New York State Bar Association

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November 16, 2000

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service, Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Jonathan Talisman, Esq.
Acting Assistant Secretary (Tax Policy)
Treasury Department, Room 1330 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: <u>Tax Shelter Regulations</u>

Dear Commissioner Rossotti and Mr. Talisman:

The enclosed Tax Section report[1] comments on tax shelter regulations issued in temporary and proposed form in February of this year and then revised in August (the "Regulations"). The Regulations seek to curb abusive tax shelters by making it easier for the Internal Revenue Service to identify, and thus to challenge, tax-motivated transactions whose legal basis is weak. In general, the Regulations would ease identification of suspect transactions by (a) requiring corporations to disclose certain transactions with their tax returns, (b) implementing statutory requirements that corporate tax shelters be registered and (c) requiring promoters to maintain lists of taxpayers—both corporate and noncorporate—that enter into suspect transactions.

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[1] The principal drafter of this report was Diana Wollman, co-chair of the Tax Section's Committee on Corporations.

We commend the Treasury and the Service for issuing the Regulations. As we have stated in prior reports and testimony, we share the government's concerns about abusive tax shelters. We believe it necessary to change the cost-benefit calculation faced by taxpayers considering questionable tax-motivated transactions. Changing one factor in this calculation—the penalty if the taxpayer's position is not sustained in court—requires new legislation. Another factor—the probability of detection and challenge—can be changed without new legislation.

By increasing information available to the Service, the Regulations may increase the probability that questionable transactions will be detected and challenged. Thus, the Regulations have the potential to change substantially taxpayers' cost-benefit calculation. Of course, increasing the amount of information available to the Service will actually increase the chance that abusive transactions will be detected and challenged only if the Service uses this information effectively. Consequently, as noted in the enclosed report, the new Office of Tax Shelter Analysis must have adequate resources and other support to ensure it effectively coordinates use of information generated by the Regulations.

Because we support the Regulations, our comments are primarily technical. Our report's recommendations are generally aimed at making the Regulations more clear and certain in their scope. For the Regulations to achieve their purposes, taxpayers and other persons potentially subject to them must be able to determine when they are required to disclose, register or maintain investor lists. In addition, the Regulations should be tailored to maximize the chance the Service can gather information about suspect transactions, while minimizing the chance it will be inundated with information about others.

The main points made in the enclosed report can be summarized as follows:

1. The Regulations should be revised to state clearly the consequences of failing to file a required disclosure. We believe that a taxpayer's failure to file a required disclosure statement with its return should

give rise to a rebuttable presumption that the taxpayer lacked "good faith" for purposes of statutory accuracy-related penalties.

2. A number of changes and clarifications are needed in the six factors ("tax shelter indicia") a taxpayer must consider under the Regulations in determining whether the Regulations require disclosure.

3. The rules for determining whether a transaction has a "projected tax effect" above a certain level, and thus is subject to disclosure, need to be made more clear. In particular, we recommend changes and clarifications in the rules for measuring projected tax effect.

4. Two exceptions to the Regulations—available where there is "no reasonable basis" for challenge and where there is a "long-standing generally accepted" understanding—need to be modified and clarified. In particular, we propose clarifying the standard for whether a taxpayer or other participant has made a "reasonable determination" that one or both of these exceptions apply (and thus can rely on them). We also recommend the "long-standing" exception be replaced by one for transactions that are "clearly contemplated by current law"; we believe an exception should apply to transactions relying on tax principles or rules that are well-accepted, even if relatively new.

5. We request clarification and revisions to certain aspects of the Regulations' definition (in the registration requirement) of transactions that "lack economic substance". We suggest the test refer to "potential pre-tax profit" rather than "reasonably expected pre-tax profit". We also recommend that, for purposes of the definition of "other tax structured transactions", the Regulations clarify what it means for tax benefits to be "an important part of the intended results" and whether this is an objective or subjective determination.

6. The August revisions substantially clarified which persons potentially are responsible for registering a transaction or maintaining a list of investors, and we commend the Treasury and Service for responding quickly to comments by making these changes. Nevertheless, some confusion remains and should be addressed by further modifications. In particular the

Regulations should be revised to clarify their application to employees of entities that are involved in the organization, management or sale of the transaction. In addition, the Regulations should be revised to clarify how they apply to outside counsel who employ so-called "value billing", rather than billing at a straight hourly rate.

Before closing, I want to comment on what may seem to be an inconsistency between some recommendations in the enclosed report and our recommendations in other submissions on legislation to revise penalty rules. We are on record as supporting new legislation—which has not been enacted—to impose strict liability for understatement penalties for tax shelters so that taxpayers could not avoid penalties by reliance on an opinion of counsel. At the same time, our comments in the enclosed report address circumstances in which taxpayers might be permitted to rely on an opinion of counsel in determining whether the requirements for disclosure, registration and list maintenance apply. Our comments here address regulations issued within a statutory framework that does not impose strict liability. In addition, our comments here deal with disclosure, registration and list maintenance, rather than with penalties for understating tax liability. For these reasons, our comments in the enclosed report should not be seen as inconsistent with other comments we have made about legislative changes to penalty rules.

Please call me if we can be of assistance as you work to revise the Regulations.

Sincerely,

Robert H. Scarborough

Enclosure

cc: The Honorable Stuart L. Brown
Eric Solomon, Esq.
Joseph M. Mikrut, Esq.
Richard W. Skillman, Esq.

CC:DOM:CORP:R (REG-103735-00)
CC:DOM:CORP:R (REG-103736-00)
CC:DOM:CORP:R (REG-110311-98)

Tax Report # 982

November 16, 2000

NEW YORK STATE BAR ASSOCIATION TAX SECTION
REPORT
ON THE TEMPORARY AND PROPOSED
TAX SHELTER REGULATIONS[1/]

I. Introduction

The purpose of this Report is to comment on the Temporary and Proposed tax shelter regulations issued earlier this year. On February 28, 2000, the Treasury Department and the Internal Revenue Service (the "IRS") released three sets of Temporary and Proposed Regulations aimed at combating the proliferation of "corporate tax shelters" by imposing enhanced disclosure obligations on tax shelter participants and organizers.[2/] On August 11, 2000, the Treasury and the IRS released revisions to the Temporary and Proposed Regulations, including significant clarifications, as well as the expansion of a portion of the regulations to apply to tax shelters marketed to individuals and other non-corporate

[1/] This report was prepared by an ad hoc committee of the New York State Bar Association Tax Section consisting of Saba Ashraf, David Hariton, Charles Morgan, Robert Heller, Dana Trier, Michael Schler, Bruce Giedra, David Miller, Jonathan Kushner, Raymond Jasen, Erika Nijenhuis, Jennifer Brown, Yaron Reich, Richard Cohen, Eugene Vogel, Kevin Adler, Larry Garrett, Gary Horowitz, Jeffrey Van Hove, Gerard Boyce, Lewis Steinberg, Ansgar Simon and Diana Wollman (who was the principal draftsperson). Helpful comments were also received from: Robert Scarborough, Robert Jacobs, Andrew Berg, Richard Reinhold, David Schnabel, Lisa Levy, Didi Welles and Michelle Scott. At least one member of the ad hoc committee has participated, on behalf of a client, in preparing a comment letter on and meeting with representatives of the Government to discuss the new regulations; and partners in the same law firms as other members of the ad hoc committee may also have participated in commenting on the regulations on behalf of clients. The persons principally responsible for preparing this Report have not been involved in any of these activities.

[2/] The Temporary Regulations were published in the Federal Register on March 2, 2000. T.D. 8877, 65 Fed. Reg. 11205; T.D. 8876, 65 Fed. Reg. 11215; and T.D. 8875, 65 Fed. Reg. 11211. The regulations were simultaneously issued in proposed form. REG - 103735-00; REG - 110311-98; and REG - 103736-00.

taxpayers.[3] As revised, these new regulations (the "New Regulations") consist of: (1) Temp. Treas. Regs. § 1.6011-4T, which requires corporate taxpayers to disclose on their annual tax returns certain large transactions that have characteristics common to tax shelters (the "Disclosure Regulations"), (2) Temp. Treas. Regs. § 301.6111-2T , which defines a new type of confidential corporate tax shelter that must be registered with the IRS under Section 6111 (the "Registration Regulations") and (3) amendments to Temp. Treas. Regs. § 301.6112-1T, which require organizers to maintain lists of investors (including individuals) in transactions that have characteristics common to tax shelters (the "Listing Regulations").

On February 28 and August 11, the IRS also issued Notices 2000-15[4] and 2000-44,[5] which together describe eleven transactions that have been identified by the IRS as having a tax avoidance purposes and are "listed transactions" for purposes of applying the New Regulations.

The IRS also announced on February 28 (in Announcement 2000-12[6]) the creation of the Office of Tax Shelter Analysis "to serve as the focal point for efforts to gather and analyze information relating to tax shelter activity and to coordinate appropriate responses".

We commend Treasury and the IRS for issuing the New Regulations, the Notices and the Announcement and especially applaud the issuance of the clarifying revisions in August to respond to some of the questions and concerns that had been raised by taxpayers and practitioners. We recognize the significant amount of time and effort necessary to prepare a cohesive set of rules to address this complicated problem and to respond so quickly to feed-

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[3] T.D. 8896. The revisions to the Temporary Regulations were published in the Federal Register on August 16, 2000. 65 Fed. Reg. 49909. At the same time, conforming changes were made to the Proposed Regulations. REG -103735-00; REG -110311-98; REG -103736-00.

[4] 2000-12 I.R.B. 826.

[5] 2000-36 I.R.B. 255.

[6] 2000-12 I.R.B. 835.

back received from the public. As we have stated previously,[7] we strongly support the Government's efforts at curbing corporate tax shelter activity. While we continue to believe that this problem ultimately calls for a legislative solution involving revisions to the existing penalty provisions, we welcome the New Regulations as a significant step in deterring taxpayers from engaging in improper transactions and in assisting the IRS in identifying and challenging them.

As we have stated in our prior submissions, we believe that enhanced disclosure is an important and useful tool for the Government in addressing the tax shelter problem. We continue to believe, however, that it is crucial that the Government devote sufficient resources to the IRS's efforts in this regard. In addition to overall funding of IRS staff to review and respond to the increased disclosure, it is particularly important that the new Official of Tax Shelter Analysis be well-funded. This Office and its staff should play a pivotal role in coordinating the IRS's efforts in this regard and should have a clear public presence and the strong support of Congress and the Administration. We believe that this support, visibility and overall coordination of the Government's efforts will increase the impact on taxpayers, tax shelter promoters and tax advisors of these new rules and the Government's enforcement efforts.

We note that our prior submissions and comments on tax shelters have focused on proposals for legislation that would seek to deter tax shelter activity by imposing enhanced understatement penalties on any understatement arising from a "tax shelter" or by adding a

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[7] *See* New York State Bar Ass'n Tax Section, *Report on Corporate Tax Shelters*, April 23, 1999; New York State Bar Ass'n Tax Section, *Report on Certain Tax Shelter Provisions*, June 22, 1999; Statement of Robert H. Scarborough, Chair, Tax Section New York State Bar Association Before the Committee on Finance, United States Senate Hearing on Penalty and Interest Provisions in the Internal Revenue Code, March 9, 2000 and Testimony of Robert H. Scarborough before the Senate Finance Committee, reprinted in Unofficial Transcript of Committee on Finance Hearings at 2000 TNT 52-27 (March 16, 2000); and New York State Bar Ass'n Tax Section, *Report on Proposal to Codify Economic Substance Doctrine*, July 25, 2000; New York State Bar Ass'n Tax Section, *Report on Revisions to Circular No. 230*, July 31, 2000; New York State Bar Ass'n Tax Section, *Letter to the Senate Finance Chair William V. Roth Jr. on Finance Draft Corporate Tax Shelter Legislation*, September 18, 2000.

new substantive disallowance rule for tax benefits from any "tax shelter". While many of the views and concerns we have expressed with respect to those proposals are applicable to the New Regulations, many of the considerations and issues involved here differ. Because the New Regulations, as disclosure rules, serve a different function from understatement penalty and substantive disallowance rules, we have reached different conclusions in this context as to certain matters.

II. Summary of Comments

The principal comments made in this Report are as follows:

1. We recommend that a failure by a taxpayer to file a required disclosure statement with its annual tax return (pursuant to the Disclosure Regulations) give rise to a rebuttable presumption that the taxpayer lacked "good faith" for purposes of applying the Section 6664(c) reasonable cause and good faith exception to the accuracy-related and fraud penalties contained in Sections 6662 and 6663. Currently there is no specific penalty for failing to file a required disclosure statement, although the Preamble to the Regulations indicates that the failure may affect the determination of whether the taxpayer acted in "good faith" for Section 6664(c) purposes and the Preamble also suggests that the failure may have other negative consequences as well. We believe that the disclosure requirement would be more effective in eliciting disclosure and deterrence of abusive transactions if the consequences of a failure to disclose were clear, specific and uniform for all taxpayers and could have a significant economic impact if the taxpayer lost on the merits. We believe that the IRS has ample authority under current law to provide for this type of rebuttable presumption in Regulations.

2. With respect to the six tax shelter indicia listed in the Disclosure Regulations, we suggest certain clarifications and modifications that we believe will make the regulations easier to understand and apply and more effective at identifying inappropriate and abusive

tax structures without affecting non-tax related aspects of legitimate business transactions. These suggestions include:

(i) with respect to the conditions of confidentiality factor, we recommend that the "structure and tax aspects of the transaction" (the disclosure of which may not be limited) consist only of the features of the transaction that are necessary to an understanding of how the intended U.S. Federal income tax benefits are to be derived; that restrictions on disclosure imposed by law, whether foreign or domestic, should not be considered conditions of confidentiality; and that the effect of exclusivity agreements and other limitations on use, particularly their effect on the determination of whether the rebuttable presumption applies, be clarified;

(ii) with respect to contractual protection against loss of the tax benefits, we recommend that this factor be met only if, as a result of a successful IRS challenge to the transaction or a change in the tax law, the taxpayer has a right to receive from the promoter a reimbursement of or reduction in organizational or promotional fees and/or a reimbursement of any additional tax costs;

(iii) with respect to the $100,000-in-fees-to-promoters factor, we recommend that it be clarified that only fees for *promotional* services be taken into account and that the threshold should be raised to $500,000;

(iv) with respect to book/tax differences of more than $5 million, we suggest that book/tax differences that are contemplated by the Code[8/] or Treasury regulations (and listed in the Regulations or in published guidance), and book/tax differences that reverse automatically within five taxable years, be disregarded;

(v) with respect to the person in a different tax position factor, we suggest that a person be considered to be in a "different tax position" from the taxpayer only if the difference is relevant to the tax consequences of the transaction to the two persons, and that

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[8/] All Section references are to the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise noted.

the difference needs to be a significant factor in enabling the transaction to be structured so as to provide the taxpayer with the intended tax benefits; and

(vi) that the sixth factor, different U.S. and foreign tax treatment of the transaction, be made into an alternative factor to the fourth and fifth factors ($5 million book/tax difference and participation of person in a different tax position), rather than an additional factor, since the sixth factor is so often likely to be present whenever either the fourth or fifth factor is present.

3. A request for certain modifications and clarifications as to how to apply the projected tax effect test and the aggregation rules of the Disclosure Regulations.

4. We agree that whether the "no reasonable basis" exception or the "long-standing generally accepted" exception applies in any case should depend upon the "reasonable determination" of the participant (or the promoter) as to whether the requisite legal standard is met. We suggest that it be clarified that the assessment of whether the taxpayer's or promoter's determination was reasonable or not will be made by taking into account all the facts and circumstances, including whether the taxpayer or promoter reasonably relied upon an opinion of tax counsel.

5. With respect to the "no reasonable basis" exception, we request that the "no reasonable basis" standard be clarified and be described in terms of the degree of support that the taxpayer would need to have for its position, rather than the level of support the IRS would need to mount a challenge.

6. With respect to the "long-standing and generally accepted" exception, we request guidance as to how the requirement that the transaction be entered into in the ordinary course of business and in form consistent with customary commercial practice applies in the case of pass-through entities, transactions entered into for investment purposes by persons not engaged in a trade or business and transactions marketed to multiple participants. We also recommend that "long-standing" be replaced with "clearly contemplated by current law" because we believe that this exception should encompass transactions that rely upon tax principles or rules that are well-accepted even if relatively new.

7. We request that the "substantially the same terms" exception be clarified and we suggest certain modifications to the example illustrating the exception in order to make it more realistic and thus more helpful to taxpayers.

8. We recommend that formal guidance be issued specifying certain "clearly-contemplated" tax benefits (such as those under the regulated investment company and tax-free reorganization provisions) that when claimed in a manner consistent with the statute and the Congressional purpose will not be taken into account in determining if a transaction is a tax shelter.

9. With respect to the Registration Regulations' definition of transactions that "lack economic substance", we reiterate our previously-expressed concerns regarding an "expected pre-tax profit" test and suggest that it be replaced with a "potential pre-tax profit" test; we also identify certain other aspects of the definition which we believe are in need of clarification.

10. With respect to the definition of "other tax structured transactions", we request that the Regulations clarify what it means for the tax benefits to be "an important part of the intended results" and whether this is an objective or subjective determination.

11. While we recognize that the August revisions substantially clarified which persons potentially have the responsibility for registering a transaction or maintaining a list of investors, we believe that some confusion remains, specifically with respect to employees of entities that are involved in the organization, management or sale of the transaction, and with respect to outside counsel who employ so-called "value billing" rather than billing at a straight hourly rate for all work. It should be clarified in the Regulations that these persons are not subject to the registration or listing requirements.

12. We also suggest certain clarifications regarding the investor list maintenance requirements and how the Government intends to use those lists.

III. General Description of the New Regulations

Before proceeding to discuss our comments on the New Regulations in detail, we will briefly describe the New Regulations.

A. The Disclosure Regulations

1. General Requirements

The Disclosure Regulations require a corporate taxpayer that participates (directly or indirectly) in a large transaction with characteristics that are common to tax shelters (a "reportable transaction") to (i) include a disclosure statement regarding the transaction with the corporation's annual tax return for each year in which the corporation's tax liability is affected by the transaction, (ii) file a copy of the disclosure statement for the first year with the IRS in Washington, DC, and (iii) retain certain records with respect to the transaction.[9/]

A "reportable transaction" is any transaction that

(1) either (a) is the same or substantially similar to one of the types of transactions that the IRS has determined is a tax avoidance transaction and has identified as a "listed transaction" in published guidance (a "listed transaction") or (b) has at least two out of six specified characteristics that are common to tax shelters and is not excluded from disclosure by one of the exceptions (an "other reportable transaction"); and

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[9/] Temp. Regs. § 1.6011-4T(d). The disclosure and record retention requirements do not apply if the corporation is not otherwise required to file a tax return under Section 11, 594, 801 or 831. The Disclosure Regulations were issued under Section 6011 of the Code, which obligates taxpayers to file returns, and include therein information, in the manner and as determined by the Secretary, and Section 6001 of the Code, which obligates taxpayers to retain the records specified by the Secretary.

(2) is expected to result in at least a specified minimum amount of tax savings (the "projected tax effect" test).[10/]

2. Listed Transactions: Transactions Identified by the IRS

The projected tax effect test is met for a listed transaction if the taxpayer reasonably estimates that the transaction will reduce the taxpayer's Federal income tax liability by more than $1 million in any single taxable year or by more than $2 million in any combination of years.[11/] To date, the IRS has identified eleven "listed transactions". [12/] There are no exceptions to the disclosure and record retention requirements for a listed transaction that meets the projected tax effect test.

