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NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON RECENT TAX SHELTER REGULATIONS

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New York State Bar Association

Report on Recent Tax Shelter Regulations[1]

Introduction

This Report comments on the Temporary and Proposed Tax Shelter Regulations (the "New Regulations") issued on October 22, 2002.[2] The New Regulations are the most recent in a series of regulations released by the Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") dealing with tax shelter registration, taxpayer disclosure and organizer/seller list maintenance.[3] The New Regulations are also one element of the program outlined by Treasury and the IRS earlier this year (the "Initiative") to combat tax shelters, and they adhere closely to the proposals outlined in the Initiative.[4]

We support the efforts of the Treasury and the IRS to address the shortcomings of the prior tax shelter regulations. As we have noted in our previous submissions, we believe that enhanced disclosure is an important element in combating the tax shelter problem.[5] However,

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1 This report was prepared by an *ad hoc* committee of the New York State Bar Association Tax Section. Dickson G. Brown was the principal author. Drafting assistance was provided by Jonathan E. Cantor, Eric S. Chun, Joshua R. Isenberg, Jeremy A. Matz, and Stephen G. Mills. Helpful comments were received from Andrew N. Berg, Peter Canellos, Samuel Dimon, Dwight Ellis, Michael Farber, Peter Farber, Janet Korins, Robert Levensohn, Erika W. Nijenhuis, Richard Reinhold, Michael L. Schler, Elissa Shendalman, Lewis R. Steinberg and Diana L. Wollman.

2 *See* T.D. 9017, 67 Fed. Reg. 64799-01 (Oct. 22, 2002); T.D. 9018, 67 Fed. Reg. 64807-01 (Oct. 22, 2002).

3 Temp. Treas. Reg. § 1.6011-4T (2000) (as amended by T.D. 8896, T.D. 8691, T.D. 9000 and T.D. 9017); Temp. Treas. Reg. § 301.6111-1T (1984) (as amended by T.D. 7990 and T.D. 8078); Temp. Treas. Reg. § 301.6111-2T (2000) (as amended by T.D. 8896, T.D. 8961, T.D. 9000 and T.D. 9017); Temp. Treas. Reg. § 301.6112-1T (1984) (as amended by T.D. 7990, T.D. 8875, T.D. 8896 and T.D. 9018).

4 *The Treasury Department's Enforcement Proposals for Abusive Tax Avoidance Transactions* (March 20, 2002, PO-2018).

5 *See* New York State Bar Ass'n Tax Section, *Report on Tax Shelter Legislation*, No. 1019 (Aug. 27, 2002); New York State Bar Ass'n Tax Section, *Letter to Treasury Department and Internal Revenue Service*

the New Regulations cannot, by themselves, solve the tax shelter problem. As recognized in the Initiative, the solution requires a number of elements, including legislation, more significant sanctions, revisions to the rules of conduct before the IRS (Circular 230) and the commitment of additional resources by the IRS (and, we would add, Congress). It also requires an adjustment in the attitude of some taxpayers toward their tax-paying responsibilities, an adjustment that the New Regulations should encourage.

This report begins by briefly discussing the prior regulations in order to provide a context for a description of the provisions of the New Regulations. It then summarizes our principal recommendations. The discussion that follows first addresses some issues that we see as applying generally to the New Regulations, such as the persons who should be subject to the provisions and the treatment of flow-through and foreign entities. It then considers each of the six categories of reportable transactions that serve as the basis for the disclosure and list maintenance requirements. The discussion concludes by considering issues applicable to the disclosure, list maintenance and registration requirements.

An overriding concern is that the New Regulations will impose substantial burdens on compliant taxpayers, while those who are the intended targets of the broader provisions may ignore, or rationalize avoidance of, the responsibilities imposed by the New Regulations, as was the case with the prior regime. We hope that the Treasury and the IRS find

