require law firms, accounting firms, investment banking firms and others to capture certain data, create the “lists” described below, and maintain the “lists” for seven years. This article discusses Congress’s and the IRS’s recent efforts to curb the use of tax shelters, and then explains the recently promulgated disclosure and List Maintenance Regulations.

Registration and Disclosure of Participation in Tax Shelters

Abusive tax shelters are viewed by the Congress and the IRS as schemes that involve artificial transactions with little or no economic reality or business purpose. These transactions often make use of aggressive allocations of income, deductions, adjusted basis and appraisals, as well as the use of disregarded entities, partnerships, limited liability companies, S corporations, non-profit entities and/or foreign entities or corporations. Abusive tax shelters commonly involve transactions that are projected from the start to generate losses, deductions, or tax credits that are greater than an investor’s present or future investment in the transaction. Such transactions are sometimes marketed in terms of the ratio of tax deductions allegedly available to each dollar invested. Over the years Congress has enacted a number of laws designed to halt the growth of abusive tax shelters. These efforts have included provisions in the Internal Revenue Code (“**IRC**”) that require the registration of tax shelters by promoters and the disclosure to the IRS by taxpayers of their participation in tax shelter transactions.

Generally, the organizers of certain tax shelters must register the shelter with the IRS. The IRS will then assign a registration number to the tax shelter. If a taxpayer is a participant in a tax shelter, the seller (or the transferor) must provide the taxpayer with the tax shelter registration number at the time of the sale (or transfer) or within 20 days after the seller or transferor receives the registration number if that date is later. The taxpayer/investor must then disclose its participation in each reportable tax shelter transaction to the IRS. The taxpayer must attach a disclosure statement to his or her tax return for each year that the taxpayer’s tax liability is affected by participation in the tax shelter transaction.

Tax Shelter Penalties

Substantial penalties can be imposed for investing in abusive tax shelters. In addition to interest on any tax deficiency, the potential penalties include the following:

Accuracy-Related Penalties. An accuracy-related penalty of 20% can be imposed for underpayments of tax due to (1) negligence or disregard of rules or regulations, (2) substantial understatement of tax, or (3) substantial asset valuation misstatements.

Negligence or Intentional Disregard Penalties. The penalty for negligence or disregard of IRS rules or regulations is imposed on the part of a tax underpayment that is due to negligence or the intentional disregard of IRS rules or regulations. Negligence includes any failure to make a reasonable attempt to comply with the provisions of the IRC.

Substantial Understatement of Tax. An understatement is considered to be “substantial” if it is more than the greater of (a) 10% of the tax required to be shown on the tax return or (b) 5,000. Two special rules apply in the case of a tax understatement due to a tax shelter. One, an understatement of tax does not include any tax due to a shelter item if the taxpayer had substantial legal authority for the tax treatment of the item and reasonably believed that the tax treatment chosen was more likely than not the proper treatment of the item. Second, disclosure of the tax shelter item on a tax return does not reduce the amount of the understatement and, therefore, does not reduce the potential understatement penalty.

Asset Valuation Misstatement Penalties. Taxpayers may be liable for a 20% penalty for substantial asset valuation misstatements. The penalty for a gross valuation misstatement is 40%.

Failure to Pay Tax. If a tax deficiency is assessed and is not paid within 10 days of the IRS demand for payment, a tax shelter investor can be assessed an additional penalty of up to 25%.

Civil Fraud Penalty. Finally, if an underpayment of tax is due to fraud, a penalty of 75% may be assessed by the IRS.

Notwithstanding the risk that these penalties may be imposed on taxpayers, the perception in Congress and the IRS is that these penalties have not been sufficient to prevent many corporations and individuals from participating in “abusive tax shelter” transactions. This perception was encouraged by a number of notable corporate failures such as the Enron debacle, where the corporation participated in many tax shelter-type transactions. In response to the perceived failures, in February 2003 the Treasury Department issued the new tax shelter disclosure and List Maintenance Regulations.