3. Other Reportable Transactions: Transactions Having Two of Six Tax Shelter Indicia

An "other reportable transaction" meets the projected tax effect test if the taxpayer reasonably estimates that the transaction will reduce its Federal income tax liability by more than $5 million in any single year or $10 million in any combination of years.[13/]

An "other reportable transaction" is any transaction that has at least two of the following six characteristics (unless one of the exceptions described below applies):

(1) the taxpayer participated in the transaction under conditions of confidentiality (as defined in the Registration Regulations[14/]);

(2) the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained;

[10/] Temp. Regs. § 1.6011-4T(b).

[11/] Temp. Regs. § 1.6011-4T(b)(4).

[12/] *See* Notices 2000-44 and 2000-15.

[13/] Temp. Regs. § 1.6011-4T(b)(4).

[14/] Temp. Regs. § 301.6111-2T(c).

(3) the taxpayer's participation was promoted, solicited or recommended by one or more persons who have received or are expected to receive fees or other consideration with an aggregate value in excess of $100,000, and such person or persons' entitlement to such fees or other consideration was contingent on the taxpayer's participation in the transaction;

(4) the expected treatment of the transaction for Federal income tax purposes in any taxable year differs or is expected to differ by more than $5 million from the treatment of the transaction for purposes of determining book income as taken into account on the schedule M-1 (or comparable schedule) on the taxpayer's Federal corporate income tax return for the same period;

(5) (a) the transaction involves the participation of a person the taxpayer knows or has reason to know is in a different Federal income tax position than the taxpayer, such as a tax-exempt entity or a foreign person, and (b) the taxpayer knows or has reason to know that such difference in tax position has permitted the transaction to be structured on terms that are intended to provide the taxpayer with more favorable Federal income tax treatment than it could have obtained without the participation of such person (or another person in a similar tax position); and

(6) the expected characterization of any significant aspect of the transaction for Federal income tax purposes differs from the expected characterization of such aspect for purposes of the taxation of any party to the transaction in another country.[15/]

4. The Four Exceptions for Other Reportable Transactions

A transaction that has two or more of the six tax shelter indicia is not an "other reportable transaction", and therefore is not subject to disclosure, if one of the following four exceptions applies:

(1) Substantially the Same Terms Exception: (a) the taxpayer has participated in the transaction in the ordinary course of its business in a form consistent with customary

[15/] Temp. Regs. § 1.6011-4T(b)(3)(i).

commercial practice, and (b) 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.[16]

(2) Long-Standing Generally Accepted Exception: (a) the taxpayer has participated in the transaction in the ordinary course of its business in a form consistent with customary commercial practice, and (b) the taxpayer reasonably determines that there is "a long-standing and generally accepted understanding" that the expected Federal income tax benefits from the transaction (taking into account any combination of intended tax consequences) are allowable under the Code for substantially similar transactions.[17]

(3) No Reasonable Basis Exception: the taxpayer "reasonably determines that there is no reasonable basis under Federal tax law for denial of any significant portion of the expected Federal income tax benefits".[18] The determination must take into account "the entirety of the transaction" and any combination of tax consequences that are expected to result from any component steps of the transaction, must not be based upon unreasonable or unrealistic factual assumptions, and must take into account all relevant aspects of Federal tax law, including judicially established principles of general application.[19]

(4) Identification in Published Guidance Exception: the transaction has been identified in published guidance as being excepted from the disclosure requirements.[20]

For purposes of the first two exceptions, a transaction is automatically considered to be part of the ordinary course of business if it involves the acquisition, disposition or

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[16] Temp. Regs. § 1.6011-4T(b)(3)(ii)(A).

[17] Temp. Regs. § 1.6011-4T(b)(3)(ii)(B).

[18] Temp. Regs. § 1.6011-4T(b)(3)(ii)(C).

[19] *Id.*

[20] Temp. Regs. § 1.6011-4T(b)(3)(ii)(D).

restructuring of a business or of an entity that is engaged in a business, or involves a recapitalization or an acquisition of capital for use in the taxpayer's business.[21/]

5. The Consequences of Disclosure or Lack of Disclosure

The Disclosure Regulations provide that filing the statement will not affect the legal determination of whether the tax benefits claimed are allowable.[22/] There is no specific penalty for failing to file the disclosure statement or retain the required records. Nevertheless, the Preamble to the Disclosure Regulations indicates that, if the transaction is successfully challenged, the failure to have filed the required disclosure may affect the determination of whether the taxpayer acted in good faith for purposes of the Section 6664 reasonable cause and good faith exception to the accuracy-related and fraud penalties of Sections 6662 and 6663.[23/]

B. The Registration Regulations

1. The Registration Requirement

The Registration Regulations "activate" the registration requirements of Section 6111(d), which has been dormant since its enactment in 1997. Under Section 6111, a transaction that meets the definition of a "tax shelter" must be registered with the Secretary. Prior to 1997, the determination of whether a transaction was a "tax shelter" was based solely on objective numerical criteria (such as the amount of money invested and the amount of the expected tax benefits). The Taxpayer Relief Act of 1997 extended the registration

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[21/] Temp. Regs. § 1.6011-4T(b)(3)(iii).

[22/] Temp. Regs. § 1.6011-4T(a)(1) (last sentence).

[23/] T.D. 8877.

requirement to transactions defined as tax shelters in new Section 6111(d), effective only to interests in such shelters offered after the Treasury prescribed guidance.[24/]

The Registration Regulations now supply this guidance by providing that a transaction is subject to registration pursuant to Section 6111(d) if it is a "confidential corporate tax shelter".[25/] A "confidential corporate tax shelter" is any transaction[26/] that satisfies the following three requirements:

(1) a significant purpose of the structure of the transaction is the avoidance or evasion of Federal income tax for a direct or indirect corporate participant, which is the case if

- (a) the transaction is a "listed transaction" (*i.e.*, the same as or substantially similar to one of the types of transaction that the IRS has identified as a "listed transaction");[27/]
- (b) the transaction "lacks economic substance," meaning that either
  - (i) the present value of the participant's reasonably expected pre-tax profit (after taking into account foreign taxes as expenses and transaction costs) from the transaction is insignificant relative to the present value of the participant's expected net Federal income tax savings from the transaction, or
  - (ii) if the substance of the transaction is a borrowing or acquisition of financial capital by a participant, the present value of the Federal income tax deductions of the taxpayer to whom the loan or financial capital is

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[24/] Sections 1028(a) and (e)(1) of the Taxpayer Relief Act of 1997.

[25/] Temp. Regs. § 301.6111-2T(a)(1).

[26/] For this purpose, a "transaction" includes "all of the factual elements necessary to support the tax benefits that are expected to be claimed with respect to any entity, plan, or arrangement, including any series of related steps carried out as part of a prearranged plan." Temp. Regs. § 301.6111-2T(a)(3).

[27/] Temp. Regs. § 301.6111-2T(b)(2).

provided "significantly exceeds" the present value of the pre-tax return of the person providing the loan or financial capital;[28] or

(c) the transaction is an "other tax structured transaction," meaning that both

(i) the transaction has been structured to produce Federal income tax benefits that constitute "an important part of the intended results" and

(ii) the tax shelter promoter (or other person who would be responsible for registration) reasonably expects the transaction to be presented "in the same or substantially similar form" to more than one potential participant;[29]

(2) the transaction is offered to any potential participant under conditions of confidentiality; and

(3) the tax shelter promoters may receive fees in excess of $100,000 in the aggregate.[30]

2. The Three Exceptions in the Registration Regulations

The three exceptions in the Registration Regulations are substantially identical to three of the four exceptions that are used in the Disclosure Regulations. None of these exceptions are available if the transaction is a "listed transaction".[31] The three exceptions are:

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[28] Temp. Regs. § 301.6111-2T(b)(3).

[29] Temp. Regs. § 301.6111-2T(b)(4).

[30] Temp. Regs. § 301.6111-2T(a)(2).

[31] Temp. Regs. § 301.6111-2T(b)(5)(i).

(1) Long-Standing Generally Accepted Exception: the promoter[32] reasonably determines that (a) the potential participant is expected to participate in the transaction in the ordinary course of its business[33] in a form consistent with customary commercial practice and (b) there is "a long-standing and generally accepted understanding" that the expected Federal income tax benefits from the transaction are allowable under the Code for substantially similar transactions.[34] This exception applies only to "other tax structured transactions" (*i.e.*, transactions described in (1)(c) above); it is not available for a transaction that "lacks economic substance" (*i.e.*, transactions described in (1)(b) above).

(2) No Reasonable Basis Exception: the tax shelter promoter (or other person that would be responsible for registration) "reasonably determines that there is no reasonable basis under Federal tax law for denial of any significant portion of the expected Federal income tax benefits".[35]

(3) IRS Determination Exception: the IRS makes a determination by published guidance, individual ruling[36] or otherwise that the transaction is not subject to registration.[37]

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[32] It should be clarified that the determination of whether this exception applies may be made by the promoter "or other person who would be responsible for registration", as it is in the case of the no reasonable basis exception under the Registration Regulations (described below). *Compare* Temp. Regs. § 301.6111-2T(b)(4) *and* Temp. Regs. § 301.6111-2T(b)(5)(i).

[33] The rule that a transaction is automatically considered to be part of the ordinary course of business if it involves the acquisition, disposition or restructuring of a business or of an entity that is engaged in a business or a recapitalization or an acquisition of capital for use in the taxpayer's business also applies for this purpose. Temp. Regs. § 301.6111-2T(b)(4)(i) (referring to Temp. Regs. § 1.6011-4T(b)(3)(iii)).

[34] Temp. Regs. § 301.6111-2T(b)(4).

[35] Temp. Regs. § 301.6111-2T(b)(5)(i).

[36] The Registration Regulations provide that taxpayers may request private letter rulings on whether a specific transaction is subject to registration. *See* Temp. Regs. § 301.6111-2T(b)(6). The Listing Regulations provide that the same procedure will be available to a person seeking guidance on whether an investor list must be maintained for a transaction.
(continued...)

3. When an Offer is Made under Conditions of Confidentiality

The Registration Regulations provide that an offer is made under conditions of confidentiality if

(1) "an offeree's disclosure of the structure or tax aspects of the transaction is limited in any way by an express or implied understanding or agreement with or for the benefit of any tax shelter promoter, ... whether or not such understanding or agreement is legally binding", or

(2) "any tax shelter promoter knows or has reason to know that the offeree's use or disclosure of information relating to the structure or tax aspects of the transaction is limited for the benefit of any person other than the offeree in any other manner, such as where the transaction is claimed to be proprietary or exclusive to the tax shelter promoter or any party other than the offeree."[38/]

Whether this test is met is determined under all the facts and circumstances.[39/]

As part of the revisions made in August, there is now an exception for "restrictions reasonably necessary to comply with [U.S.] federal or state securities laws" provided that "such disclosure is not otherwise limited".[40/] The Registration Regulations also provide the following rebuttable presumption: "Unless facts and circumstances clearly indicate otherwise, an offer is not considered made under conditions of confidentiality if the tax shelter promoter provides express written authorization to each offeree permitting the offeree (and each employee, representative, or other agent of such offeree) to disclose the structure

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[36/](...continued)
See Temp. Regs. § 301.6112-1T A-4(b).

[37/] Temp. Regs. § 301.6111-2T(b)(5)(ii).

[38/] Temp. Regs. § 301.6111-2T(c)(1). This definition is incorporated by reference into the Disclosure Regulations (Temp. Regs. § 1.6011-4T(b)(3)(i)(A)).

[39/] Temp. Regs. § 301.6111-2T(c)(1).

[40/] Temp. Regs. § 301.6111-2T(c)(2).

and tax aspects of the transaction to any and all persons, without limitation of any kind on such disclosure."[41/]

4. Penalties for Failure to Register

Section 6707, which was also revised in 1997, imposes a penalty on each person that is required to register a shelter, but fails to do so, or that files false or incomplete information with the registration. In the case of a confidential corporate tax shelter, the penalty is the greater of (i) $10,000 and (ii) 50% of the fees paid to all promoters with respect to offerings made before the shelter was registered.[42/] If the failure is due to reasonable cause, no penalty is imposed[43/] and, if the failure is intentional, the 50% is increased to 75%.[44/] If the person subject to the penalty is a participant required to register the shelter under Section 6111(d)(3), the amount of the penalty is determined by taking into account only the fees paid by that person.[45/]

C. The Listing Regulations

1. Requirement to Maintain a List of Investors

The Listing Regulations were issued under Section 6112 and are revisions to the existing Question and Answer ("Q&A") regulations of Temp. Treas. Regs. § 301.6112-1T. Section 6112, which was enacted in 1984 and was not amended in 1997, provides that any person that organizes or sells an interest in (i) a tax shelter that is subject to registration under Section 6111 or (ii) "any entity, investment plan or arrangement, or other plan or

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[41/] Temp. Regs. § 301.6111-2T(c)(3). This rebuttable presumption was substantially revised as part of the amendments made in August.

[42/] Section 6707(a)(3)(A).

[43/] Section 6707(a)(1).

[44/] Section 6707(a)(3)(A).

[45/] Section 6707(a)(3)(B)(ii).

arrangement which is of a type which is the Secretary determines by regulations as having a potential for tax avoidance or evasion" must maintain a list of each person to which an interest in the shelter was sold and any other information required by regulations.[46/]

Prior to the issuance of the New Regulations, the investor list maintenance requirement applied to a transaction only if it was subject to registration under Section 6111 or was a "projected income investment", which is generally an investment that satisfies the numerical tests under Section 6111(c) for registration but is exempt from registration during the period that the income from the investment exceeds the tax deductions or credits that it generates.[47/]

The Listing Regulations add to the list of transactions "having a potential for tax avoidance or evasion" for which investor lists must be maintained any transaction a significant purpose of the structure of which is the avoidance or evasion of Federal income tax (within the meaning of Section 6111(d) and the Registration Regulations) for any potential participant.[48/] The amendments made in August expanded this requirement so that it now applies regardless of the type (or types) of taxpayers the transaction is marketed to. Thus, a transaction marketed solely to individuals, solely to corporations or to both individuals and corporations is now potentially covered. Accordingly, the scope of transactions covered by the Listing Regulations is far broader than the Registration Regulations, since the Listing Regulations omit the requirements that the transaction generate tax savings for a corporation, that the transaction have been offered under conditions of confidentiality and that the promoters receive at least $100,000 in fees.

[46/] Sections 6112(a) and (b).

[47/] Temp. Regs. § 301.6112-1T A-4; Temp. Regs. § 301.6111-1T A-57A.

[48/] Temp. Regs. § 301.6112-1T A-4.

2. The *De Minimis* Fee and Tax Savings Exceptions

The August amendments added two *de minimis* exceptions to the listing requirements. Generally, a purchaser of an interest in the tax shelter is not required to be included on the list if either

(1) the total consideration paid to all organizers and sellers with respect to such person's acquisition of the interest is less than $25,000, or

(2) the "organizer reasonably believes" that such person's acquisition of the interest will not result in a reduction of the Federal income tax liability of (a) any corporation or corporations that exceeds (aggregating the savings of all such corporations) $1 million in any single taxable year or $2 million for any combination of taxable years and (b) any noncorporate taxpayer or taxpayers that exceeds (aggregating the savings of all such taxpayers) $250,000 in any single taxable year or $500,000 for any combination of years.[49/]

3. Penalties for Failure to Maintain an Investor List

Penalties for failure to maintain the list are provided in Section 6708 which, like Section 6112, was not amended in 1997. Under Section 6708, "any person who fails to meet any requirement imposed by section 6112 shall pay a penalty of $50 for each person with respect to whom there is such a failure", unless the failure is due to reasonable cause and not willful neglect. The maximum penalty for any calendar year is $100,000. Temporary Regulations under Section 6708, issued in 1984, provide that if an organizer or seller fails to provide the list to the IRS as soon as practicable or in a form that the enables the IRS to obtain the required information without undue delay or difficulty (as required by the existing

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[49/] Temp. Regs. §§ 301.6112-1T A-8(b), A-10 (last sentence) and A-17(a)(3). For purposes of determining if these thresholds are met, fees paid by and tax savings of all related persons (within the meaning of Section 267 or 707(b)) are aggregated. Neither *de minimis* exception is available for a transaction that is required to be registered, is a listed transaction or is a projected income investment.

temporary regulations under Section 6112[50]), the penalty will apply.[51] In addition, the Section 6708 regulations indicate that a person required to maintain a list could also be liable for a fine under Section 7203 for willful failure to supply information.[52]

IV. Comments on the New Regulations

A. Consequences of A Failure to File a Section 6011 Disclosure Statement

For the reasons discussed below, we recommend that the regulations provide that the failure to file a required disclosure statement give rise to a rebuttable presumption that the taxpayer did not act in "good faith" for purposes of applying the Section 6664(c) reasonable cause and good faith exception to the accuracy-related and fraud penalties imposed under Sections 6662 and 6663.

As noted above, the Disclosure Regulations do not impose any specific penalty for failing to disclose a reportable transaction (or retain the required records). Nevertheless, the Preamble and informal comments by IRS and Treasury personnel indicate that the Disclosure Regulations are intended to encourage disclosure and deterrence of inappropriate transactions by increasing the likelihood that the Section 6662 substantial understatement penalty will apply if a reportable transaction is not disclosed and the taxpayer's treatment is found to have been improper.

Specifically, the Preamble states that, if there is an underpayment resulting from the reportable transaction, the taxpayer's failure to satisfy the disclosure requirement "may affect its exposure to penalties under sections 6662 and 6663 of the Code". The Preamble goes on to say that in determining whether a taxpayer has acted in good faith, for purposes of the

[50] Temp. Regs. § 301.6112-1T Q&A-21.

[51] Temp. Regs. § 301.6708-1T Q&A-2.

[52] Temp. Regs. § 301.6708-1T Q&A-7.

Section 6664(c) reasonable cause and good faith exception to these penalties, "the non-disclosure could indicate that the taxpayer has not acted in 'good faith' with respect to the underpayment, even if the taxpayer's return position has sufficient legal justification to meet the minimum requirements of section 6664(c)(1)"[53/] and that "all the facts and circumstances, including the reason or reasons why the taxpayer failed to make the required disclosure" will be taken into account.[54/]

The Preamble to the Disclosure Regulations also indicates that the failure to file a required disclosure statement means that the tax return is incomplete since the disclosure statement is a "required part of the return to the same extent as information required pursuant to prescribed forms".[55/] This could be read to mean that the IRS may assert that the omission of a required disclosure statement should result in a taxpayer being treated as though it failed to file a return under Section 6651.

Finally, the Preamble provides that a taxpayer's verification of its tax return includes an affirmation that all disclosures required by the Disclosure Regulations have been made, suggesting that the taxpayer may be subject to penalties for a false verification.[56/]

Thus, although there is no *specific* penalty, it appears that there may well be a variety of potential negative consequences from failing to file a required disclosure. But precisely what those consequences may be and how and when they may be imposed is not clear. We believe that the Disclosure Regulations would be more effective if a failure to file had clear, specific and uniform consequences for all taxpayers.

[53/] These requirements are described in the following section of this Report.

[54/] T.D. 8877.