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commenting on the Treasury Proposals, No. 1012 (May 22, 2002); New York State Bar Ass'n Tax Section, *Letter to Congressional Tax Writing Leaders commenting upon pending Tax Shelter deterrent legislation*, No. 999 (Oct. 30, 2001); New York State Bar Ass'n Tax Section, *Letter to Treasury Officials commenting upon modifications to Temporary Regulations governing tax shelter disclosure, registration and listing requirements*, No. 998 (Oct. 30, 2001); New York State Bar Ass'n Tax Section, *Report on the Temporary and Proposed Tax Shelter Regulations*, No. 982 (Nov. 16, 2000); New York State Bar Ass'n Tax Section, *Letter and Report on Corporate Tax Shelters, proposed Section 6662A of the Internal Revenue Code to Hon. William V. Roth, Jr., Chairman, Finance Committee, United States Senate,* No. 979 (Sept. 18, 2000); New York State Bar Ass'n Tax Section, *Report on Certain Tax Shelter Provisions*, No. 956 (June 22, 1999); New York State Bar Ass'n Tax Section, *Report on Corporate Tax Shelters*, No. 950 (Apr. 23, 1999). Copies of these documents are available on the Tax Section web site at www.nysba.org/taxreports.

the flexibility to temper those burdens while adjusting to inevitable avoidance schemes. We are concerned that notwithstanding the substantial new burdens placed on taxpayers and the IRS alike, the New Regulations may not prove effective in combating tax shelters. We continue to believe that statutory amendments that impose strict liability on tax shelter understatements are required in addition to rules requiring disclosure of tax shelter transactions.[6]

I. Prior Regulations

The prior regulations included contain three separate regimes, described below.

A. Prior Disclosure Regulations

The first regime, set forth in the prior version of Temp. Treas. Reg. § 1.6011-4T (the "Prior Disclosure Regulations"), requires that certain taxpayers disclose their direct or indirect participation in reportable transactions on statements attached to their tax returns for each affected taxable year. The Prior Disclosure Regulations list two types of reportable transactions. First, a transaction is considered a reportable transaction with respect to any taxpayer if it is the same as or substantially similar to a tax avoidance transaction that the IRS has identified by published guidance (a "Listed Transaction").[7] The second type of reportable transaction is any transaction that, subject to certain exceptions, reduces a corporate taxpayer's federal income tax liability by more than $5 million in any single taxable year or by more than $10 million for any combination of taxable years and has at least two of five characteristics enumerated in Temp. Treas. Reg.

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6 *See* New York State Bar Ass'n Tax Section, *Report on Tax Shelter Legislation*, No. 1019 (Aug. 27, 2002) at p. 2; New York State Bar Ass'n Tax Section, *Letter to Treasury Department and Internal Revenue Service commenting on the Treasury Proposals*, No. 1012 (May 22, 2002) at p. 5.

7 The Prior Disclosure Regulations as in effect before the Initiative applied only to corporate taxpayers. Amendments made pursuant to T.D. 9000, 67 Fed. Reg. 41324 (June 18, 2002) required individuals and flow-through entities to disclose direct or indirect participation in Listed Transactions.

§ 1.6011-4T(b)(3)(i). Generally speaking, these five characteristics are (1) conditions of confidentiality, (2) contractual protection for the intended tax benefits, (3) involvement of a promoter or organizer who receives fees contingent on the taxpayer's participation in the transaction, (4) a significant book-tax difference, and (5) a structure whose intended tax benefits are dependent on the participation of a tax-indifferent party.

Notwithstanding the foregoing, a transaction is not a reportable transaction under the Prior Disclosure Regulations if (1) it is entered into in the ordinary course of the corporate taxpayer's business consistent with customary commercial practices and is not tax-motivated, (2) it is entered into in the ordinary course of the corporate taxpayer's business consistent with customary commercial practices and there is a "long-standing and generally accepted understanding" that the expected tax benefits are allowable, (3) there is no reasonable basis for the denial of the expected tax benefits,[8] or (4) the transaction is listed in published guidance as being exempted from disclosure.[9]

Although there is no statute specifically imposing sanctions for non-disclosure, a taxpayer's exposure to penalties under sections 6662 and 6663[10] could be affected by non-disclosure.[11]

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8 This exception is not available for Listed Transactions.

9 Temp. Treas. Reg. § 1.6011-4T(b)(3)(ii).

10 All section references are to the Internal Revenue Code of 1986, as amended (the "Code"). If a taxpayer has an underpayment of tax for a particular year, that underpayment is potentially subject to an accuracy-related penalty of 20% under section 6662 and a fraud penalty of 75% under section 6663. Those penalties are inapplicable if the taxpayer establishes that there was reasonable cause for its position and that it acted in good faith. *See* section 6664.