February 2003 Regulations

The new List Maintenance Regulations build on the previous Congressional and IRS attempts to curb tax shelter investments. The new Regulations continue the requirements that promoter-types register potentially abusive tax shelters with the IRS, and that Taxpayers involved in tax shelter transactions disclose certain reportable transactions to the IRS on their annual federal income tax returns. Currently taxpayers must use IRS Form 8886 (Reportable Transaction Disclosure Statement) to report their tax shelter investments to the IRS. The former tax shelter regulations have, however, been substantially expanded to include accounting firms, law firms, investment bankers and other organizations as entities required to maintain lists of their clients and other persons involved in “potentially abusive tax shelter” and other reportable transactions.

Under the new List Maintenance Regulations, any person, who (1) provides any tax advice regarding certain transactions, and (2) is compensated above certain threshold levels (\$10,000 for IRS “listed transactions;” \$250,000 for a transaction in which all participants are C corporations; and \$50,000 for most other potentially abusive tax shelters) is a so-called “material advisor” and must comply with the new Regulations.

The new List Maintenance Regulations require “list maintenance” by material advisors, including law firms and accounting firms, with respect to the following types of transactions:

- (1) “Listed Transactions,” which are transactions that the IRS includes, from time to time, in published notices as tax shelter transactions. To date, the IRS has identified twenty five discrete “listed transactions,” including certain S corporation/Employee Stock Ownership Plan (ESOP) transactions, income and tax basis shifting transactions, pass through entity straddle transactions, tiered partnership transactions, contingent liability transactions, and a number of transactions between U.S. taxpayers and foreign entities or persons;
- (2) “Confidential Transactions,” which are transactions that are subject to certain nondisclosure requirements and limitations;
- (3) Transactions with contractual protection, which are transactions where a portion of the taxpayer’s fees paid to promoters and advisors will be refunded if the anticipated tax benefits from participating in the transaction are not obtained by the taxpayer;
- (4) Certain “loss transactions” under IRC Section 165;
- (5) Transactions with significant (\$10 Million+) book-tax differences; and
- (6) Certain tax credit based transactions with brief asset holding periods (typically, 45 days or less).

If a transaction does not fall into one of these categories, the new Regulations do not require either disclosure of the transaction to the IRS or list maintenance by the “material advisor.”

If, however, a “list” must be created and maintained by a material advisor because the transaction falls within one of the above categories of tax shelter transactions, the list must contain the following information and documents:

- The name and IRS registration number, if any, for each tax shelter transaction;
- The taxpayer identification number (“**TIN**”), if any, for each transaction;
- The name, address, and TIN number of each person on the list;
- The number of units or ownership interest acquired by each person on the list;
- The date each interest was acquired;

- The amounts invested by each person on the list;
- A description of each transaction;
- A summary of the anticipated tax consequences to each person on the list;
- Copies of tax opinions and other written materials relating to the transaction that have been delivered or shown to potential or actual investors in the transaction; and
- The name of the person from whom the interest was acquired.

Once created, each “list” must be maintained by the material advisor for seven years and, importantly, is subject to periodic inspection(s) by the IRS. Effectively, the new List Maintenance Regulations shift to material advisors the burden of creating and maintaining information and documents on taxpayers, including the clients of law firms and accounting firms, in order that the IRS can audit and monitor taxpayer compliance with the tax shelter disclosure rules. Similar to the penalties imposed on participants in tax shelter transactions, significant penalties are imposed on material advisors in the event that the advisors fail to create and maintain accurate tax shelter “lists” and related documents.

While not yet enacted into law, President Bush’s fiscal year 2004 budget includes additional “proposals ... to combat abusive tax avoidance transactions.” If enacted, the President’s proposals would impose upon material advisors, including law firms and accounting firms, the additional obligation to file “information returns” with the IRS regarding their clients’ (and other parties’) participation in reportable tax shelter transactions. The President’s proposals also substantially increase the penalties applicable to material advisors in connection with a material advisor’s failure to create or maintain accurate investor lists. In addition, the President’s proposals would impose new penalties on material advisors for their failure to file the required information returns with the IRS (\$50,000 penalty for most reportable transactions; and a \$200,000+ penalty for “listed transactions”).

In conclusion, the new List Maintenance Regulations and the President’s 2004 tax shelter budget proposals are intended by the President, Congress and the IRS to place the burden on law firms and accounting firms (and other advisors) to oversee their clients’ compliance with the IRC’s tax shelter disclosure rules. We believe that these developments are an unwelcome intrusion into the professional relationships between taxpayers and their attorneys and accountants.

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