[55/] *Id.*

[56/] *Id.*

1. Background: Current Law with Respect to Substantial Understatement Penalties

In order to describe what we see as the benefits of our recommendation of a rebuttable presumption, we begin with a brief summary of the current substantial understatement penalty rules. Under current law, if a corporation enters into a transaction (including an investment) that results in a substantial understatement, two different sets of exceptions apply to imposition of the 20% substantial understatement penalty under Section 6662, depending upon whether the transaction is or is not a "tax shelter" within the meaning of Section 6662(d)(2)(C)(iii). A transaction is a tax shelter within the meaning of Section 6662(d)(2)(C)(iii) if "a significant purpose" of the transaction is the avoidance or evasion of Federal income tax.[57]

If the transaction is not a Section 6662(d)(2)(C)(iii) tax shelter, three exceptions to the 20% penalty are available:

(1) there was "substantial authority" for the taxpayer's treatment of the transaction;[58]

(2) the transaction was disclosed on the taxpayer's return and there was a "reasonable basis" for the taxpayer's treatment;[59] or

(3) there was reasonable cause for and the taxpayer acted in good faith with respect to its treatment of the transaction.[60] Under regulations, this is determined by taking into account all the pertinent facts and circumstances, but generally the most important factor is

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[57] This definition was significantly revised by the Taxpayer Relief Act of 1997, which substituted "a significant purpose" for "the principal purpose." *See* Pub. L. 105-34 § 1028(c)(2). The regulations have not been revised to reflect this change. *See* Regs. § 1.6662-4(g)(2) (referring to "the principal purpose").

[58] Section 6662(d)(2)(B)(i).

[59] Section 6662(d)(2)(B)(ii).

[60] Section 6664(c)(1).

"the extent of the taxpayer's efforts to assess the taxpayer's proper tax liability".[61] This standard may be satisfied by reasonable good-faith reliance on a professional tax advisor's opinion or advice, provided that the advice is based upon an application of the law to all the pertinent facts and circumstances (including the taxpayer's purpose for entering into the transaction) and does not rely upon any unreasonable factual or legal assumptions. Beyond these guidelines, there are no requirements as to the form of the advice (for example, it could even by given orally) or the degree of assurance of success that must be specified in the advice.[62]

If the transaction is a Section 6662(d)(2)(C)(iii) "tax shelter", only the reasonable cause and good faith exception is available; and, in determining whether the reasonable cause and good faith standards are met, the taxpayer's belief as to the merits of its position will be taken into account only if

(1) there was substantial authority (within the meaning of Treas. Regs. § 1. 6662-4(d)) for the corporation's treatment of the transaction; and

(2) the corporation reasonably believed that the treatment was more likely than not proper (*i.e.*, that there was a greater than 50% likelihood of success if the transaction was challenged), based either upon its own independent analysis or a "greater than 50% likelihood of success" opinion from a tax advisor.[63]

In addition, the Section 6664 regulations specifically provide that, if a transaction is a Section 6662(d)(2)(C)(iii) tax shelter, satisfaction of these two additional requirements (referred to as "minimum legal justification") may not establish the requisite reasonable cause and good faith, particularly if the transaction lacked significant business purpose, the tax benefits claimed were unreasonable in comparison to the taxpayer's investment or the

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[61] Regs. § 1.6664-4(b)(1).

[62] Regs. § 1.6664-4(c).

[63] Regs. §§ 1.6662-4(g)(4)(ii) and 1.6664-4(e).

taxpayer agreed with the organizer or promoter that the taxpayer would protect the confidentiality of the tax aspects of the transaction.[64/]

2. A Failure to Disclose or Retain Records Should Give Rise to a Rebuttable Presumption that "Good Faith" Was Lacking

As noted above, currently the consequences of failing to file a required disclosure are unclear. We believe that the Disclosure Regulations will be more effective at encouraging disclosure (as well as deterrence) of overly aggressive and tax-motivated transactions if the failure to disclose will have a specific negative consequence that may directly impact the cost of entering into the transaction. The effectiveness of the Regulations will also depend, however, upon insuring that the IRS is not inundated with disclosures of non-abusive transactions. Accordingly, the "penalty" for nondisclosure should be aimed at transactions where the tax benefits claimed were ultimately not sustained. Using a single penalty, aimed at transactions that have not been sustained on the merits, will also promote even-handed and uniform enforcement of the disclosure rules, which should foster a perception amongst taxpayers that the rules are reasonable and are being administered fairly.

Therefore, we recommend that a failure to disclose a reportable transaction or to maintain sufficient records give rise to a rebuttable presumption that the taxpayer did not act in "good faith" for Section 6664(c)(1) purposes.

We believe that the IRS has ample authority for this under current law. In fact, the existing regulations under Section 6664 almost go this far now. Not only do they set higher standards in the case of a transaction that is a Section 6662(d) tax shelter, they also provide that, even if those standards are met (*i.e.*, there was substantial authority and the taxpayer reasonably believed it had a 50% or greater likelihood of success), reasonable cause and good

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[64/] Regs. § 1.6664-4(e)(3). Thus, prior to the issuance of the New Regulations, if a transaction was a Section 6662(d) tax shelter, there was no apparent benefit from disclosing it on the taxpayer's return. After the definition of a Section 6662(d) tax shelter was broadened in 1997, this meant that there was essentially no voluntary disclosure of those types of tax-structured transactions that the IRS wanted to have brought to its attention.

faith may be lacking if the transaction (i) lacks a significant business purposes, (ii) generates tax benefits that are unreasonable in relation to the investment or (iii) there is a agreement to keep the structure confidential.

We also believe that a rebuttable presumption would not conflict with the intent of Section 6664(c)(1), which is to provide a possible exception to penalties for a transaction that falls within the Section 6662(d) definition of a "tax shelter". Because the proposed presumption would be rebuttable, it would not foreclose satisfying the exception. In addition, we expect that many of the same considerations will be relevant to the determination of whether the transaction was reportable as to whether the taxpayer acted in good faith and with reasonable cause. Specifically, as discussed in more detail below, whether a transaction is or is not a "reportable transaction" is dependent, in large part, upon the taxpayer's "reasonable determinations" as to whether any of the exceptions or the projected tax effect test set out in the Disclosure Regulations are met. For example, whether the projected tax effect test is met is based upon the taxpayer's reasonable determination as to the tax consequences of the transaction. If the taxpayer's determination that the test was not met is unreasonable, then an unreported transaction could become reportable. Similarly, whether any of the exceptions are met, including the exceptions that involve an assessment of the strength of the taxpayer's position, is dependent upon the taxpayer's reasonable determination; if the determination was unreasonable, the exception would not apply. Thus, it seems appropriate and fair to rebuttably presume that the taxpayer did not act in "good faith" if the taxpayer fails to establish that it made these determinations reasonably.

While we recognize that fear of the rebuttable presumption might result in over-disclosure by some taxpayers, we believe that the negative effects of some over-disclosure will be outweighed by the benefits of a rule that will more effectively encourage disclosure, as well as deterrence, by making the consequences of a failure specific, clear and significant. In addition, this rule would provide better guidance to the IRS and the courts as to how to take into account a failure to disclose and this will have the additional benefit of promoting taxpayer confidence in the fairness of the disclosure and penalty system.

As an alternative to a rebuttable presumption, we considered whether it would be appropriate and effective to make disclosure optional (for transactions other than listed transactions) but to provide that, if the transaction fit within the Disclosure Regulations' definition of a reportable transaction and the taxpayer failed to disclose it, a loss on the merits would result in strict liability for the Section 6662 substantial understatement penalty. The arguments in favor of such a rule include that it would be more effective at eliciting disclosure (since a non-disclosing taxpayer would face a bigger risk) and that it would be easier to administer. On the other hand, strict liability might result in a greater degree of over-disclosure, which would compromise the effectiveness of the Regulations; and the additional administrative efficiency of such a rule is likely to be minimal since the determination of whether a transaction is or is not a "reportable transaction" will still entail a fact-intensive inquiry of the application of the six factors and the reasonableness of the taxpayer's determinations as to the projected tax effect and the applicability of the exceptions.

We were also concerned as to whether such a rule would be consistent with Sections 6662 and 6664 which specifically reject an automatic penalty standard for a Section 6662(d)(2)(C)(iii) tax shelter. We are aware that the Treasury and the IRS have expressed concern regarding this issue in the past. While we share these concerns we believe that a strong argument can be made that it would be consistent with the statute, as well as the existing regulations under Section 6664, to provide that Section 6664 "good faith and reasonable cause" are *per se* lacking if there was no Section 6011 disclosure. Nevertheless, we recognize that it would be best if any such *per se* rule were instituted legislatively.

3. Consequences of Failure to Disclose or Maintain Records Should Be Stated Clearly in the Text of the Regulations

The only discussion of the consequences of a failure to file a required disclosure statement is in the Preamble to the Disclosure Regulations, rather than the Regulations themselves. Even if our rebuttable presumption recommendation is not adopted, the consequences or possible consequences of a failure to disclose a reportable transaction or retain the required records is an important aspect of the Regulations and therefore should be included in the text of the Regulations. This will increase taxpayer awareness, further encourage compliance with the disclosure and record retention requirements and legitimate the IRS's position in any future litigation that non-disclosure should be a relevant factor in determining if the Section 6664(c)(1) exception is met.

If our rebuttable presumption recommendation is adopted, we believe that the rebuttable presumption should be provided for in the Section 6664 regulations and that it should be cross-referenced in the Disclosure Regulations, as well as the regulations under Section 6001 (which governs record-keeping in general). If this recommendation is not adopted, we still believe that the Disclosure Regulations themselves should include the points made in the February Preamble and that the Regulations under Section 6001 and 6664(c)(1) should cross-reference this portion of the revised Disclosure Regulations.

As a related point, the current regulations under Section 6001 should cross-reference the detailed record retention requirements in the Disclosure Regulations,[65/] which the Preamble indicates were issued in part under Section 6001.

We also recommend that the Section 6664 regulations provide that the fact that a transaction was properly disclosed under Section 6011 should not be taken into account in determining if the taxpayer acted with reasonable cause and in good faith under Section 6664. The clear intent of Sections 6662 and 6664 is to eliminate the use of disclosure to

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[65/] Temp. Regs. § 1.6011-4T(e).

avoid penalties with respect to a transaction that is a Section 6662(d)(C)(iii) "tax shelter", which a reportable transaction will almost invariably be.

We think it is important that the regulations clarify that the failure to file a required disclosure statement will not be treated as a failure to file a tax return under Section 6651. While we believe that this would be the result under current law, a clarification would be helpful. We also request clarification of the statement in the Preamble that the signature on the return is a verification that any required disclosure statement has been included. If this is intended to mean that the taxpayer or the return preparer could be subject to other penalties for failing to include the disclosure statement, this should be stated clearly and the potential penalties specified.

B. The Disclosure Regulations: Comments on the Six Indicia and the Projected Tax Effects Test

1. Clarification of the Six Tax Shelter Indicia is Necessary to Ensure that the "Two-of-Six" Test Serves Its Intended Purposes

We understand that the purpose of the two-out-of-six test is to provide an objective means of identifying transactions that the IRS might want to subject to careful scrutiny. The six criteria are intended to be features that are common to tax shelters and that may indicate that the transaction involves an inappropriate avoidance or evasion of Federal income tax. Because these criteria may be present in many legitimate business transactions where tax benefits are not being claimed inappropriately, the Disclosure Regulations include the four exceptions, which ideally will distinguish legitimate, well-supported transactions from the questionable transactions that the IRS would be interested in reviewing.

In order for the Disclosure Regulations to work as intended it is important that (i) the six "objective" factors be clear enough that it can be determined with a fair degree of certainty whether each factor is or is not present in a transaction, (ii) that the factors not be so broad or overlapping that the two-or-more test is met for such a large number of transactions that the test becomes essentially meaningless, (iii) that the exceptions not be so narrow that they do not filter out transactions that should not be subject to special scrutiny and (iv) that the exceptions be clear and specific enough that determining whether or not they apply is relatively straightforward. If the requirements are ambiguous, unworkable or perceived to be overly broad, the likely results will be noncompliance in some cases and significant over-disclosure in others, to the detriment of both taxpayers and the IRS.

In this section we focus on the six factors, and then after, discussing the projected tax effect test and the transaction aggregation rules, we will turn to the four exceptions. While we generally agree the six factors are common to tax shelter transactions, we believe that certain clarifications and revisions are necessary.

a. Factor 1: Conditions of Confidentiality

The confidentiality factor is present if the taxpayer has participated in the transaction under conditions of confidentiality. The Disclosure Regulations provide that "conditions of confidentiality" has the same meaning for this purpose as it has in the Registration Regulations.[66/] Under the Registration Regulations, a transaction is not required to be registered unless it is offered to any potential participant under conditions of confidentiality; this requirement is imposed by Section 6111, which also provides a definition of conditions of confidentiality.[67/] The definition in the Registration Regulations is based upon the statutory definition. Although there is no statutory requirement that this same definition be used in the Disclosure Regulations, we agree with the decision to provide a single definition for both purposes.

[66/] Temp. Regs. § 1.6011-4T(b)(3)(i)(A) (cross-referencing Temp. Regs. § 301.6111-2T(c)).

[67/] Section 6111(d)(2) provides that an offer is considered made under conditions of confidentiality if (i) the offeree or its agents has "an understanding or agreement with or for the benefit of any promoter of the tax shelter that" the offeree or its agent "will limit disclosure of the tax shelter or any significant tax features of the tax shelter" or (ii) the tax shelter promoter claims, knows or has reason to know, knows or has reason to know that another person other than the offeree is claiming or causes any person to claim that "the tax shelter (or any aspect thereof) is proprietary to any person other than the potential participant or is otherwise protected from disclosure to or use by others."

The definition in the Registration Regulations was substantially revised in the August amendments in response to formal and informal comments made to Treasury and IRS personnel regarding the February version of the New Regulations. We commend the Treasury and the IRS for reacting so swiftly and directly to the concerns raised by taxpayers and practitioners. We also recognize how difficult it is to craft a workable definition of "conditions of confidentiality" given the endless variety of factual scenarios that can be posed and the myriad of issues raised. While the August amendments go a long way towards clarifying and refining the definition, several open issues and ambiguities remain.

i. Summary of the confidentiality rules

As revised, the Registration Regulations provide that an offer is made under conditions of confidentiality if

(1) "an offeree's disclosure of the structure or tax aspects of the transaction is limited in any way by an express or implied understanding or agreement with or for the benefit of any tax shelter promoter, ... whether or not such understanding or agreement is legally binding", or

(2) "any tax shelter promoter knows or has reason to know that the offeree's use or disclosure of information relating to the structure or tax aspects of the transaction is limited for the benefit of any person other than the offeree in any other manner, such as where the transaction is claimed to be proprietary or exclusive to the tax shelter promoter or any party other than the offeree."[68]

The Registration Regulations also provide the following rebuttable presumption: "Unless facts and circumstances clearly indicate otherwise, an offer is not considered made

[68] Temp. Regs. § 301.6111-2T(c)(1) (incorporated by reference in Temp. Regs. § 1.6011-4T(b)(3)(i)(A)). The August revisions amended clause (2) of this definition; in the February version of the Disclosure Regulations, clause (2) read as follows: "the tax shelter promoter knows or has reason to know that the transaction is protected from disclosure or use in any manner, such as where the transaction is claimed to be proprietary to the promoter or any party other than the offeree." Temp. Regs. § 301.6111-2T(c)(1) (prior to August 11, 2000).

under conditions of confidentiality if the tax shelter promoter provides express written authorization to each offeree permitting the offeree (and each employee, representative, or other agent of such offeree) to disclose the structure and tax aspects of the transaction to any and all persons, without limitation of any kind on such disclosure."[69/]

ii. The "structure or tax aspects of the transaction" should include only features necessary to understand the U.S. Federal income tax analysis

First, the definition and the presumption hinge on whether the restrictions on disclosure or use relate to the "structure or tax aspects of the transaction".[70/] What is the "structure" of the transaction for this purpose? Does it include aspects of the transaction that have no relationship to the U.S. tax treatment of the parties? Prior to the August revisions, this phrase was used only in clause (1) of the definition set forth above. Clause (2) of the definition referred to "the transaction" being proprietary or being subject to limitations on use or disclosure; and the presumption required authorization to disclose "every aspect of the transaction". Thus, the replacement of these broader phrases with the narrow phrase, "structure or tax aspects", appears to have been intended to potentially narrow the range of information being referred to.

The Registration Regulations (like the Disclosure Regulations) define the term "transaction" as including "all the factual elements necessary to support the tax benefits that are expected to be claimed with respect to any entity, plan, or arrangement, including any series of related steps carried out as part of a prearranged plan".[71/] Should the "structure of a transaction" mean "all the factual elements necessary to support the U.S. Federal income tax benefits that are expected to be claimed"?

[69/] Temp. Regs. § 301.6111-2T(c)(3).

[70/] Temp. Regs. §§ 301.6111-2T(c)(1) and (3).

[71/] Temp. Regs. § 301.6111-2T(a)(3).

In other words, for the two-out-of-six disclosure test, should an agreement not to disclose or use an aspect of the structure that has no relationship to the U.S. tax benefits be considered an indicator of a tax shelter? In the registration context, should the confidentiality feature that is a statutory prerequisite to registration be present if the taxpayer is restricted from disclosing only aspects of the transaction that have no relationship to the U.S. tax benefits? We recognize that the underlying policy reason for the confidentiality tests is to facilitate IRS and Treasury discovery of potentially abusive transactions -- the confidentiality tests do this by either causing (together with other factors) disclosure under the Disclosure Regulations or registration under the Registration Regulations or by resulting in the voluntary elimination by the promoter or organizer of the confidentiality requirement.[72/]

Given these goals, should an agreement between two taxpayers or a promoter and a taxpayer to not reveal an aspect of the structure that resolves a foreign legal or tax issue or a regulatory issue or a state or local tax issue trigger disclosure or registration of the transaction? One on the one hand, we are sympathetic to promoters and taxpayers that want to maintain confidentiality with respect to aspects of the structure that have no relationship to the U.S. tax consequences. On the other hand, we recognize that in many cases it may not be so clear that certain aspects of the structure did not contribute to the U.S. tax benefits. For example, take a cross-border transaction where the promoter developed a novel way of solving a foreign regulatory restriction and the promoter wants to impose a restriction on disclosure of this solution. If the transaction could not have proceeded without this solution, did this aspect of the structure contribute to the U.S. tax benefits? Should the IRS and Treasury care whether the promoter's solution is subject to confidentiality?

If the purpose of discouraging confidentiality agreements is to make it more likely that the taxpayer will actually tell other persons about the transaction, for example, other potential organizers or other potential counterparties, then the answer is yes. Arguably,

[72/] Of course, the elimination of the confidentiality requirement does not ensure that the transaction or its details will become public knowledge.

however, it is not appropriate for the Treasury and the IRS to attempt to influence disclosure of non-U.S. tax aspects of transactions.[73/]

Taking all of these factors into account, we believe that "confidentiality" should be an indicator of a tax shelter for purposes of the Disclosure and Registration Regulations only if the confidentiality relates to features of the transaction that are necessary to an understanding of how the intended U.S. Federal income tax benefits are derived. We think it might be helpful to think of this in terms of the redactions that would be made from the publicly-released version of an IRS private letter ruling. Thus, any information that is not necessary to understand the U.S. Federal income tax analysis can be subject to confidentiality, including the names of the parties involved, dates, the specific jurisdictions involved, detailed information regarding the assets involved, structural aspects that have no effect on the U.S. tax consequences, the subject matter or content of any governmental or regulatory rulings or relief requested or received (whether or not such rulings relate to taxes),[74/] intellectual property and other proprietary information unrelated to the U.S. Federal income tax aspects of transaction, such as commercial secrets, know how and trade secrets, the content of any "fairness" or similar types of opinions or appraisals regarding the transaction and, in most cases, the amount of money and rates of return, if any, involved.