11 The preamble to the most recent amendment to the Prior Disclosure Regulations indicates that by failing to file a disclosure statement, a taxpayer may be deemed not to have acted in good faith with respect to an underpayment, even if its return position has sufficient legal justification to satisfy the "reasonable cause" standard. *See* T.D. 8877 (2000). For a description of recently proposed regulations under sections 6662 and 6664 that would provide more definite guidance on the consequences of non-disclosure of a reportable transaction, see the discussion below under "Penalties."

B. Prior List Maintenance Regulations

The second regime, set forth in the prior version of Temp. Treas. Reg. § 301.6112-1T (the "Prior List Maintenance Regulations"), requires that organizers of "potentially abusive tax shelters" maintain a list of the persons who have acquired interests in the transaction.[12] The Prior List Maintenance Regulations broadly defines an organizer responsible for maintaining an investor list to include any person who participates in the organization, management or sale of the tax shelter. However, attorneys or accountants were often not subject to the list maintenance requirements because of an exception for persons unrelated to the tax shelter who do not participate in the entrepreneurial risks or benefits of the tax shelter.[13]

The term "potentially abusive tax shelter" includes any transaction a significant purpose of which is the avoidance or evasion of federal income tax.[14] A transaction meets this test if it is either (1) structured to produce U.S. federal income tax benefits that constitute an important part of the transaction, and the promoter (or other person who would be responsible for registering the transaction) reasonably expects the transaction to be presented in substantially similar form to more than one potential participant, or (2) a Listed Transaction. As with the Prior Disclosure Regulations,

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12 Sellers are also required to maintain lists of persons to whom they transfer interests in the tax shelter.

13 Temp. Treas. Reg. § 301.6112-1T, A-5 (referencing Temp. Treas. Reg. § 301.61111-1T, A-30).

14 The term also includes "projected income investments" as defined in Temp. Treas. Reg. § 301-6111-1T, A-57A.

exceptions are available for transactions that are deemed not abusive.[15] The Prior List Maintenance Regulations also provide *de minimis* exceptions.[16]

The list must include information with respect to both corporate and noncorporate taxpayers who acquire interests in the tax shelter. Any list required to be maintained under section 6112 must be made available to the Treasury upon request and maintained for seven years.

Under section 6708, any person who is responsible for maintaining an investor list and fails to do so is subject to a penalty of $50 for each person with respect to whom there is a failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. However, the maximum penalty imposed on any given taxpayer for failing to maintain an investor list is $100,000 per calendar year.

C. Registration Regulations

The third set of regulations, contained in Temp. Treas. Reg. § 301.6111-2T (the "Registration Regulations"), requires that promoters of confidential corporate tax shelters register such transactions with the IRS.[17] A "confidential corporate tax shelter" is defined as any entity, plan, arrangement or transaction that satisfies the following three conditions: (1) a significant purpose of the structure of the transaction is the avoidance or evasion of federal income tax for a corporate participant, (2) the transaction is offered to

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15 *See* exceptions (2), (3) and (4) above under "Prior Disclosure Regulations".

16 Except for Listed Transactions, transactions subject to registration under section 6111, and "projected income investments" described in Temp. Treas. Reg. § 301.6111-1T, A 57A, listing is not required for (i) purchasers who paid less than $25,000 to all organizers and sellers with respect their acquisition of an interest in the tax shelter, and (2) persons whose expected tax benefits are less than specified thresholds (for corporations, $1 million in any taxable year and $2 million in any combination of taxable years, and for noncorporate taxpayers, $250,000 in any taxable year and $500,00 in any combination of taxable years).

17 The definition for "promoter" is the same broad definition used for "organizers" in the Prior List Maintenance Regulations.

prospective participants under conditions of confidentiality and (3) the promoters receive aggregate fees in excess of $100,000.[18] The same exceptions apply as under the Prior List Maintenance Requirements.