We also think the Regulations should clarify that a customary agreement requiring the parties to the transaction to coordinate and agree upon the content and timing of public

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[73/] Moreover, now that the Regulations seem to provide that an organizer can require a potential participant to enter into an exclusivity agreement (if coupled with an unfettered right to disclose) without triggering this factor, voluntary disclosure by taxpayers will be rare since the most likely type of disclosure -- that is, disclosure to a competing organizer that might charge a smaller fee -- will be forestalled by the monetary "exclusivity" penalty.

[74/] We believe this should apply to tax rulings, as well as non-tax rulings, because a taxpayer may have a legitimate interest in not disclosing that it was the recipient of ruling, particularly where the ruling request and the ruling are open to public inspection and include non-tax information about the parties or the transaction that the taxpayer would not want to have publicly associated with it.

disclosures (such as formal press releases) and filings with applicable authorities (whether before or after the transaction is consummated) is not a condition of confidentiality. This rule would not apply, however, if the agreement were used as a means of imposing confidentiality, for example by insuring that the transaction was never disclosed by refusing to agree on the timing and content of a press release or other public disclosure.

iii. Restrictions imposed by law, whether foreign or domestic, should not be considered conditions of confidentiality

The August revisions added the "securities law exception" which provides that an "offer is not considered made under conditions of confidentiality if disclosure of the structure or tax aspects of the transaction is subject to restrictions reasonably necessary to comply with federal or state securities laws and such disclosure is not otherwise limited".[75/] The exception would apply if the taxpayer and organizer entered into an agreement to limit disclosure "to the extent necessary in order to not violate any U.S. Federal or state securities laws"; and it would also appear to apply if the agreement were more specific, such as an agreement to "not disclose the transaction prior to the date of the first public filing with the Securities and Exchange Commission" (a "specific agreement"). The exception is explicitly limited to restrictions imposed by U.S. Federal or state securities laws and thus excludes restrictions imposed by non-U.S. securities law, and U.S. and non-U.S. laws that are not securities laws.

We believe that the Regulations should clarify that the mere existence of legal restrictions on disclosure, whether imposed by U.S. Federal or state or foreign laws, administrative authorities or self-regulatory organizations (such as the National Association of Securities Dealers) are not conditions of confidentiality. In other words, that a "condition of confidentiality" means a condition imposed or agreed upon by the parties involved. It would be both unfair and unadministrable for the IRS to consider "confidentiality" triggered simply because there is a external legal requirement that prohibits or limits disclosure.

[75/] Temp. Regs. § 301.6111-2T(c)(2).

Moreover, we do believe that such a result was not intended by the drafters of Section 6112 or the New Regulations.

That being said, we have a hard time finding a justification for triggering the confidentiality factor if the parties enter into an agreement to comply with all limitations on disclosure imposed by any applicable law or any self-regulatory organization. We recognize that an agreement that spells out the particulars of such limitations (*i.e.*, an agreement like the "specific agreement" referred to above) raises administrability concerns because it complicates the inquiry into whether the confidentiality agreement is broader than the external legal requirements. Therefore, we support the decision to limit "specific agreements" to those describing limitations imposed by U.S. Federal and state securities laws. Nevertheless, we believe that general agreements to comply with other legal restrictions (whether or not specified by name) should not be considered confidentiality agreements, and that taxpayers and organizers should be entitled to describe, in the agreements, their common understanding of the limitations imposed by those external laws, providing that the actual restrictions imposed by the contract depend ultimately on the scope of the underlying law and not any such "understandings" of the parties.

We believe that these clarifications and changes would not compromise the effectiveness of the New Regulations and would reduce the likelihood that this factor will interfere with legitimate agreements to abide by applicable laws. We also note that the failure to allow parties to explicitly agree to abide by foreign law restrictions may inappropriately discourage cross-border transactions.

iv. Limitations on use and the rebuttable presumption

Another source of confusion is the inclusion in the definition of a "condition of confidentiality" of the phrase "a limitation on use". The confidentiality provision essentially has two alternative triggers: the first, a limitation on disclosure, and the second, a limitation on use. The Preamble to the August revisions provides that the Treasury and the IRS believe that an agreement requiring an offeree to pay fees to the promoter if the offeree engages in the transaction, whether or not the offeree uses the service of the promoter (referred to in the Preamble to the August revisions as an "exclusivity agreement") is a limitation on "use" and thus within the scope of Section 6111(d)(2)(B). The revised Regulations are intended to clarify this by adding "or exclusive" to clause (2) of the definition of conditions of confidentiality set forth above.

The Preamble to the August revisions indicates, however, that the existence of an exclusivity agreement is not the end of the story: "an exclusivity arrangement ordinarily will not result in an offer being made under conditions of confidentiality if the tax shelter promoter provides express written authorization ....[to] each offeree to disclose the structure and tax aspects of the transaction to any and all persons, without limitation of any kind on such disclosure."[76/] Thus, it appears that an exclusivity agreement is "ordinarily" permissible if the terms of the rebuttable presumption are met.

We have two concerns regarding these clarifications of the consequences of a limitation on use. First, the Treasury and the IRS should clarify what the "ordinarily" means. The purpose of the rebuttable presumption is to give taxpayers some degree of comfort in determining that the confidentiality condition is not met. The point of the Preamble seems to be that a garden-variety exclusivity agreement, without more, plus a written authorization for full and free disclosure is not a "condition of confidentiality". If that is the intent, or if something else is intended, it should be clarified.

Relatedly, we think that the rebuttable presumption is flawed because it address only one of the two alternative confidentiality triggers, *i.e.*, disclosure. Even though a restriction on either disclosure or use can cause the factor to be met, the presumption appears to apply if the promoter authorizes unfettered disclosure -- regardless of the limits imposed on use. Yet, the Preamble indicates that a restriction on use may be a "condition of confidentiality". To further complicate matters, the presumption begins "Unless the facts and circumstances provide otherwise". The Preamble can be fairly read to say that an exclusivity agreement

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[76/] T.D. 8896 (Emphasis added.)

would not be such a fact and circumstance, but this is not beyond argument and it certainly is not clear from the Regulations themselves. And suppose there was a limitation on use that was broader than a standard exclusivity agreement, would this outweigh the presumption? The Regulations should explicitly describe the types of restrictions on use which would be within the presumption.

Finally, we think it should be clarified as to how the presumption can be rebutted. For example, is it rebutted solely by evidence that, notwithstanding the written authorization for free-disclosure, the parties had orally agreed not to disclose the transaction? Or is it instead rebuttable by evidence that the promoter or a third party may consider the structure to be "proprietary"? If so, should it be necessary that the taxpayer was aware of this fact?

b. Factor 2: "Contractual Protection Against Possibility that Tax Benefits Will not be Sustained"

The Disclosure Regulations provide that this factor is met if

> The taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax benefits will not be sustained, including, but not limited to, rescission rights, right to a full or partial refund of fees paid to any person, fees that are contingent on taxpayer's realization of tax benefits from the transaction, insurance protection with respect to the tax treatment, or a tax indemnity or similar agreement (other than a customary indemnity provided by a principal to the transaction that did not participate in the promotion of the transaction to the taxpayer).[77]

While we agree that certain types of contractual protections against loss of intended tax benefits are an indicium of a tax shelter, we believe that the scope of this factor needs to be clarified. There are essentially four types of contractual protections that could be given to a tax shelter participant:

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[77] Temp. Regs. § 1.6011-4T(b)(3)(i)(B).

(1) the fees are paid up-front and, if the transaction is successfully challenged, the taxpayer is reimbursed in whole or in part for any previously paid fees and/or any additional taxes;

(2) the fees are to be paid out over the life of the transaction and, if the transaction is successfully challenged, the taxpayer has the right to shut down the transaction and thus avoid paying any additional fees and avoid the undesirable tax consequences going forward;

(3) the fees are paid up-front and, if the transaction is successfully challenged, the taxpayer has the right to shut it down and thus avoid the undesirable tax consequences going forward; and

(4) the taxpayer enters into a separate transaction to hedge all or part of its exposure on the tax shelter transaction.

i. The right to receive a reimbursement of fees or taxes or to cease paying fees if tax benefits are not sustained should constitute "contractual protection"

With respect to the first type, a right to be reimbursed for additional taxes should clearly be covered. If the taxpayer has a right to be reimbursed for previously paid fees and this right is triggered by a successful challenge to the claimed tax results or an early termination of the transaction as a result of a change in the tax law that affects the intended tax results, that should also be covered. It should be clarified, though, that the right to the fee refund must be triggered by an actual loss of the intended tax benefits (in whole or in part) or an early termination of the transaction as a result of a change in the tax law.

With respect to the second type, we believe that the second type should also be covered but only if the fees that are being paid over time relate to services incident to designing, establishing and/or marketing the shelter ("organizational fees") and the early termination is triggered by a successful challenge to the tax benefits or a change in law that threatens the tax benefits. The payment of those types of fees over time has the same effect as an up-front payment followed by a partial refund if the transaction is shut down early. We do not believe that this factor should be triggered, however, if the fees paid over time are attributable to services or property that are being provided over time. We recognize that organizational fees may be imbedded in other consideration that is paid over time, such as interest on borrowings, rents or royalties for the use of property or fees for management or administrative services. In that case, we believe that any off-market component of those payments should be treated as organizational fees. While we recognize that identifying the off-market component may be difficult, we think such a rule is necessary because otherwise this factor would be present any time the organizer or promoter provides any funds, property or services during the life of the transaction.

ii. The right to terminate a transaction or the existence of an arms' length hedge should not constitute "contractual protection"

If, however, the only contractual protection is a type (3) right to shut-down and prevent any undesirable tax results in the future, we believe the contractual protection factor should not be triggered. It is not clear whether the drafters had this kind of early termination right in mind when they referred to "rescission rights". We understand a "rescission" to mean an agreement that "un-does" or reverses a transaction so that the transaction is treated as never having occurred at all. This is different from an earlier termination or un-winding of a transaction, usually referred to as a "tax-call" when it is triggered by a change in tax law or a challenge to the intended tax results. The Regulations should clarify what is meant by "rescission rights" and provide that a tax-call, without a right to any reimbursements from the organizer, will not result in this factor being met.

Similarly, we believe that a hedge should not be considered to be a contractual protection of this type, unless it is entered into with the promoter and has an off-market component that serves as a means of providing for a reimbursement of fees or tax costs.

c. Factor 3: Fees Paid to Promoters Factor

This factor is met if one or more persons that promoted, solicited or recommended participation in the transaction to the taxpayer have received or are expected to receive fees or other consideration in excess of $100,000 and such person or persons' entitlement to the fees or other consideration is contingent upon the taxpayer's participation.[78]

Our primary concern with this factor is that as drafted it basically turns the two-out-of- six test into a one-out-of- five test: in almost every transaction we believe it will either definitely apply or taxpayers, lacking certainly, will have to assume it applies. We agree that payments of contingent fees to promoters are indeed an indicator of a tax shelter and thus we suggest that the factor be revised and clarified as follows.

i. Only fees paid to "promoters" as defined under the revised Listing Regulations and for promotional activities should be considered

We are concerned that the reference to persons that "recommended" the transaction could be interpreted as including persons that simply provide advice or opinions regarding a transaction (whether they be legal opinions, fairness opinions or appraisals) for a fee and the fee could be considered "contingent upon the taxpayer's participation" in that the services would not be necessary or would not be as extensive if the transaction were not completed. We do not think that fees paid to these types of service providers should be included. Therefore, we recommend that this factor take into account fees paid only to persons that qualify as "promoters" under the Listing Regulations. As discussed further below, this should exclude persons that provided professional advice or services but do not engage in marketing or designing the transaction.

The Regulations refer to fees or "other consideration" received by persons that "promoted, solicited, or recommended" the taxpayer's participation in the transaction. This seems intended to be limited to *promotional* as opposed to *organizational* services. Thus, if the person that designed, organized, or established the tax shelter is not the person that promoted, solicited or recommended it to the taxpayer, only the fees paid to the latter person are taken into account for this purpose. This should be clarified. In addition, as noted above, the persons that promoted the transaction may also provide funding, property or services

[78] Temp. Regs. § 1.6011-4T(b)(3)(i)(C).

during the term of the transaction. We believe that this factor should apply with respect to fees paid for the promotional services only, including any off-market component of any other payments that are really payments for promotional services.

ii. The threshold dollar amount should be raised to $500,000

We recognize that the benchmark of $100,000 in fees to promoters is included in Section 6111(d) (in defining confidential corporate tax shelters that are subject to registration), but there is no requirement that the same dollar amount be used here. We believe this number is too low in the context of the Disclosure Regulations, where a transaction that has two of the six factors must result in a tax savings of at least $5 million in any single year or $10 million in any combination of years to be subject to disclosure. We agree that a large fee paid to a promoter is an indicator of a tax shelter, but $100,000 sets the bar too low. Therefore, we recommend that the threshold be raised to $500,000. If, however, the fees that are taken into account are not limited to fees for promotional as opposed to organizational activities, we would recommend that the dollar amount be raised to $1 million.

iii. Clarify how the amount of fees paid is determined

As discussed in more detail below, the Registration Regulations provide specific guidelines for determining if the $100,000-in-fees-to-promoters requirement under Section 6111(d) is met. These guidelines include a rule that the fees from all substantially similar transactions are aggregated and a rebuttable presumption that the promoters will receive fees in excess of $100,000 unless it can be shown otherwise.[79/] It is not clear if these rules are also intended to apply for purposes of the Disclosure Regulations' fees-to-promoters test. We have two concerns about using these guidelines in the context of the Disclosure Regulations. First, the requirement that all substantially similar transactions be aggregated, regardless of when they are entered into, conflicts with the rule used in measuring the projected tax effects

[79/] Temp. Regs. §§ 301.6111-2T(d) and (g)(2)(vi)(A).

under the Disclosure Regulations. That rule applies aggregation only in the case of "any series of substantially similar transactions entered into in the same taxable year".[80/] Second, applying the presumption in the case of the Disclosure Regulations would again turn the two-of-six test into a one-of-five test. If the presumption is to apply for this purpose, we recommend that the Regulations include a nonexclusive list of examples of how the presumption may be rebutted.

d. Factor 4: Book/Tax Difference of More Than $5 Million

This factor is present if the expected treatment of the transaction for Federal income tax purposes in any taxable year differs or is expected to differ by more than $5 million from the treatment of the transaction for the purposes of determining book income as taken into account on the taxpayer's Schedule M-1.[81/] We recommend that, in determining whether the $5 million threshold is met (i) specific book/tax differences that are clearly contemplated by the Code or Treasury Regulations not be taken into account and (ii) book/tax differences that will reverse within five years (without any additional action) not be taken into account.

i. Book/tax differences specifically contemplated by the Code or Treasury Regulations should be excluded

The Regulations should identify certain book/tax differences that will not be taken into account because they are specifically contemplated by the Code or existing Treasury Regulations, including differences arising from treating foreign tax credit inclusions under Section 902 (and Section 1248) as "deemed dividends", including subpart F income and passive foreign investment company qualified electing fund inclusions into income and excluding from income distributions of "previously taxed income", recognizing dividend income under Section 304 or 305, and the different tax and book treatment of employee stock options, ESOPs and other employee benefits. We also believe the list should refer to any

[80/] Temp. Regs. § 1.6011-4T(b)(1).

[81/] Temp. Regs. § 1.6011-2T(b)(3)(i)(D).

imputed dividends and tax credits arising under a U.S. tax treaty, such as the income tax treaties with the U.K. and France.

ii. Book/tax differences that reverse automatically within five years should be excluded

With respect to other book/tax differences, we believe that book/tax differences that are merely a matter of timing and are reversed within a relatively short period of time are not a significant indicator of tax shelter activity. Many differences in book and tax accounting have developed to address the different policies and goals of tax computations and financial statement computations.[82/] Where the difference is only temporarily it seems to us to be far less likely to indicate that the tax benefits are inappropriate. We recognize, however, that book/tax difference that are merely a timing matter may be present in many abusive transactions. Accordingly, we recommend that book/tax differences that the taxpayer reasonably believes will reverse, without any further action by the taxpayer, within at least five taxable years be disregarded.[83/] This is the same number of years that was used to phase-in the Section 481(a) adjustments when the mark-to-market rules of Section 475 were enacted. Because the Disclosure Regulations incorporate an annual test to determine if a transaction that was not initially "reportable" has become "reportable," if the difference has not actually reversed after the end of the fifth year, or the taxpayer determines, in an earlier year, that it will not reverse by the end of the fifth year, the book/tax difference factor would at that time be triggered.

We believe that, in light of the other factors and the two-out-of-six test, this change would not compromise the effectiveness of the Regulations at picking out transaction that

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[82/] For example, there may be differences in the timing of income and deductions due to mark-to-market adjustments (whether they be for tax or financial accounting purposes), tax-free transactions, different depreciation schedules or rules regarding write-offs, or as a result of using "purchase accounting" or "pooling accounting" for an acquisition.

[83/] Some of our members felt that this period should be far longer, such as 15 years, by analogy to the 15 year period for amortization under Section 197.

warrant scrutiny and would help in minimizing the likelihood of over-disclosure. We also note that the IRS will continue to receive annual reporting of all book/tax differences on corporate taxpayers' Schedule M's.

e. Factor 5: The "Participation of a Person in a Different Tax Position"

This factor is present if the transaction involves the participation of a person the taxpayer knows or has reason to know is in a different Federal income tax position than the taxpayer and the taxpayer knows or has reason to know that such difference in tax position has permitted the transaction to be structured on terms that are intended to provide the taxpayer with more favorable Federal income tax treatment than it could have obtained without the participation of such person (or another person in a similar tax position).[84/] The Regulations provide only two examples of a person in a different tax position: a tax-exempt entity and a foreign person.

There are two elements to this factor: first, the other person must be in a "different tax position" and second, that difference must have made it possible to structure the transaction so as to provide the U.S. taxpayer with more favorable U.S. Federal income tax treatment.

i. The meaning of a "different tax position" should be clarified

The meaning of a person in a different tax position should be clarified. For example, does it apply if the other party is on mark-to-market accounting (under Section 475), has a different functional currency under Section 985, has excess foreign tax credits or expiring net operating losses; or, if one party has recently realized a large capital gain and the other has net losses? What if one party is a regular subchapter C corporation and the other is an individual (or a partnership with individual partners or an S corporation)? We believe that if the meaning of a "different tax position" is defined this broadly it will apply in virtually

[84/] Temp. Regs. § 1.6011-4T(b)(3)(i)(E).

every case, as two taxpayers are rarely in exactly the same position. Nevertheless, we believe that tax shelters often depend upon bringing together two taxpayers with what might be thought of as "complementary positions" and thus limiting this factor to persons with a different overall tax status will not cast the net wide enough.

We propose therefore that it be clarified that two persons are in "different tax positions" if they are subject to different rules or tax rates with respect to the items generated by the transaction or have different tax attributes that are relevant to the tax consequences of the transaction to them.

ii. The different tax position should be significant to the structuring or should result in significantly more favorable tax treatment

We also recommend that the second prong of the test be more narrowly targeted so that the factor is present only if the taxpayer knew or should have known that this difference was a *significant* factor in structuring the transaction so as to provide the taxpayer with more favorable Federal income tax treatment or, alternatively, that this difference resulted in *significantly* more favorable Federal income tax treatment for the taxpayer. While we recognize that these proposals add complications, we believe that this would make the factor more workable by permitting taxpayers to ignore differences in tax positions unless the differences play a significant role in generating the $5 million or $10 million of tax benefits that are necessary to pass the projected tax effect threshold.

f. Factor 6: Different Foreign Tax Treatment

i. Because this factor overlaps with the book/tax-difference and different-tax-position factors, this factor should be an alternative to those factors

The different foreign tax treatment factor is present if the expected characterization of any significant aspect of the transaction for Federal income tax purposes differs from the expected characterization of such aspect for purposes of the taxation of any party to the transaction in another country.[85] While we agree that this is a feature that is common to many tax shelters, we believe that if this factor is present, the book/tax difference factor or the taxpayer in a different tax position factor will invariably also be present. We think this factor should be retained, but as an alternative to the book/tax difference and different tax position factors. In other words, this factor would continue to count as one factor, unless the *other* factor that was present was the book/tax difference or person in a different tax position factor.

ii. Clarify that an aspect of the transaction is "significant" if it is significant to the threshold tax savings

Unlike the person in a different tax position factor, the presence of this factor is not dependent upon the difference in the U.S. and foreign treatments being relevant to the ability of the parties to agree upon a structure that results in the U.S. tax benefits for the U.S. taxpayer. Nevertheless, the difference must relate to a "significant aspect of the transaction". The Regulations should be clarified that an aspect of the transaction is "significant" for this purpose if it significant to generating the $5 million or $10 million of U.S. Federal tax savings for the U.S. taxpayer.

It should also be clarified whether a difference in the "characterization of any significant aspect of the transaction" includes differences in the timing, amount or source of items of income, gain, deduction or expense, as well as differences in the entity classification of parties to the transaction (*i.e.*, as separate corporations, branches or pass-throughs).

2. The Projected Tax Effect Test of the Disclosure Regulations

a. The Regulations' Rules for Determining the Projected Tax Effect

As indicated above, the projected tax effect test is met if the taxpayer reasonably estimates that the transaction will reduce the taxpayer's U.S. Federal income tax liability by

[85] Temp. Regs. § 1.6011-4T(b)(3)(i)(F).

more than $1 million in a single year or by a total of more than $2 million in any combination of years, if the transaction is "listed transaction", and more than $5 million in any single year or more than $10 million in any combination of years, if the transaction is not a "listed transaction".[86] The Disclosure Regulations provide that the projected tax reduction is determined in accordance with the following rules:

(1) In determining whether the multiple-year thresholds are met, only years in which taxes are estimated to be reduced are taken into account.[87]

(2) The amount of the reduction in Federal taxes from a transaction is the amount by which the taxpayer's Federal income taxes would be increased if the tax treatment claimed was disallowed.[88]

(3) The estimate of the effect of a transaction on a taxpayer's Federal income tax liability must take into account "all projected Federal income tax consequences, including all deductions, exclusions from gross income, nonrecognition of gain, tax credits, adjustments (or the absence of adjustments) to the basis of property, and any other tax consequences that may reduce the taxpayer's Federal income tax liability by affecting the timing, character or source of any item of income, gain, deduction, loss, or credit."[89]

(4) The estimate may not take into account income resulting from the transaction if the elements of the transaction that result in the creation of the income are "not necessary to achieve the intended tax results, whether or not these elements are an integral part of the transaction."[90] The Regulations include, as an example, that "gross income may not be taken into account to the extent that it would have been reasonably possible for the taxpayer to have participated in the transaction in a manner that would have been expected to produce

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[86] Temp. Regs. § 1.6011-4T(b)(4)(i).

[87] *Id.*

[88] Temp. Regs. § 1.6011-4T(b)(4).

[89] Temp. Regs. § 1.6011-4T(b)(4)(ii).

[90] *Id*.

less gross income without a commensurate effect on the other tax consequences of the transaction."[91/]

(5) The estimate may not take into account gain on property that the taxpayer acquired independent of its participation in this transaction.[92/]

(6) The estimate may not take into account alternative transactions that the taxpayer might have entered into in place of this transaction.[93/]

i. Clarify how the test works and the intended roles of Rules (4) and (5)

Rule (1) is significant because it means that transactions that generate only a timing benefit may pass the thresholds, even if the overall *value* of the timing benefit is well below the thresholds. We agree with this approach and recommend that the Regulations include an example illustrating this so that it is clear to taxpayers.

Rule (2) means that the tax savings is not determined by comparing the corporation's tax liability assuming the transaction is consummated with the tax liability assuming it is not consummated. Rather, the savings is determined by comparing the corporation's total taxes assuming the transaction is consummated and the tax treatment claimed is respected versus total taxes assuming the transaction is consummated and the tax treatment claimed is not respected.[94/]

[91/] *Id.*

[92/] *Id.*

[93/] *Id.*

[94/] This is made clear by Examples 2 and 3 of Temp. Regs. § 1.6011-4T(b)(5). In Example 3, the taxpayer determines that, by treating the leases at issue (*i.e.*, the tax shelter) as leases for tax purposes rather than loans, the taxpayer's taxes will be reduced by more than $10 million in the first three years of the leases. Similarly, in Example 2, the taxpayer determines that by using the enhanced method of depreciation (*i.e.*, the tax shelter) to depreciate the costs of a building, its taxes will be reduced by more than $10 million over the life of the building. The only example that is ambiguous in this regard is Example 1, which describes a transaction in which a taxpayer purchases financial instruments that have been structured
(continued...)

Rule (4) and (5) seem to conflict with Rule (2). If the "savings" in each year equals the difference between (i) the year's total taxes if the transaction is treated in the manner reported versus (ii) the year's total taxes if the transaction is treated in a less favorable way, there seems to be no reason for removing income from "unnecessary" aspects of the transaction or "unrelated" transactions. If, on the other hand, the savings test was a with-and-without comparison -- that is, a comparison of the tax liability assuming the transaction was consummated (and treated in the manner reported) versus the tax liability had the transaction never been consummated -- we see the purpose for an "anti-stuffing" rule that defines the "transaction" for this purpose by excluding aspects that produce income that is not necessary to achieve the tax savings.

Thus, we request that the Regulations be revised to clarify what the appropriate benchmark is for measuring the projected tax savings and, if the test is *not* a with-and-without test, to also clarify the intended roles of Rules (4) and (5).[95/]

ii. The assumed tax treatment if the benefits are disallowed should be the alternative that would be most likely to prevail

If the test is a comparison of hoped-for treatment versus disallowance and less-favorable treatment, clarification is needed as to how a taxpayer is to determine what the alternative less-favored treatment would be. In some cases, the IRS might claim the transaction never occurred; in others, the IRS might recognize the transaction but

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[94/](...continued)
to enable the holder to claim a capital loss on the disposition of one or more of the instruments while deferring gain on the retained instruments. The example states that the projected tax savings threshold is met because the loss created on the first sale reduces the taxpayer Federal income tax liability by more than $5 million. This conclusion seems to be based upon the assumption that the "alternative" treatment would be a deferral of the loss into a later year. This should be clarified, however, so that the example better illustrates the application of the projected tax effect test.

[95/] Of course, in certain cases the IRS may assert that the entire transaction should be disregarded as a "sham", in which case the disallowance of the claimed tax treatment would be the same as treating the transaction as if it were never consummated.

recharacterize the source, character or timing of an item of income or deduction. Or, the IRS might assert a Section 482 adjustment that alters the amount, timing or character of income and/or deductions.

We recognize that in some transactions, there is only a single reasonable alternative characterization and it is clear what that is.[96/] But, in many cases, there could be multiple alternative characterizations, each with a different tax result. We do not believe it would be appropriate simply to provide that the alternative used must be the one that results in the *highest* tax liability, because that alternative may be one that the taxpayer (and others) believe is unlikely of being asserted by the IRS and/or prevailing. Rather, we recommend that the alternative treatment be the one which the taxpayer "reasonably determines is the most likely to prevail in the event of a successful challenge to the taxpayer's treatment".

iii. Income from "unnecessary" aspects of the transaction or "unrelated transactions" should not be excluded

If the test *is* a with-and-without test, in which case Rule (4) would potentially have some effect, we question whether as a policy matter it is appropriate and fair to exclude aspects of the transaction that are "integral".[97/] If the transaction would not have been consummated but for these aspects, why should they be ignored for this purpose? Relatedly, clarification would be needed of what "reasonably possible"[98/] means in this case: whether it means reasonably possible as a U.S. Federal income tax matter to recognize the benefits without that income or reasonably likely as a business matter that the taxpayer would have entered into the transaction if the income were not an expected result. In our view, if the test is a with-and-without test, the projected tax effect should be estimated by taking into account all elements of the "transaction" (as broadly defined by the Regulations), other than transactions that are entered into in connection with the reportable transaction but are not

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[96/] This seems to be the premise in Examples 2 and 3 under Temp. Regs. § 1.6011-4T(b)(5).

[97/] *Id*.

[98/] *Id*.

reasonably necessary to achieving the business objectives or the intended U.S. Federal, state or local or foreign tax results.

We also do not understand the rationale for Rule (5) which removes income from unrelated transactions.[99] Such income should be included in both sides of the equation, whether the test is a hoped-for-treatment versus less-favorable treatment test *or* a with-and-without test. Moreover, the tax savings generated by the transaction might well depend upon the existence of income from unrelated transactions. For example, in the *ACM Partnership* case,[100] the tax-structure created a capital loss that was used to offset a sizeable capital gain from an independent disposition. If the capital gain had not been taken into account, the transaction would not have resulted in the immediate tax savings.

b. The Authorization Granted in the Regulations to Reduce the Projected Tax Effect Dollar Thresholds "Pursuant to Forms Prescribed for Reporting" Should be Removed

Finally, we are concerned about the following sentence, which appears in the section of the Disclosure Regulations that sets forth the $1 million/$2 million and $5 million/$10 million thresholds: "These dollar thresholds may be adjusted pursuant to forms prescribed for reporting under this section and the instructions to such forms."[101] This sentence is not discussed in the Preamble. Although it is not clear, this sentence seems to us to mean that the drafters contemplated that the dollar thresholds could be lowered by Treasury at any time and that this could be done simply by Treasury's publication of a disclosure form that reflected the lower thresholds.

We strongly urge that this sentence be removed from the Disclosure Regulations. We believe that the imposition of the new disclosure and record retention requirements are significant regulatory actions with broad policy implications and practical effects on both

[99] Temp. Regs. § 1.6011-4T(b)(4)(ii).

[100] *ACM Partnership v. Commissioner*, 157 F.3d 231 (3rd Cir. 1998).

[101] Temp. Regs. § 1.6011-4T(b)(4)(i) (last sentence).

taxpayers and the IRS. The dollar thresholds are a pivotal element of these regulations and therefore decisions regarding what those thresholds are should be determined in the context of the regulatory drafting, review and approval process, and those decisions should be subject to public review and comment in the manner provided in the Administrative Procedure Act for regulatory actions.

In addition to these substantive concerns, we believe that the possibility that these thresholds could be lowered by means of a tax reporting form published by the Government also raises practical concerns. The most obvious concern is whether taxpayers will be given fair warning of any such changes. Second, will it be clear whether the reduced rates apply to transactions that have already been entered into? For example, assume that today a taxpayer enters into transaction (that is not a "listed transaction") that is expected to generate a multiple-year savings of $7 million ($700,000 for each of 10 years), so it is not disclosable under current law. If the multiple-year threshold is reduced to $5 million during the 5th year of the transaction, is the taxpayer required to commence disclosure? These kinds of questions are usually resolved during the regulatory drafting and public commentary process.

If this concept is retained in the Disclosure Regulations, we recommend that there be a clearer statement of what is contemplated and a clearer warning to taxpayers that this aspect of the projected tax effect test is subject to modification in this manner. Otherwise, we believe that this will be a trap for the unwary rather than a means of expanding the scope of disclosed transactions.

3. The Aggregation Rules in the Definition of "Transaction" Should Be Clarified

For purposes of the Disclosure Regulations, a "transaction" is defined as including "all of the factual elements necessary to support the tax benefits that are expected to be claimed with respect to any entity, plan, or arrangement, and includes any series of related steps carried out as part of a prearranged plan and any series of substantially similar transactions entered into in the same taxable year."[102] This definition is significant because it may affect (i) whether two of the six criteria are present, (ii) whether the projected tax effect test is met, (iii) the contents of any required disclosure and (iv) which documents are required to be retained. The definition is also important because it will presumably operate as a sort of "anti-abuse" rule, preventing taxpayers from carving up a single transaction into several parts in order to avoid triggering the two-out-of-six or projected tax effect tests. For these reasons, we think that the meaning of the definition must be clear and must not be easily manipulable.

a. Clarify that a "Series of Substantially Similar Transactions" means Transactions that Depend upon the Same Legal Analysis

Our concern lies in the phrase "any series of substantially similar transactions entered into in the same taxable year". We believe it is appropriate to aggregate multiple transactions if a taxpayer enters into the same transaction multiple times and the projected tax effect test, the $100,000 fee test or the $5 million book/tax difference test would be met by taking the transactions together. We also agree that transactions that are essentially the same or that are part of a planned series of transactions should be grouped together. Thus, we suggest that the Regulations clarify that separate transactions will be considered "a series of substantially similar transactions" where they differ only with respect to features that do not affect the legal analysis (including the relevant underlying authorities) of the tax consequences. Thus, if a taxpayer entered into a cross-border transaction relying in part of the provisions of the U.S. tax treaty with country A, and then repeated the transaction relying on the corresponding provision of the U.S. tax treaty with country B, the transactions would not be aggregated. On the other hand, if a taxpayer entered into a transaction to monetize asset C, a building, and then entered into the same transaction to monetize asset D, an airplane, the two transactions would be aggregated. If this suggestion is not adopted, we request that the

[102] Temp. Regs. § 1.6011-4T(b)(1).

Regulations clarify when transactions will be aggregated under this rule and perhaps illustrate the rule with an example.

b. Substantially Similar Transactions Entered into Within the Same Twelve-Month Period (Rather than the Same Taxable Year) Should be Aggregated

We also question the decision to aggregate transactions only if they are entered into in the same taxable year. While we recognize that the Regulations must incorporate some amount of arbitrary line-drawing, the taxable year rules seems to us simply to invite gamesmanship because a transaction consummated during the 2001 year may become reportable if a similar transaction is entered into on December 30, 2001, but not if the second transaction is instead consummated on January 3, 2002. We suggest that separate transactions be eligible for aggregation if consummated within any twelve month period. While we recognize that this also leaves room for gamesmanship, it is a benchmark that has been used in other provision (*e.g.*, the Section 708(b)(1)(B) partnership termination rules) and it will impose a real restriction on taxpayers that are trying to separate transactions to avoid the disclosure requirement.

We also think it should be clarified that transactions that are properly aggregated are treated as a single transaction for all reporting and disclosure purposes, including the rule that a single disclosure statement is required for each separate transaction.[103/]

c. The Consequences of Intentionally Avoiding the Aggregation Rules Should be Clarified

Finally, we think the effect of these rules on the determination of whether the taxpayer acted in good faith for purposes of the penalty provisions should be clarified. Specifically, will the IRS impute bad faith to a taxpayer if the IRS believes that the taxpayer has timed separate transactions so as to insure that they are not grouped together as a single transaction? What if a taxpayer slightly alters the form of a transaction solely or primarily

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[103/] *See* Temp. Regs. § 1.6011-4T(a).

to support a claim that the later transactions are not substantially similar to the earlier ones (and thus should not be aggregated)?

C. The Exceptions: What They Mean and How They Will Be Applied Should Be Clarified

As indicated above, there are four exceptions overall in the Regulations: (1) the substantially the same terms exception, (2) the long-standing generally accepted exception, (3) the no reasonable basis exception and (4) the identification in published guidance/IRS determination exception. All four are used in the Disclosure Regulations and all except the first are used in the Registration and Listing Regulations. In commenting on the exceptions, we will first address their function and purpose in the context of the Disclosure Regulations, then their function and purpose in the Registration and Listing Regulations and finally we will suggest certain clarifications and modifications to the terms of the exceptions.

1. The Exceptions in the Disclosure Regulations

We believe that the exceptions have an important function in the Disclosure Regulations and that this function should be clarified. We understand that the Disclosure Regulations are intended to provide an objective method of identifying transactions that warrant disclosure (because they may be abusive). Thus, the presence or absence of the six criteria are meant to be objectively determinable -- the taxpayer's motives or intentions in entering into the transaction are not relevant. This can be contrasted to the definition of "tax shelter" in Section 6662 which, as discussed above, turns upon whether the taxpayer had the avoidance or evasion of Federal income tax as a significant purpose.[104/]

Two or more of the six factors may be present, however, in many transactions that are part of the ordinary course of business, are non-abusive and/or are based upon sound tax analysis. Because over-disclosure (and rules that seem to require over-disclosure) will

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[104/] Section 6662(c).

compromise the effectiveness of the disclosure requirement,[105] the exceptions are added to filter out the transactions that are not likely to be abusive or inappropriate. Of course, crafting exceptions that do this effectively is the difficult part. Ideally, the exceptions would be as "objective" as the six factors – it would be clear whether any of the exceptions was satisfied and therefore whether disclosure was required.

The reality, however, is that the exceptions are based upon highly subjective assessments of the legal merits of the taxpayer's position and of what the taxpayer would have done in the absence of the tax benefits. This subjectivity has given rise to concerns amongst taxpayers as to how they can determine with any degree of assurance that one of the exceptions is met, and amongst practitioners as to how they can appropriately advise their clients as to such matters. The Regulations are silent as to the role of an outside advisor in determining if an exception is met. This is in sharp contrast to the regulations under Sections 6662 and 6664 which specifically address how and when an outside advisor's advice may be relied upon.[106]

In light of these issues, we considered *when* the question of whether an exception was or was not met in any specific case is likely to arise. As discussed above, there is no specific penalty for failure to comply with the Disclosure Regulations but the Preamble indicates that noncompliance may affect the determination of whether the good faith and reasonable cause exception to penalties under Section 6664 is met. Thus, whether or not our rebuttable presumption recommendation is adopted, the question of whether disclosure was or was not required is likely to arise in court, after the taxpayer has lost on the merits and the IRS has asserted that penalties are due. The IRS would then use the taxpayer's failure to file the required disclosure as evidence that the taxpayer did not act in good faith and with

[105] The ability of the IRS to review and respond appropriately to the disclosure statements would be severely compromised and the seemingly unjustified burden on taxpayers would likely result in overly aggressive interpretations of the rules and subsequent noncompliance.