Under section 6707, a person who fails to register a confidential corporate tax shelter in a timely manner is subject to a penalty in an amount equal to the greater of (1) 50% of the fees paid to all promoters with respect to offerings made prior to the date of late registration, or (2) $10,000. If the failure to file is intentional, however, the applicable percentage is 75% instead of 50%. No penalty is imposed for a failure to register a confidential corporate tax shelter if the failure is due to reasonable cause.

II. Summary of Temporary and Proposed Regulations

The New Regulations include completely revised versions of Temp. Treas. Reg. § 1.6011-4T (the "New Disclosure Regulations") and Temp. Treas. Reg. § 301.6112-1T (the "New List Maintenance Regulations") and effect minor amendments to the Registration Regulations.

A. The New Disclosure Regulations

The New Disclosure Regulations revise the definition of a "reportable transaction" generally to include any transaction (or series of transactions) within any of the following categories:

1. *Listed Transactions*. Transactions which are the same as or substantially similar to a transaction that the IRS has determined in published guidance to be a tax avoidance transaction.

2. *Confidential transactions*. Any transaction offered under conditions of confidentiality, taking into account all the facts and circumstances. A

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[18] Another statutory provision (section 6111(c)) requires registration for investments that, generally speaking, generate tax losses in excess of two times the amount invested and are publicly offered or sold to 5 or more substantial investors.

presumption against confidentiality applies if every person who makes or provides a statement as to the potential tax consequences of the transaction provides express written authorization, effective without limitation of any kind from the commencement of discussions, permitting the taxpayer to disclose the structure and tax aspects of the transaction.

3. *Transactions with contractual protection.* Any transaction for which the taxpayer has received contractual protection against the possibility that some or all of the intended tax consequences will be denied. For this purpose, contractual protection includes, but is not limited to, rescission rights, the right to a full or partial refund of fees paid, fees contingent on the realization of the intended tax benefits, insurance protection with respect to the tax treatment of the transaction, and tax indemnity or similar agreements. This rule does not apply to interest gross-ups applicable if withholding is imposed, or to an issuer's right to call a debt instrument as to which interest gross-ups have been triggered.

4. *Loss transactions.* Any transaction that results in, or is reasonably expected to result in, a gross loss deductible under section 165 (disregarding loss limitation rules) in excess of certain threshold dollar amounts:

    - for corporate taxpayers, the threshold is $10 million in one (taxable) year or $20 million in any combination of years;
    - for partnerships and S corporations, the threshold is $5 million in one year or $10 million in any combination of years; and
    - for individuals and trusts, the threshold is $2 million in one year or $4 million in any combination of years; or, if the loss arises with respect to a foreign currency transaction, $50,000 in one year.

5. *Significant book-tax differences.* With respect to reporting companies under the Securities Exchange Act of 1934 or business entities with $100 million or more in gross assets, any transaction producing or reasonably expected to produce a book-tax difference of at least $10 million in any taxable year, other than certain timing differences and various enumerated items. Special rules deal with book-tax differences with respect to partnerships and shareholders of certain foreign companies.

6. *Transactions with brief asset holding periods.* Any transaction resulting in a tax credit exceeding $250,000, if the underlying asset giving rise to the credits was held by the taxpayer for less than 45 days.

In an attempt to make the New Regulations more objective and less susceptible to interpretive abuse, there are no general regulatory exceptions to the definition of "reportable transactions."[19] In particular, the "no reasonable basis" and "customary commercial practice" exceptions of the Prior Disclosure Regulations will not apply.[20] The New Disclosure Regulations also require the disclosure of transactions identified as Listed Transactions involving estate, gift, employment, pension excise and public charity excise taxes. Regulated investment companies are not required to disclose participation in loss transactions or transactions with significant book-tax differences.

Any taxpayer that directly or indirectly participates in any reportable transaction must attach new IRS Form 8886 ("Form 8886") to its federal income tax return for each year in which its federal income tax liability is affected by its participation in the transaction.[21] A copy of Form 8886 must also be submitted to the Office of Tax Shelter Analysis ("OTSA") at the same time Form 8886 is first filed with IRS. Generally, the New Disclosure Regulations apply to transactions entered into on or after January 1, 2003.