[106] *See* Regs. §§ 1.6662-4(g)(4) and 1.6664-4(c).

reasonable cause (as required for the Section 6664(d) exception to apply). We would all likely agree that the taxpayer would have little chance of success if the taxpayer had to convince the judge that just ruled against the taxpayer on the merits that disclosure was not required because (i) the IRS had no reasonable basis to challenge the taxpayer's treatment of the transaction, or (ii) the taxpayer's treatment was supported by long-standing and generally accepted principles of tax law. Nevertheless, the exceptions in the Disclosure Regulations do not place that burden on the taxpayer -- rather, the taxpayer must convince the judge that "the taxpayer reasonably determined" that the exception's requirements were met.

a. Whether The Taxpayer's Determination Was "Reasonable" Should be Based Upon All the Facts and Circumstances, Including Any Advice of Counsel

The New Regulations should clarify that the assessment of whether the taxpayer's determination was reasonable or not will be made by taking into account all of the facts and circumstances relating to that determination, including whether the taxpayer reasonably relied upon an opinion of tax counsel. The facts and circumstances that would be relevant would include, for example, the facts and circumstances referred to in Treas. Regs. §§ 1.6662-4(g)(4)(ii) and 1.6664-4(b)(1), as well as whether the taxpayer's accountants required that a reserve be established for the tax risks, whether the taxpayer's securities lawyers required that the tax risks be disclosed in any manner and whether the taxpayer was aware of any threatened or actual challenges by the IRS to the same or similar transactions entered into by other taxpayers. An opinion of counsel should be a relevant factor, but whether the taxpayer's reliance upon that opinion was reasonable should be subject to special scrutiny in which all the surrounding facts and circumstances are considered, including, in addition to the factors set forth in Regs. § 1.6664-4(c)(1)(i) and (ii), whether this was the taxpayer's regular outside counsel or someone selected (or hired) by the organizer or promoter, whether the opinion is addressed to the taxpayer and is tailored to the taxpayer's situation or is addressed to the promoter and is a generic "marketing opinion", whether the taxpayer is aware of other counsel (including in-house counsel) who refused to give the opinion (or a similar opinion) to the taxpayer or any other person or who took a contrary view, whether the counsel's compensation for the opinion is contingent upon the realization of the tax benefits or the success of the offering and sale of the shelter, the reputation of the counsel and their familiarity and prior experience with similar transactions, whether the advice addresses contrary authorities (including principles of general application that may affect the analysis) or weaknesses in the analysis that the taxpayer is aware of, the on-going relationship, if any, between the organizer or promoter and the tax counsel (for example, whether they are affiliated in any formal or informal manner), how well reasoned and convincing the opinion is and the strength of its conclusions. An opinion of counsel would not be a relevant fact in determining if the substantially the same terms exception was satisfied since that exception is not based on a legal analysis.

In the context of the long-standing generally accepted and no reasonable basis exceptions, we believe that reasonable reliance on an outside opinion should be a significant fact, but should not establish *per se* that the taxpayer's determination was reasonable. While we believe that it is important that taxpayers be permitted to rely on outside advisors for advice as to the strength and nature of the legal support for their positions, we believe that too often taxpayers will seek to use an opinion of outside counsel as a license to take an aggressive position without risking penalties. We believe that in order for the Regulations to have any deterrent effect, taxpayers need be encouraged and required to do something beyond finding a lawyer who will bless the transaction.

We believe that this clarification would work well with our suggestion that a determination that a taxpayer failed to file a required disclosure result in a rebuttable presumption that the taxpayer did not act in good faith. For example, if a taxpayer was unreasonable in relying upon an opinion of counsel to determine that it did not need to disclose the transaction, it would be appropriate (and, we believe, consistent with the existing Regulations under Section 6664) to presume an absence of good faith.

2. The Exceptions in the Registration and Listing Regulations

In the context of the Registration and Listing Regulations, the function of the exceptions is somewhat different. Like the exceptions in the Disclosure Regulations, the exceptions in the Registration and Listing Regulations depend upon the "reasonable determination" of the organizer or promoter of the transaction. The vast majority of entities that are designing and promoting the type of tax shelter products that these Regulations are aimed at are sophisticated institutions with extensive in-house tax expertise. The registration and listing requirements are intended to be triggered by transactions that seem to have been or were designed in large part to generate tax benefits -- because the expected tax benefits are disproportionate relative to the remainder of the transaction or the tax benefits are an important part of the intended result and the transaction is being marketed to other taxpayers. If the Regulations are triggered because the tax benefits are disproportionate, the only way out is to satisfy the no reasonable basis exception; if the regulations are triggered because the tax benefits are important and the transaction is marketed to others, the somewhat less onerous long-standing and generally accepted exception is available, in addition to the no reasonable basis exception. Thus, the only exceptions are based upon the strength of the legal support for the tax position, and where the transaction seems more likely to be abusive (because the tax benefits are disproportionate) that legal support must be even stronger. As currently drafted, the exceptions are met if the organizer or promoter "reasonably determines" that the requisite standard is met.

We believe that the Registration and Listing Regulations should be and are designed to provide the IRS access to information about abusive and inappropriate transaction and to deter organizers and taxpayers from promoting and utilizing these types of transactions, without preventing taxpayers from seeking and utilizing advice regarding appropriate means of lowering the tax costs of operating their businesses or earning money. We have considered but could not reach a consensus as to whether these goals would be better served if the exceptions did not depend upon the organizer's or promoter's reasonable determination but instead were absolute objective tests. An objective test would be like the current "substantial authority" test under Regs. § 1.6662-4(d), the standard either would or would not be met and what the organizer or promoter *thought* would be irrelevant. In other words, the phrase "the organizer reasonably determined that" would be removed from the lead-in to each exception.

In support of this approach, it can be argued that someone who is designing and marketing tax-structured transaction can fairly be held to, and indeed should be held to, a higher standard than the taxpayers to whom the transactions are marketed. In addition, a promoter contesting application of registration requirements -- in contrast to a taxpayer contesting application of disclosure requirements -- will not be in the position of arguing to a court that the IRS had no reasonable basis to challenge its position after the court has just decided in favor of the IRS on the merits.

We also considered whether it would be appropriate to provide that an organizer or promoter could not rely, in whole or in part, on an opinion of counsel to support its reasonable determination as to satisfaction of the no reasonable basis or long-standing generally accepted standards. We considered the argument that an organizer or promoter can almost always find a law firm or accounting firm that will bless even the most aggressive transaction. In addition, the primary rationale for sanctioning the use of outside opinions in the context of the Disclosure Regulation is that a corporate taxpayer cannot be expected to have the requisite expertise in-house to determine the merits of the tax analysis, given the degree of complication of the tax law and the types of transactions involved. In the case of registration and listing, however, if the entities and individuals involved are sophisticated and knowledgeable enough to design and market the transactions, it is perhaps fair to hold them responsible for assessing the strength of the underlying legal analysis.

On the other side are the arguments that making the exceptions completely objective or removing the ability to rely upon outside tax advice is too onerous, particularly since the meaning of the standards in the exceptions are inherently unclear and the "transactions lacking economic substance" and "other tax structured transactions" tests may pick up structures that are suggested to taxpayers in the context of advising on ordinary course transactions that are not tax-driven. Since the registration and listing requirements may be imposed upon many persons that would not be viewed as sophisticated peddlers of tax shelters, it is argued that such strict standards would be unfair and inappropriate. Finally, it is argued that most of these concerns will be resolved in determining whether the organizer's or promoter's determination was reasonable under all the facts and circumstances.

Therefore, as we suggest above in the context of the Disclosure Regulations, we suggest that it be clarified that the determination as to whether the organizer's or promoter's conclusion was reasonable will be made based upon all the facts and circumstances, including the organizer's or promoter's knowledge of contrary views and all the other factors specified above.

3. Further Recommendations for Clarification of the Exceptions

We also recommend the following modifications to the terms of the exceptions so that their meanings are clearer and less subject to individual interpretation.

a. The "No Reasonable Basis" Standard Should Be Clarified and Stated In Terms of the Strength of the Taxpayer's Position

This exception applies if the taxpayer (or the promoter or other person that would be responsible for registering the shelter[107/]) "reasonably determines that there is no reasonable basis under Federal tax law for denial of any significant portion of the expected Federal income tax benefits."[108/] The determination must take into account "the entirety of the transaction, and any combination of tax consequences that are expected to result from any component steps of the transaction, must not be based on any unreasonable or unrealistic factual assumptions, and must take into account all relevant aspects of Federal tax law, including the statute and legislative history, treaties, authoritative administrative guidance,

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107/ Temp. Regs. § 301.6111-2T(b)(5)(i). Clarification is needed that in the context of the Listing Regulations the determination could be made by the specific person whom the IRS is asserting had a responsibility to keep the list.

108/ Temp. Regs. § 301.6111-2T(b)(5)(i).

and judicial decisions that establish principles of general application (*e.g.*, *Gregory v. Helvering*, 293 U.S. 465 (1935))."[109/]

The meaning of this exception is extremely important both as a policy matter and as a practical matter. It is the only exception available to a transaction that "lacks economic substance" under the Registration and Listing Regulations. This exception is also likely to be the primary filter in the Disclosure Regulations for transactions that would not be entered into on the same terms without the tax savings and are not supported by a "long-standing and generally accepted" understanding -- in other words, transactions that are well-supported but somewhat novel. It is extremely important that the meaning of this exception be clear so that the focus of the inquiry can be on the complicated question of whether the taxpayer (or organizer or promoter) reasonably determined that the appropriate standard was met, rather than on what the appropriate standard *is*. The benchmark should be set so as to filter out unusual or novel transactions that are not likely to be abusive. We recognize, of course, that there is no ideal formulation and that whatever solution is adopted will inevitably be underinclusive or overinclusive or both.

Since the Regulations were released, there has been a great deal of discussion as to what specific percentage or level of assurance is necessary to meet the "no reasonable basis" test: is it 90%? 80%? 70%? Or, using the terminology that has, until now, been used in opinion practice, is it a "will opinion"? A "clean will" or a "reasoned will"? Is it a "strong should"? Or what about a "reasoned should"?

In considering this question, it is useful to review the "levels" of authority that are used in the Code and regulations currently. The Joint Committee on Taxation's *Description and Analysis of Present-Law Rules and Recent Proposals Relating to Corporate Tax Shelters*, issued on November 10, 1999, laid out the following categories and percentages:

[109/] Temp. Regs. § 301.6111-2T(b)(5)(i).

(1) substantial authority means at least a 40% likelihood of success if challenged;

(2) a realistic possibility of being sustained on its merits means a 33.3% or greater likelihood of success if challenged;

(3) a reasonable basis (the Section 6662 standard) means a 20% or greater likelihood of success if challenged; and

(4) a position is not frivolous if there is a 5 to 10% likelihood of success if challenged;

Similarly, the existing penalty regulations provide that:

(1) more likely than not means a greater than 50% likelihood of success;[110/]

(2) substantial authority is less stringent than more likely than not but is more than reasonable basis; it means that the weight of authorities supporting the treatment is substantial in relation to weight of authorities supporting contrary treatment;[111/] and there may be substantial authority for more than one position;[112/] and

(3) reasonable basis is "a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper". The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the types of authorities set forth in Treas. Regs. § 1.6662-4(d)(3)(iii)(taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in Treas. Regs. § 1.6662-4(d)(2).[113/]

Turning back to the New Regulations and the no reasonable basis exception. Does the "reasonable basis" in "no reasonable basis" have the same meaning as "reasonable basis"

[110/] *See* Regs. §§ 1.6662-4(d)(2) and 1.6662-4(g)(4)(i)(A).

[111/] Regs. § 1.6662-4(d).

[112/] Regs. § 1.6662-4(d)(3)(i).

[113/] Regs. § 1.6662-3(b)(3).

has in Section 6662? In other words, if the IRS has less than a 20% likelihood of success, does it have "no reasonable basis" to challenge the taxpayer's treatment? If the answer is yes, then this would appear to mean that this exception is satisfied if the taxpayer reasonably determines that it has a greater than 80% likelihood of success. Although this position has some arithmetic logic behind it, it is not clear from the Regulations that this was what was intended.

While many of our members believe that the bar should be set higher than 80%, other members feel that the Regulations are so broadly drafted that they will pick up many ordinary course non-abusive transactions and that therefore the exceptions must be easier to satisfy in order to avoid disclosure and list-keeping overload (or the flip-side, noncompliance). In addition, while some members feel that it is important that the Regulations state the standard in percentage terms, others feel that using a percentage is not helpful since measuring the strength of support for a tax position is not an exact science and that reducing the likelihood of success to an exact number is inherently impossible or meaningless.

Whether or not a specific percentage is stated, we urge that the meaning of the exception be clarified and that in doing so the standard be described in terms of the degree of assurance that the taxpayer would need to have, rather than the level of support that the IRS might have for a challenge. This is the way that the existing penalties rules are drafted and taxpayers and practitioners have become accustomed to assessing the taxpayer's likelihood of success in this way. To view it from the other side -- the level of support for a challenge -- introduces an entirely new way of assessing the merits of a transaction and one that we believe will result in confusion, unnecessarily increase the burdens imposed by the Regulations on taxpayers and compromise the effectiveness of the Regulations.

b. The "Long-Standing Generally Accepted" Exception

In the context of the Disclosure Regulations, this exception applies if (i) the taxpayer has participated in the transaction in the ordinary course of its business in a form consistent with "customary commercial practice" and (ii) the taxpayer reasonably determines that there is "a long-standing and generally accepted understanding that" the expected Federal income tax benefits from the transaction (taking into account any combination of intended tax consequences) are allowable under the Code for substantially similar transactions.[114] In the context of the Registration and Listing Regulations, the promoter makes the "reasonable determination" and the first prong is slightly different: the promoter must reasonably determine that *the potential participant is expected to participate* in the ordinary course of its business in a form consistent with customary commercial practice.[115]

i. Ordinary course of business/customary commercial practice prong: how is it to be applied in practice?

Beginning with the first prong of the exception, we believe that the Government should clarify that where the transaction is entered into by an entity (such as a partnership, an S corporation or a controlled foreign corporation) whose owners derive the tax savings, the ordinary course of business test could be applied either at the entity level or, if it was consistent with customary commercial practice for the owners to engage in this type of transaction through such an entity, at the level of its owners. For example, in the case of an existing partnership engaged in an active trade or business, the test could be applied at the partnership level; and, where two corporations enter into a partnership joint venture to engage in a specific transaction, the test could be applied at the corporate partner level but would not be met unless it was customary commercial practice to enter into such a transaction through a partnership joint venture. We would not change the rule that all members of a consolidated group are treated as a single taxpayer for purposes of the Disclosure Regulations.[116] Thus, if an affiliated group entered into the transaction through

[114] Temp. Regs. § 1.6011-4T(b)(3)(ii)(B).

[115] Temp. Regs. § 301.6111-2T(b)(4).

[116] *See* Temp. Regs. § 1.6011-4T(f). We see no reason why this rule should not also apply for purposes of this prong of the long-standing generally accepted under the Registration and Listing Regulations.

a special purpose corporation, the ordinary course test would be applied based upon the activities of the affiliated group as a whole.

Our second concern with the ordinary course/customary commercial practice test is how it can be applied in the context of the Registration and Listing Regulations where transactions offered to different taxpayers are aggregated. Under the Registration Regulations, all "transactions involving similar business assets and similar plans or arrangements that are offered to corporate taxpayers by the same person or related persons" are aggregated and treated as part of a single tax shelter.[117/] Under the Listing Regulations, "interests in substantially similar tax shelter transaction that are sold to different persons generally are to be treated as interests in the same tax shelter".[118/] If the same or similar transaction is entered into by more than one participant and for some participants the transaction is in the ordinary course of business and for others it is not, it is not clear how the aggregation rules operate. We believe that the Regulations should specify that any transaction offered to or entered into by a specific participant will not be subject to the Regulations (and thus will not be aggregated with other transactions) unless the former transaction itself meets the definition of a "tax shelter" -- in other words, after applying the exceptions to the specific participant involved.

This issue is of particular concern since individual investors are required to be included on the investors lists. In this regard, we believe the Regulations should clarify what ordinary course of business means for an individual who is not engaging in the transaction as part of a trade or business. Specifically, if the transaction is part of an individual's investment activities, how does the ordinary course of business test apply? If this requirement can never be met for an investment transaction, then the only exception available for transactions entered into by individuals (or entities that engaged solely in investment activities) is the no reasonable basis exception. As a policy matter, it is not clear to us why

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[117/] Temp. Regs. §§ 301.6111-2T(e)(2)(i) and 301.6111-1T Q&A-22.

[118/] Temp. Regs. § 301.6112-1T A-18.

an investment transaction entered into in customary commercial form by an individual taxpayer or an investment entity should not be eligible for the long-standing and generally accepted exception. In any event, these matters should be clarified.

ii. Replace "long-standing" with "clearly contemplated by current law"

With respect to the second prong, we are troubled by the ambiguity inherent in the term "long-standing". How many years or months must have passed since the transaction was first used or since the tax treatment became "generally accepted"? And how can a taxpayer or organizer determine when general acceptance first occurred?

Reliance on this concept also means that the exception will not apply to tax results that are clearly contemplated by recently enacted provisions of the Code or the Treasury Regulations. For example, the legislative history of Section 1259 is widely viewed as evidencing the legislators' intent that certain transactions (such as collars with a band in excess of 15%) not result in constructive sales under Section 1259. Thus, it was clearly contemplated by Congress that such transactions would not be recast as constructive sales. We believe that the Regulations will be more effective if they incorporate an exception that applies where the tax treatment is clearly contemplated by current law, even if that law is relatively new.[119/]

Therefore, we recommend that the second prong be re-worded to (i) delete the phrase "long-standing and" and (ii) insert at the end "or the expected tax treatment is clearly contemplated by current law". For this purpose, current law would include the Code, legislative history to the Code (including the Joint Committee on Taxation's General Explanations), the Treasury Regulations, preambles to Treasury Regulations, tax treaties and explanations of tax treaties prepared by Congress, Congressional committees and the Joint Committee.

[119/] We believe that the no reasonable basis exception will not necessary apply to certain cases where the results are clearly contemplated by the legislative history but are not set forth explicitly in the Code.

iii. Clarify the difference between the "long standing and generally accepted" standard and the "no reasonable basis" standard

Finally, we think that the Regulations should clarify, perhaps by way of example, the difference between the long-standing and generally accepted exception and the no reasonable basis exception -- specifically, what kind of a transaction could meet the former exception but not the latter? Our understanding is that a transaction that fits within the long-standing and generally accepted exception could be one that the IRS would have a reasonable basis to challenge. In other words, a long-standing generally accepted transaction is a transaction that no one expects the IRS to challenge, but that, in the case of certain transactions that fall within the exception, the IRS might have a reasonable basis for mounting such a challenge.

c. The "Substantially the Same Terms" Exception

i. Is this intended to apply to aggressive tax positions with respect to transactions that would be entered into without the additional tax benefits?

This exception (which is used only in the Disclosure Regulations) applies if (i) the taxpayer has participated in the transaction in the ordinary course of its business in a form consistent with customary commercial practice, and (ii) 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.[120/] We interpret this exception to apply to a transaction that the taxpayer would have entered into regardless, but as to which the taxpayer takes a somewhat aggressive return position. Whether or not this is accurate, we believe clarification would be helpful.

[120/] Temp. Regs. § 1.6011-4T(b)(3)(ii)(A).

ii. Example 2 should be revised to be more realistic

Example 2 of the Disclosure Regulations, which illustrates this exception, would be more instructive if it were made more realistic. In the example, after D, a domestic corporation, has completed construction of an office building to be used in D's business, Y, a promoter, offers D a set of programs to maximize D's depreciation deductions with respect to the building and related furniture and fixtures. At least two of the six factors are present because D pays a $150,000 fee and agrees to conditions of confidentiality. The example concludes that the substantially the same terms exception applies because D reasonably determines that it would have constructed and owned the building in the same manner irrespective of the enhanced depreciation.[121/]

We believe that the holding of the example would not be compromised and the example would be far more helpful to taxpayers if the facts were altered such that (i) Y approached D before D had entered into a binding obligation to buy the land or construct the building and (ii) D would have bought land and constructed a building regardless of the enhanced depreciation, but did take the potential tax benefits into account in deciding on the amount it would pay for the land and the construction. The example would also be enhanced if the building contractor introduced the enhanced depreciation scheme to the taxpayer during the course of negotiations over the price of the construction and was compensated indirectly for the idea through the overall terms of the construction contract.

d. Identification in Published Guidance

This exception applies if the transaction has been identified in published guidance as being excepted from the disclosure requirements.[122/]

i. Taxpayers should be permitted to request issuance of "published guidance"

[121/] Temp. Regs. § 1.6011-4T(b)(5) Example 2.

[122/] Temp. Regs. §§ 1.6011-4T(b)(3)(ii)(D) and 301.6111-2T(b)(5)(ii).

Taxpayers should be permitted to file requests for transactions to be so identified. The format and process applicable to requests for private letter rulings could be used for this purpose. We believe this would make it easier for the IRS to provide guidance on a broader range of transactions on an efficient basis and thus improve the effectiveness of the regulations.

ii. Published guidance should identify specific tax benefits not to be taken into account in determining if a transaction is a tax shelter

We suggest that the Regulations or published guidance provide an exception for specified tax benefits. This type of safe harbor is currently provided in Treas. Regs. § 1.6662-4(g)(2)(ii) for purposes of defining a Section 6662(d) "tax shelter". These regulations list benefits that when claimed in a manner consistent with the statute and the Congressional purpose will not in and of themselves establish a principal purpose of evading or avoiding Federal income tax.[123/] We think the same list should be included in New Regulations and broadened to include: the regulated investment company, real estate investment trust, real estate mortgage investment conduit and financial asset securitization trust provisions and the tax-free reorganization, spin-off and like-kind exchange provisions.

D. The Registration and Listing Regulations: Comments on the Definition of "Tax Shelters" Subject to Registration and Listing

As noted above, both the Registration and Listing Regulations apply to a transaction "a significant purpose of the structure of which is the avoidance or evasion of Federal income tax".[124/] A transaction meets this test if it is a listed transaction or if it falls within the

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[123/] Regs. § 1.6662-4(g)(2)(ii). *See also* Regs. § 1.701-2.

[124/] Temp. Regs. §§ 301.6111-2T(a)(2)(i) and 301.6112-1T A-4(a). In the case of the Registration Regulations, the avoidance or evasion of Federal income tax must be for a direct or indirect corporate participant and the confidentiality and $100,000 in fees to promoters factors must also be met. The August revisions clarified that the Listing Regulations apply without regard to whether the taxpayer involved is a corporation.

Registration Regulations' definition of a transaction that "lacks economic substance" or is an "other tax structured transaction".

1. Transactions "Lacking Economic Substance"

A transaction "lacks economic substance" if either

(1) "the present value of the participant's reasonably expected pre-tax profit (after taking into account foreign taxes as expenses and transaction costs) from the transaction is insignificant relative to the present value of the participant's expected net Federal income tax savings from the transaction",[125] or

(2) if the substance of the transaction is a borrowing or acquisition of financial capital by a participant, the present value of the Federal income tax deductions of the taxpayer to whom the loan or financial capital is provided "significantly exceeds" the present value of the pre-tax return of the person providing the loan or financial capital.[126]

This is essentially the same as the test used in the Administration's proposal to codify the economic substance doctrine, included in its Budget Proposal for the Fiscal Year 2001. As we discussed in our recent Report on the Proposal to Codify the Economic Substance Doctrine, we have serious concerns about a test that compares expected tax savings to expected pre-tax profit. As we discussed in our Economic Substance Report, we believe that the appropriate guidepost for distinguishing transactions that have no purpose other than tax avoidance from transactions that have valid non-tax motives (in addition to a desire to gain a beneficial tax result) is to compare the expected tax benefits to the potential pre-tax profit.

Nevertheless, in our view the issues raised in this respect in that Report are less of a concern in the context of an administrative rule such as this, that merely mandates disclosure, as opposed to a substantive disallowance rule, as was the subject of the Economic Substance Report. For example, we recognize that in the context of the Registration and

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[125] Temp. Regs. § 301.6111-2T(b)(3)(i)

[126] Temp. Regs. § 301.6111-2T(b)(3)(ii).

Listing Regulations the definition is being used to identify transactions that the Government may have an interest in learning more about, rather than being used as the basis for denying the tax benefits claimed. We recognize that, in order to cast the net wide enough, the Regulations will inevitably incorporate tests that will draw in non-abusive transactions, and, that it is hoped that many of the non-abusive transactions are filtered out by the exceptions. Yet, as discussed above, the exceptions are narrow and ambiguous and taxpayers may be apprehensive about relying upon them. Thus, while we make specific recommendations below as to how this test can be clarified and made more workable, we believe that it will be important for the IRS to monitor how this test is functioning in the field and whether it is resulting in investor lists being maintained for transactions that the Government has no interest in reviewing.

More specifically, there are a number of ambiguous terms used in this test. First, what degree of likelihood is necessary to establish that a specific amount of profit is "reasonably expected"? What if there are three alternative scenarios, each dependent upon factors that the parties cannot control and each estimated to be equally likely to occur? Of course, this gets back to our first point and highlights one of the benefits of a test that incorporates "reasonably possible" profit rather than reasonably expected profit. If the "reasonably expected" formula is retained, the Regulations should explain what that means.

The next ambiguous concept in the test is the term "insignificant". While there are some transactions where everyone will agree that the pre-tax profit is insignificant relative to the tax savings -- *e.g.*, $1 of pre-tax profit and $100 of tax savings -- our concern is with the transactions where it will not be clear. Is the pre-tax profit significant if it equals the expected tax savings? If yes, then what if the pre-tax profit is 50% of the expected tax savings? 50% is generally considered a significant percentage, so what if it is 20%? Throughout the Code and the Regulations, 20% is used to specify a significant percentage, so it probably is not an insignificant percentage. So, what about 10%? 10% is a sufficiently significant investment to make a shareholder a "U.S. shareholder" of a controlled foreign corporation and to qualify for indirect foreign tax credits under Section 902. Of course, as a policy matter, none of these examples necessarily have any relevance to the inquiry in this case. But, the point is that without specific guidance taxpayers will be forced to turn to such analogies to interpret the word "insignificant". Similarly, we also request guidance as to the meaning of "significantly exceeds", used in the second prong of the test.

The Registration Regulations provide an example of a transaction lacking economic substance. In the example, Promoter enters into a partnership ("PRS") with a foreign entity not subject to U.S. tax ("FC"). FC contributes cash to PRS in exchange for a 99% interest. PRS purchases personal property, leases the property and then sells the rights to the lease payments in exchange for cash. The income is allocated 99% to FC and 1% to Promoter. Shortly thereafter, a U.S. corporation ("X") buys FC's 99% interest. (The example does not indicate what happens to the cash, but presumably it is distributed to FC prior to the sale or to X immediately after the sale.) The depreciation deductions on the leased property are allocated 99% to X and 1% to Promoter.

The example concludes that the transaction "lacks economic substance" because X's reasonably expected pre-tax profit is insignificant relative to the present value of X's expected net Federal income tax savings from the transaction.[127/] The example appears to be incomplete because there are no facts given to support any estimate of X's expected pre-tax profit and how it compares to X's expected net Federal income tax benefits. The example would be more instructive if this information were given and the numbers were not so extreme as to make the outcome obvious.

We also request clarification as to why the expected tax benefits are to be discounted to present value while the expected profit is not. While we recognize that present-valuing the benefits would generally decrease the benefits, we believe that the rationale for this distinction should be clarified.

With respect to the second prong of the test, we think that it is important that the Regulations clarify that the tax deductions to be taken into account are solely those arising

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[127/] Temp. Regs. § 301.6111-2T(b)(7) Example 1.

with respect to the payments due to the person providing the loan or financial capital. In other words, if a taxpayer incurs a plain-vanilla fixed rate coupon borrowing and invests the proceeds in depreciable equipment, the Federal income tax deductions that are taken into account are only those arising from the interest expense and do not include the taxpayer's depreciation deductions.

2. "Other Tax-Structured Transactions"

The other type of transaction potentially subject to Registration and Listing is an "other tax-structured transaction" which is defined as a transaction that

(1) "has been structured to produce Federal income tax benefits that constitute an important part of the intended results" and

(2) is reasonably expected by its promoter, or other person responsible to register it as a tax shelter, "to be presented to more than one potential participant".[128]

Depending upon what "an important part of the intended results" means, this test could be met by a huge number of transactions -- and likely many that the IRS or a court is not interested in reviewing. The other prong of the test is not likely to filter out many transactions since most promoters try, even if they do not succeed, to leverage the work they put into any transaction by interesting other taxpayers in the same or a similar transaction. While the exceptions will presumably filter out transactions that have strong legal support, they may not filter out enough transactions. We are concerned about not only excessive listing, but also that a test that seems so broad may be subject to a wide variety of interpretations (including "self-help narrowing") as taxpayers try to make sense of it. Therefore, we recommend that the Regulations clarify what it means for the tax benefits to be an important part of the intended results.

It is also not clear *how* it is determined if the tax results are an important part of the intended results. Example 2 of the Registration Regulations describes a transaction that

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[128] Temp. Regs. § 301.6111-2T(b)(4).

qualifies as an "other tax structured transaction". In the example, Y, the promoter, designs a package of financial instruments to be issued by corporations. The instruments are intended to be treated as equity for financial accounting purposes and as debt giving rise to interest deductions for Federal income tax purposes. Y expects to market this transaction to more than one corporation. The example assumes that this is not a transaction that "lacks economic substance" and then summarily concludes that the transaction is an "other tax structured transaction" but without any discussion of how it was determined that the transaction "has been structured to produce Federal income tax benefits that constitute an important part of the intended results".

Does this mean that the test of the importance of the tax results is an objective (*i.e.*, what the IRS thinks) test rather than a subjective test? If that was the intent, this should be clarified in the Regulations and a nonexclusive list of the factors which the IRS will take into account in making this determination should be included in the Regulations.

3. The Consequences under the Registration Regulations of Imposing Confidentiality on a Noncorporate Participant

Section 6111 and the Registration Regulations provide that the confidentiality requirement is met if the transaction is offered under conditions of confidentiality to "*any* potential participant". Now that the Listing Regulations have been expanded to apply to transactions marketed solely to individuals (or other non-corporate taxpayers) as well as to individuals and corporations, the question has been raised as to whether the confidentiality feature could be triggered for a "confidential corporate tax shelter" if the transaction is offered to corporations without any confidentiality restrictions but is offered to individuals with confidentiality restrictions. We believe that the intent of this requirement was that the transaction be offered to a *corporation* under confidentiality conditions and request that this be clarified in the Registration Regulations.

E. Technical Comments on the Form and Contents of the Disclosure Statement and the Document Retention Requirement: The Required Form and Contents of the Disclosure Statement Should Be Clarified

Under the Disclosure Regulations, the corporate taxpayer that has participated directly or indirectly in the reportable transaction must attach the required disclosure statement to its Federal income tax return for each taxable year for which the taxpayer's Federal income tax liability is affected by its participation in the transaction.[129/] In addition, for the first taxable year the disclosure is included with the return, a copy of the disclosure must be sent to the IRS in Washington, DC, at the same time as the return is filed.[130/] A separate disclosure statement is required for each reportable transaction.[131/]

The disclosure statement must include the following:

(1) the name by which the transaction is known or commonly referred to by the taxpayer, and if there is none, a short-hand designation to distinguish this transaction from other transactions in which taxpayer may have participated or may participate;

(2) a statement indicating whether, to the best knowledge of the taxpayer, the transaction has been registered as a tax shelter, and, if so, the number assigned to the tax shelter;

(3) a "brief description of the principal elements of the transaction that give to the expected tax benefits";

(4) a "brief description of the expected tax benefits of the transaction (*e.g.*, loss deductions, interest deductions, rental deductions, foreign tax credits, etc.)";

(5) identification of each taxable year (including prior taxable years) for which the transaction is "expected to have the effect of reducing the taxpayer's Federal income tax liability" and an estimate of the amount of the expected reduction for "each such taxable year"; and

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[129/] Temp. Regs. §§ 1.6011-4T(a) and (d)(1).

[130/] Temp. Regs. § 1.6011-4T(d)(1).

[131/] Temp. Regs. § 1.6011-4T(a).

(6) the names and addresses of "any parties that 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 to participate".[132/]

First, we think that it should be clarified that the "tax benefits" referred to in (3) and (4) above (*i.e.*, Temp. Treas. Regs. §§ 1.6011-4T(c)(1)(iii) and (iv)) are "U.S.Federal income tax benefits". Second, we think that the reference in (5) above (*i.e.*, Temp. Treas. Regs. § 1.6011-4T(c)(1)(v)) to prior taxable years in which a Federal income tax reduction is expected should be clarified. Is this intended to refer only to prior years in which a reduction is expected as a result of a carryback from the current year or future years, or is it intended to refer to all prior years in which the taxpayer realized a savings that has not been disallowed. Does it include prior years for which a disclosure statement was filed? Does it include prior years for which the statute of limitations has closed?

With respect to the requirement in (6) above (*i.e.*, Temp. Treas. Regs. § 1.6011-4T(c)(1)(vi)), clarification is needed of the terms "promoted, solicited, or recommended the taxpayer's participation".[133/] We suggest this phrase have the same meaning as it does for purposes of the $100,000 fee factor (discussed above). We also suggest that the second prong of the test, that the person have a financial interest in the taxpayer's decision to participate, be satisfied only if the taxpayer knew or had reason to know that such party had a financial interest in the taxpayer's decision to participate.

Finally, we think that it should be clarified that while disclosure on one page would be preferable,[134/] the inability to get all information required on a single page will not in and of its be taken into account as indicating bad faith or failure to comply with the Regulations.

F. Comments Relating to Who May be Responsible for Registering a Tax Shelter and/or Maintaining an Investor List

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[132/] Temp. Regs. § 1.6011-4T(c)(1).

[133/] Temp. Regs. § 1.6011-4T(c)(1)(vi).

[134/] *See* Temp. Regs. § 1.6011-4T(c)(1).

1. Clarification as to Which Persons Are Responsible for Registration and List Maintenance

The August revisions to the Registration and Listing Regulations substantially modified and clarified the rules as to which persons are potentially responsible for registration and list maintenance. We were pleased to see these changes but believe that certain matters remain unclear.

As discussed above, the obligations to register a tax shelter and maintain an investor list may be imposed upon the persons that participate in the "organization", "management" or "sale" of the tax shelter. If these "persons" are entities, do the registration and listing requirements apply to the individual employees of those entities who participated in these activities *as employees*? In the context of the Registration Regulations, the obligation to register is satisfied if any person registers the shelter. If the employer determines registration is not required, must an employee make an independent judgment (presumably by hiring its own tax advisor) and independently register the shelter if the employee determines that registration is required? It seems inappropriate to impose this obligation on an individual whose only involvement is as an employee and representative of an organization that is the actual party involved.

The consequences under the Listing Regulations are a little different. The obligation applies to each person that participates in the "organization" and "management" (within the meaning of the Registration Regulations) *unless* that person enters into a written agreement with a designated list-keeper; and a person may not qualify as a designated list-keeper unless that person is an organizer *and* is not a resident of and does not maintain a principal place of business in a foreign country. Does this mean that a U.S. corporation that is an organizer needs to enter into a written agreement with each employee involved in the tax shelter? And, that where the organizer is a non-U.S. person, each employee must either maintain his or her own list or, if there is a U.S. organizer willing to be the designated list-keeper, enter into a written agreement with that U.S. organizer? Surely, this cannot have been the intent and we request that this be clarified.

The August revisions clarified that in determining who has participated in the "organization", "management" or "sale" of the tax shelter, the definitions of these terms included in the pre-existing Regulations under Section 6111 are to apply -- specifically, Temp. Treas. Regs. § 301.6111-1T Q&A-26 through Q&A-33. We understand that the main purpose of this clarification was to resolve the confusion over whether lawyers and other outside advisors who played no role in the design and marketing of a shelter would be subject to these rules simply because they had advised participants as to the legal or accounting consequences of the transaction or facilitated the transaction by drafting, reviewing or negotiating documents, filing documents with regulators and obtaining regulatory consents, creating entities, drafting organizational documents, issuing legal or accounting opinions or undertaking other similar activities. Thus, the revisions provided that, among other things, Temp. Treas. Regs. § 301.6111-1T A-30 was to apply for this purpose. A-30 provides that a person will not be considered to participate in the organization or management of a tax shelter unless the person

> (a) is a "principal organizer" (*i.e.*, the person principally responsible for organizing the tax shelter), (b) is related (within the meaning of Section 168(e)(4)) to or employed by the tax shelter or a principal organizer or has an interest (other than as a creditor) in the shelter or (c) participates in the entrepreneurial risks or benefits of the tax shelter (by receiving compensation contingent on any matter relating to the tax shelter or in the form of any interest in the tax shelter).[135/]

As an example, A-30 provides that a law firm that is paid a flat hourly rate for preparing documents necessary to register the offering of securities in the tax shelter would not be considered to have participated in the organization of the shelter.[136/]

[135/] Temp. Regs. § 301.6111-1T Q&A-30.

[136/] Temp. Regs. § 301.6111-1T A-33 also provides that a person performing support services or ministerial functions (such as typing, photocopying or printing) will not be considered as having participated in the organization, management or sale.

While we appreciate the clarification added by the August revisions, we believe that some confusion remains. Specifically, does this exclusion for outside legal or other advisors include advisors who use so-called “value billing”. Value billing is a common method of billing for legal work that computes the total bill for services by taking into account not only the number of hours worked at an “hourly rate” but then adjusts the result up or down to reflect such factors as the overall quality of the representation, the degree of difficulty involved in the legal work, the time demands and any extreme inconveniences imposed by the transaction schedule and the overall success of the transaction for the client. We believe that firms that use value billing use that billing method for all of their legal work and that it has come to be accepted as more appropriate and fair to the client and the lawyers than straight hourly billing. We believe that A-30 was intended to exclude lawyers and other advisors who do not have an ongoing stake in the success of the tax shelter and that the use of value billing by lawyers does not amount to having an ongoing stake in the tax shelter. Thus, we request that the Regulations clarify that a law firm that uses value billing of the type we describe is eligible for the A-30 exception provided it is not otherwise described in A-30.

In addition, clause (b) of A-30 refers to any person who is “employed” by the tax shelter or a principal organizer. The law firm example illustrates that a person who is hired as an independent contractor (as opposed to an individual that is a common law employee) is not “employed” by the shelter or the principal organizer for this purpose, but that should be clarified.

2. Participants Should Not Have the Burden of Registering a Transaction If an Organizer or Promoter Has a “Related” U.S. Person onto Which That Burden Could Instead Be Imposed

We also believe that the Registration Regulations’ interpretation of the Section 6111(d)(3) registration obligation imposed on a potential participant that discusses the transaction is broader than the statute intended and that the registration obligation should be imposed on a U.S. person that is related to the promoter before it is imposed on a potential participant.[137]

Specifically, Section 6111(d)(3) provides that persons that discuss participation may be obligated to register a transaction only if no "tax shelter promoter" is a U.S. person. The statute defines a tax shelter promoter as including not only the persons active in the shelter, but also all persons related to such persons within the meaning of Section 267 or 707. Thus, the statute seems to us to contemplate imposing the obligation on participants and potential participants only if the promoters and all their related persons are foreign persons (although, it must be noted that, the statute does not impose an affirmative obligation on any related person to do the registration).