B. The New List Maintenance Regulations

The New List Maintenance Regulations provide that a transaction is a "potentially abusive tax shelter" (for which list-keeping is required) if it is required to be registered under section 6111, or is a Listed Transaction, or if the organizer or seller, at

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19 The regulations do provide that "[a] transaction will not be considered a reportable transaction, or will be excluded from any individual category of reportable transaction ... if the Commissioner makes a determination, by published guidance, individual ruling ... or otherwise, that the transaction is not subject to the reporting requirements of this section." Temp. Treas. Reg. § 1-6011-4T(b)(8).

20 *See* "Prior Disclosure Regulations," above.

21 Thus, the distinction under the Prior Disclosure Regulations between the disclosure requirements for corporations and other taxpayers has been eliminated.

the time the transaction is entered into, knows or has reason to know that the transaction is otherwise a "reportable transaction" as defined in the New Disclosure Regulations.

The New List Maintenance Regulations subsume the categories of "organizer" and "seller" in the new category of "material advisor," defined as any person who receives, or expects to receive, a fee in connection with the transaction in excess of certain thresholds and who makes or provides any statement, oral or written, to any person regarding the potential tax consequences of the transaction. The minimum fee is $250,000 if all persons who acquire an interest, directly or indirectly in the transaction, are corporations (other than S corporations), and $50,000 for all other transactions. The determination of whether the minimum threshold is met is made separately with respect to each transaction that is a potentially abusive tax shelter.

The list must include the name of each person to whom a material advisor makes or provides a statement, oral or written, as to the potential tax consequences of the transaction and who the material advisor knows, or has reason to know, participated or will participate in the transaction or a substantially similar transaction. In addition, a person will be treated as participating in a transaction if the material advisor knows (or has reason to know) that the person sold or transferred (or will sell or transfer) an interest in that type of transaction to a "subsequent participant." The material advisor also must list any subsequent participant whose identity the material advisor knows or has reason to know.

The information that must be maintained on the list is generally the same as under the Prior List Maintenance Regulations. The list must be furnished to the IRS within 20 business days following the date of a request. The material advisor must

maintain the list for 10 years following the last date on which the material advisor made a written or oral statement regarding the potential tax consequences of the transaction.

While multiple material advisors may designate one material advisor to maintain the list for a transaction, such designation will not relieve any other material advisor from its obligation to furnish the list to the IRS, or from potential liability if the designated material advisor fails properly to maintain the list.

The New List Maintenance Regulations apply to any transaction that is a potentially abusive tax shelter entered into, or any interest acquired therein, on or after January 1, 2003. However, they also apply to any transaction that was entered into, or in which an interest was acquired, after February 28, 2000, if the transaction becomes a Listed Transaction on or after January 1, 2003.

C. The Registration Regulations

The New Regulations also make minor conforming changes to the Registration Regulations. The preamble to T.D. 9017 notes that pending legislation would modify section 6111 to require registration of transactions that are required to be disclosed under section 6011. The preamble states that Treasury and the IRS expect to make further changes to the regulations under section 6111 when such legislation is enacted.

III. Comments

As noted in our previous submissions, transactions that are structured to permit taxpayers to make questionable claims to tax benefits harm the fisc in numerous ways. Moreover, such transactions also affect the public's perception of business ethics. We continue to believe that prompt, systematic disclosure of tax shelter transactions is an important and necessary element in the IRS's arsenal of tax shelter weapons.

In promulgating the New Regulations, Treasury and the IRS have addressed many of the shortcomings that resulted in insufficient disclosure and list maintenance under the prior regulations, while awaiting legislation to revise the Registration Regulations. We welcome the coordination of the disclosure and listing rules. We are also sympathetic to the frustration that has given rise to the substantial expansion of transactions and persons subject to the New Regulations. However, we have serious concerns that the breadth of some of the changes will make administration difficult and unnecessarily burden taxpayers engaged in transactions that are not tax shelters. This report is generally supportive of the New Regulations, and we encourage new initiatives by Treasury and the IRS until the tax shelter problem is brought under control. However, some provisions of the New Regulations need to be tempered.