The Regulations, on the other hand, provide that (i) a person must presume that all promoters are foreign persons unless the person either discusses participation with a promoter that is a U.S. person or obtains and reasonably relies upon a written statement from one of the promoters that at least one of the promoters is a U.S. person,[138] and (ii) any person that is promoter solely by reason of being related under Section 267 or 707 to a foreign promoter will be treated as a foreign promoter.[139] Thus, under the Regulations if a foreign subsidiary of a U.S. entity is the only promoter that has contact with a potential participant, the participant would be responsible for registration, even if it decides not to participate (unless it satisfies the written notice-within 90 days requirement).[140] In addition, even if the potential participant has contact with the U.S. parent entity, unless the U.S. parent is itself "promoting" the shelter, the U.S. parent will be automatically treated as a foreign person under the rule (set forth above) that all persons treated as promoters solely by being related to a foreign promoter will be treated as foreign promoters.

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[137] Temp. Regs. § 301. 6111-2T(g)(2).

[138] Temp. Regs. § 301.6111-2T(g)(2)(iii).

[139] Temp. Regs. § 301.6111-2T (g)(2)(vi)(B).

[140] Temp. Regs. § 301.6111-2T(g)(2)(vi)(B).

This seems to us an unfair allocation of the registration burden. We believe that if any participant reasonably believes that a promoter is a U.S. person or if any related person to a promoter is a U.S. person (or the potential participant reasonably believes that is the case), the potential participant should not have any registration obligation.

We also believe that the Treasury has authority under existing law to impose a registration obligation on U.S. persons that are "related" to foreign promoters of tax shelters. Section 6111(f)(4) authorizes the Secretary to prescribe regulations which provide "such rules as may be necessary or appropriate to carry out the purposes of this section in the case of foreign tax shelters". The term "foreign tax shelter" is not defined and we believe that it could be interpreted by the Treasury to include shelters promoted by foreign persons. We believe that such regulations would be appropriate in carrying out the purposes of Section 6111 by imposing the registration and related obligations on persons that have the best access to information about the shelter and the participants.

We note that the August revisions limited the list maintenance requirement to persons that participate in the organization or management of the tax shelter directly, whereas the February version of the Regulations had also imposed the obligation on related persons. Our suggestion is not inconsistent with that change because that change merely eliminated a duplicative requirement, whereas our suggestion imposes the burden on the most appropriate party.

3. Presumption that $100,000 in Fees to Promoters Requirement Is Met Should Not Apply in Imposing Registration Obligation on Participants

Under the Registration Regulations,[141/] for purposes of the $100,000–in–fees–to–promoters test, the amount of fees paid to the promoters is determined as follows:

[141/] As discussed above, we request clarification as to whether these rules or some variation of them applies in determining if the $100,000 fee indicium of the Disclosure Regulations is met.

(1) all the facts and circumstances relating to the transaction are considered;[142/]

(2) all consideration the promoters may receive is taken into account including contingent fees, fees in the form of equity interest and fees the promoters may receive for other transactions, but which the facts and circumstances indicate are consideration for promoting this tax shelter;[143/]

(3) all substantially similar transactions are considered part of the same tax shelter and the fees from all of them are aggregated;[144/]

(4) the promoters include each person that participates in the organization, management or sale of the shelter (excluding persons that did solely ministerial work such as copying or printing);[145/] and

(5) it will be presumed that the tax shelter promoters will receive fees in excess of $100,000 unless the person responsible for registering the tax shelter can show otherwise.[146/]

We assume that the presumption referred to in item (5) above is included in order to deal with situations where the fees are embedded in other consideration paid to the promoters or it is difficult for the IRS to obtain the information and evidence necessary to establish that the fee test is met. Thus, the presumption is intended to impose the burden of proof on the parties that have the best access to the information. Nevertheless, we believe that the presumption is likely in practice to function as an irrebuttable presumption. While we question whether this is consistent with Section 6111, we believe that the balance of the equities weighs in favor of the presumption, provided, however, that it not be applied in imposing registration obligation on a participant or potential participant (under Section 6111(d)(3)). Instead, the $100,000 test should be met in the case of a potential participant

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[142/] Temp. Regs. § 301. 6112-1T(d).

[143/] *Id.*

[144/] *Id.*

[145/] Temp. Regs. § 301.6111-2T(f).

[146/] Temp. Regs. § 301.6111-2T(g)(2)(vi)(A).

only if the potential participant knows or has reason to know that the $100,000 limit will likely be met.

If the same guidelines are used for determining if the $100,000 limit is met under the Disclosure Regulations,[147] we believe that it is extremely important that this revision also apply for that purpose.

In addition, while the first four rules are set forth in Temp. Treas. Regs. § 301.6111-2T(f), the presumption appears in an entirely different section of the regulations entitled "Person required to register."[148] We think the presumption should be moved to Temp. Treas. Regs. § 301.6111-2T(f).

4. Clarify Transactions For Which a Designated List-Keeper May Be Used

Finally, we request clarification of the scope of transactions for which a designated list-keeper may be used. The Listing Regulations provide that a designated list-keeper may not be used unless the tax shelter is registered or is described in Temp. Treas. Regs. § 301.6112-1T Q&A-4. A-4 refers to all other types of tax shelters for which listing is required.[149] Thus, while the intended effect seems to be to exclude only shelters which are required to be but are not registered, this has created some confusion.

G. Investor Lists: What Is Their Intended Function? What Should it Be?

Neither the Listing Regulations nor the preamble thereto indicate how the investor lists are to be used by the IRS. Will the lists be used solely to identify investors in shelters that the IRS has decided to challenge? Or will the lists be used to identify potentially abusive transactions that the IRS was not previously aware of and/or to learn more about how an identified transaction is structured, how it is supposed to work and how the tax benefits are

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[147] Temp. Regs. § 1.6011-4T(b)(3)(i)(C).

[148] *See* Temp. Regs. § 301.6111-2T(g)(2)(vi)

[149] Temp. Regs. § 301. 6112-1T Q&A-11

intended to be derived and supported? And how will the IRS initiate a review of a list -- will the IRS agent ask to see the list for a specified transaction or will the agent ask to see all the lists? Can the agent ask to see the lists for all transactions that involve foreign tax credits? All the lists for transactions that involve instruments categorized as debt for one purpose and as equity for another? All the lists that involve investments over a specified dollar threshold? Tax savings over a specified dollar threshold? These questions raise significant policy and procedural issues.

1. We Would Support Using the Lists to Identify New Transactions Provided This is Clarified in Published Guidance

Section 6112, which was enacted in 1984, gives the Treasury broad authority to determine the types of transactions for which investor lists must be maintained, the information that must be included on those lists and the manner in which the lists must be retained. Section 6112 also provides that the person required to maintain any such list must make it available for inspection by the Secretary upon request. The statute does not specify the intended role of the lists or the required form or content of any request by the Secretary to inspect a list. The legislative history, however, makes it clear that the legislators were concerned about the audit lottery that permitted some investors in faulty tax schemes to avoid detection altogether and others to enjoy substantial deferral. The legislative history indicates that the goal of the legislation was to facilitate detection of all of the investors and thereby insure that none of the investors escaped detection and that they were all treated in the same manner. The Committee Reports imply that the drafters contemplated that the government would identify the faulty transactions first and then seek the list of investors. Nevertheless, neither the legislative history, nor the statute, indicates that the government may not use the lists as a means of identifying potentially abusive transactions and/or gathering details about how a transaction is structured, how it is supposed to work and how the tax benefits are intended to be derived and supported.

Although the Listing Regulations do not address these issues directly, the description of the required contents of the lists suggests that the lists may serve many different functions for the government. Under the pre-existing regulations, the contents of the list were limited to the information necessary to identify the investors. The Listing Regulations substantially broadened the scope and amount of information and documentation that must be included in the investor list and treat, all "substantially similar tax shelter transactions" that are sold to different persons as a single tax shelter for listing purposes.[150/] In addition to policy issues, this expansion of the contents of the lists raises significant procedural and compliance issues.

Under the pre-existing regulations, a list maintained by an organizer was required to include:

(1) the name, the registration number and the taxpayer identification number ("TIN"), if any, of the shelter,

(2) the name, address and TIN of each purchaser of an interest in the tax shelter (provided, generally, that the organizer knew or should know about the purchase), and number of units in the shelter acquired by each and the date on which acquired, and

(3) the name and address of each agent of the organizer that negotiates the transfer of an interest in the shelter.[151/]

As revised, each list now must also include[152/]:

(4) the name, address and TIN of "any indirect corporate participant in the shelter if known to the organizer or seller",[153/]

(5) the amount of money invested in the shelter by each purchaser,

(6) "a detailed description of the tax shelter that describes both the structure of the tax shelter and the intended tax benefits for participants in the tax shelter",

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[150/] Temp. Regs. § 301.6112-1T Q&A-18.

[151/] Temp. Regs. § 301.6112-1T Q&A -17 and 18.

[152/] Temp. Regs. § 301.6112-1T A-17(a)(3)-(9).

[153/] This requirement does not apply to a transaction that is subject to listing as a result of meeting the numerical tax shelter tests of Section 6111(c).

(7) "a summary or schedule of the tax benefits that each person is intended or expected to derive from participation in the tax shelter, if known by the organizer or seller",

(8) "copies of any additional written materials, including tax analyses or opinions, relating to the tax shelter that have been given to any potential participants in the tax shelter or to any representatives, tax advisors, or agents of such potential participants by the organizer or by any other person who has participated in the offering of the tax shelter", and

(9) identification of each other tax shelter, if any, that the organizer has offered that has not been treated as part of the same tax shelter, "but that utilizes a similar structure or is intended to produce similar benefits".[154/]

The list of contents strongly suggests that the government contemplates using the lists to identify new transactions that it might find abusive and to learn more about how identified transactions operate and what the promoters and their advisors think are the strengths and weaknesses of the underlying tax analysis. We have considered whether using the lists in this manner is improper in light of the legislative history of Sections 6111 and 6112. In particular, we have considered whether this imposes the equivalent of a registration obligation on transactions that do have the confidentiality required by Section 6111.

While we believe that using the lists in this manner does goes beyond what the legislators contemplated, we do not believe that it is improper. We note that the statute gives the Secretary broad discretion over substantially all aspects of the listing requirement. We also recognize and share the Government's concern regarding the recent proliferation of the tax shelter problem, driven by the increasing sophistication of the promoters, the complications and innumerable variations in the designs of these schemes and the large dollar amounts involved. Given these considerations, we believe that it is not inappropriate for the government to use the lists to find out about new transactions or to learn more about identified transactions. We do believe, however, that the government should address these

[154/] This additional requirement is included in A-18; it should be moved to A-17 where the remainder of the list is set forth.

matters either in the Regulations themselves or in written guidance, such as a Revenue Procedure.

2. The New Definition of "Acquiring an Interest" in a Tax Shelter: Persons That Do Not Consummate the Transaction Should Not Be Included among Those That "Directly or Indirectly" Pay the Organizer

The Listing Regulations also revise the meaning of "acquiring an interest" (and "selling an interest") in a tax shelter. Under the pre-existing Regulations the list was required to include "all persons who acquire an interest in the tax shelter", and "an interest" in a tax shelter was defined as "any right to participate in the tax shelter by reason of (a) a partnership interest, a shareholder interest, or a beneficial interest in a trust, (b) any interest in property (including a leasehold interest), or (c) the entry into a leasing arrangement or a consulting, management, or other agreement for the performance of services".[155/] Thus, a person acquired an interest by investing in an entity or in property or by participating in a transaction of some kind.

The Listing Regulations provide that a person will be considered to have acquired an interest in a tax shelter if the person "has directly or indirectly paid consideration to an organizer or seller for the right to participate in a tax shelter, for services necessary to the organization or structure of such tax shelter, or for information that is integral to participation in such tax shelter".[156/] This revision is not discussed in the Preamble, but appears to be aimed at adapting the Regulations to a world in which promoters of tax shelters are not offering potential participants the opportunity to invest in a specific arrangement, but are instead selling ideas: ways of structuring transactions to maximize the tax benefits and ways of modifying existing structures or investments to generate increased tax benefits. We support these revisions but believe that some clarification is required to insure that the new language does not inadvertently encompass persons that never consummate the tax shelter

[155/] Temp. Regs. § 301.6112-1T Q&A-7 and Q&A-8.

[156/] Temp. Regs. § 301.6112-1T Q&A-7.

transaction. Specifically, we are concerned that any person that pays a fee to an advisor for advice regarding a potential "tax shelter" transaction could be considered, under the New Regulations, to have acquired in an interest in the tax shelter by reason of having "paid consideration ... for information that is integral to participation in such tax shelter". Similarly, a person might pay a promoter for services necessary to organize a tax shelter transaction and then abandon the transaction before it is consummated. We believe that such persons should not be included on the list of investors and that persons that provide such advice or services should be entitled to rely on their reasonable belief regarding which potential participants have actually consummated the transaction. Accordingly, we suggest that there be added to the end of the new sentence "unless the organizer or seller reasonably believes that the person has not actually participated in the tax shelter".

3. The Required Contents of the Investor Lists May Pose Unnecessary Burdens and Should Be Clarified in a Revenue Procedure

While we recognize the value of using the lists to gather information regarding the details of the tax schemes involved, we believe that the Listing Regulations impose significant burdens on list-keepers and that these burdens could be lessened without significantly compromising the effectiveness of the lists to the Government.

Under the Listing Regulations, each person responsible for maintaining the list must prepare a "detailed description" describing both the structure and the intended tax benefits for participants and a summary or schedule of the tax benefits that each participant is intended or expected to derive, if known.[157/] This will be time consuming and will clearly require review by the tax and non-tax lawyers involved for accuracy. In addition, list-keepers will be required to make a significant number of judgement calls, including how much detail needs to be included, how much background and explanation of the structure and the tax analysis is required, and what other transactions qualify as substantially similar tax shelters or a transaction utilizing a similar structure or intended to produce similar tax benefits.

[157/] Temp. Regs. §§ 301.6112-1T Q&A-17(a)(7) and (8).

Relatedly, in the absence of additional guidance, list-keepers will have no way of knowing if the format of these written descriptions, the manner in which their lists are maintained, catalogued and indexed and other aspects of their list-keeping practices are acceptable to the Government.

We suggest that the Government issue a Revenue Procedure addressing these issues. The Revenue Procedure could provide that the description of the structure and tax benefits need not be any more detailed than is necessary for a full and complete understanding of the structure and intended tax benefits; that a list-keeper could use one tax benefits schedule to cover several participants if the tax benefits to each are substantially the same and that lists should be indexed by the name given to the shelter, if any, and the date first entered into by a participant. The Revenue Procedure should also address the appropriate procedures for IRS agents and taxpayers to follow in the event the IRS requests to review the lists; how the IRS will make its request to review a given list (by name? by type of tax benefits? by amount involved?) whether the list-keeper must produce the specific lists requested or may instead simply lead the IRS agent to a room where the lists are kept; whether list-keepers will be required to provide copies of materials to the IRS or only on-site access.

4. Clarify How Are Penalties to Be Calculated in Light of the Expanded Contents for the Investor List?

The penalties for failure to maintain the list are included in Section 6708 which, like Section 6112, was not amended in 1997. Under Section 6708, "any person who fails to meet any requirement imposed by section 6112 shall pay a penalty of $50 for each person with respect to whom there is such a failure", unless the failure is due to reasonable cause and not willful neglect. The maximum penalty for any calendar year is $100,000. Now that the contents of the list have been expanded beyond simply identifying purchasers, to include descriptions of the transactions, prepared written materials, memoranda and opinions and information regarding other similar and not-so-similar transactions, how will these requirements be enforced and how will these penalties be applied? This should be clarified in Regulations under Section 6708 or in the Revenue Procedure requested above.

H. Technical Comments on Requests for Private Rulings on Registration and Listing Requirement and "Protective Registrations"

The Registration Regulations and the Listing Regulations provide that if a tax shelter promoter or other person that would be responsible for registration or list maintenance is uncertain as to whether a transaction must be registered or an investor list must be maintained, the person may (i) submit a request, on or before the date registration would be required, for an IRS ruling as to whether the transaction is required to be registered; and if the request fully discloses all relevant facts relating to the transaction, the registration requirement will be suspended while the request is pending; or (ii) the person may register the transaction in accordance with the Regulations, and append a statement to the registration form indicating that the person is uncertain whether registration is required and is filing the form on a "protective basis".[158/]

1. A Request for a Private Ruling Should Not Be Required to Include Disclosure of the Other Parties Involved in the Organization or Sale of the Transaction or the Potential Participants

Although we have doubts as to whether taxpayers will file requests for rulings or make protective registrations, we recognize that these alternatives are intended to promote compliance and believe that this goal could be furthered if the requirements and consequences of these alternatives were spelled out more clearly.

We think it should be stated specifically that a ruling request would not need to include (and the IRS would not be entitled to request as a condition to issuing the ruling) identification of any person involved in promoting, organizing, managing or operating the transaction or any taxpayers to whom the transaction has been or may be offered or sold

[158/] Temp. Regs. § 301.6111-2T(b)(6).

(other than the person filing the ruling request).[159] We believe this is crucial to making the ruling request a viable alternative.

We also think it should be clarified that any person that might have the registration obligation is entitled to file the ruling request, even if the person may not have the primary or secondary obligation. We also think that the regulations should specify how the other aspects of the registration regulations are to be complied with if the IRS determines that registration is required after interests in the transaction have been sold. For example, how the person that filed the request can satisfy its obligation to convey the registration number to participants and how participants can satisfy their obligations to include the number on their returns.

2. The Meaning and Effect of a "Protective Registration" Should be Clarified

With respect to the protective filing, it is not clear to us how this differs from a regular filing — does the filer still have to provide the registration number to all participants? Are participants permitted to note on their returns that the filing was protective? Is the only advantage that the person that is registering the shelter is not admitting that it thinks registration is required? Is there any reason why every registration could not be filed with a designation that it is being filed on a protective basis?

I. Effective Date of August Revisions Should be Clarified

1. Effective Date of Revisions to the Definition of "Conditions of Confidentiality" as Used in the Disclosure Regulations

The Registration Regulations provide that the revisions apply to interests in tax shelters offered after August 11, 2000, but that a promoter may rely on the revised definition for interests offered after February 28, 2000. There is no specific guidance as to when the new definition takes effect for purposes of the Disclosure Regulations, which incorporate the

[159] Temp. Regs. § 301.6111-2T(b)(6) required full disclosure of all relevant facts and information.

definition by reference. Presumably, the intent was that the revised definition applies to transactions entered into after August 11, 2000, but could be relied upon at the taxpayer's election for transactions entered into after February 28, 2000. This should be clarified.

2. Transactions Subject to Disclosure by Corporations Filing Returns Under Sections 594, 801 or 831

As initially issued, the Disclosure Regulations applied only to corporations filing returns under Section 11 and did not apply to any transaction (other than a "listed transaction") entered into prior to February 28, 2000. When the August revisions expanded the disclosure requirement to apply to corporations filing returns under Sections 594, 801 and 831, they did not give these corporation the analogous "grandfathering" of pre-existing transactions. This appears to have been unintentional and should be clarified.