One of the principal difficulties that arise from the objective nature of the New Regulations is that neither a taxpayer's subjective tax motivation, nor the fact that a taxpayer's reporting is clearly correct, is any longer a factor. Thus, transactions that are motivated entirely by non-tax considerations, or that present no tax issue worth considering, will be caught up in the New Regulations. We considered recommending the reintroduction of some of the exceptions contained in the earlier regulations as a means of addressing the overly inclusive nature of the New Regulations, but decided not to do so at this time. We reached this decision in part because of the shortcomings of the earlier regulations, as evidenced by the limited disclosure they produced. Thus, we support the objective approach of the New Regulations and do not suggest the elimination of any of the reportable transaction categories contained in the New Regulations.

We do, however, suggest that "less is more." The Treasury and the IRS are attempting to marshal information so that they may more effectively combat inappropriate tax structured transactions. By limiting the breadth of some of the provisions of the New Regulations, the IRS will be better able to focus on relevant information, and innocent taxpayers will experience less inconvenience. Admittedly, some not-so-innocent transactions may escape attention, but we believe that the New Regulations, modified as we suggest, will bring to light more transactions than the IRS has resources to address. Moreover, the IRS can fine-tune the information it receives by adding to the Listed Transaction category.

A. Summary of recommendations

As discussed above, in principle we support the approach of the New Regulations. We have a number of suggestions, however, many of which relate to narrowing the scope of the New Regulations so as to provide more helpful information to the IRS and reduce unnecessary burdens on taxpayers and advisors. The principal recommendations presented in this report include:

1. clarifying the meaning of "transaction" for purposes of the New Regulations;

2. clarifying the meaning of "participation" in a reportable transaction for purposes of the disclosure and list maintenance rules;

3. limiting flow-through reporting requirements (for partners, beneficiaries, or shareholders) with respect to reportable transactions entered into by partnerships, trusts and S corporations;

4. clarifying and possibly modifying the application of the New Regulations to foreign corporations and their shareholders;

5. providing a periodic composite summary of Listed Transactions, and more regularly including in published guidance that identifies a Listed Transaction a description of "substantially similar" characteristics;

6. modifying the confidentiality safe harbor to make it more workable, including providing a safe harbor for typical M&A confidentiality agreements and clarifying the treatment of "exclusivity" arrangements;

7. clarifying and expanding the exceptions to the contractual protection category;

8. clarifying the meaning of "reasonably expected losses" and providing additional exceptions to the loss category;

9. simplifying the application of the book-tax difference category and substantially expanding the exceptions to this category;

10. providing an exception under the brief holding period category (similar to the provisions of section 901(k)(4)) for certain credits claimed by securities dealers;

11. raising the threshold for fees that trigger the requirement to maintain investor lists to $250,000 unless all taxpayers are individuals; and

12. limiting application of the requirement to maintain investor lists to persons who make material statements regarding the tax consequences of the transaction.

B. General Issues

Some of the issues we have identified relate generally to provisions of the New Regulations and are discussed in the following paragraphs.

Meaning of "Taxes". In many places the New Regulations refer to "taxes" or "tax purposes." The New Regulations apply generally with respect to U.S. federal income taxes, although in the case of Listed Transactions, the New Regulations also apply to estate, gift, pension excise and public charity excise taxes. Accordingly, the statement of tax consequences that causes a person to be a "material advisor" for purposes of the New Listing Regulations (provided that such person receives a sufficient fee) should relate only to U.S. federal income taxes (or, in the case of a Listed Transaction, the category of U.S. tax identified in the ruling describing the Listed Transaction), not state, local or foreign taxes. This should be made clear. Similar

clarification is needed with respect to the other references to "tax" that appear throughout the New Listing Regulations and the New Disclosure Regulations.

Meaning of "Transaction". What constitutes a transaction is relevant for a number of purposes including:

- the information that must be reported on Form 8886;
- the satisfaction of the dollar threshold under the loss and book-tax difference categories;
- the parties and/or information that must be included under the list maintenance rules;
- the satisfaction of the $50,000/$250,000 fee threshold for material advisors; and
- the application of effective date rules.

The meaning of the term is ambiguous in a number of circumstances. For example, the New Regulations indicate that similar transactions in the same year are to be treated as a single transaction for disclosure statement purposes. Thus, a taxpayer that enters into a series of similar transactions within the same calendar year would apparently be required to aggregate them for purposes of testing the dollar thresholds for the loss and book-tax difference categories and to report all such transactions on a single Form 8886, regardless of whether they involved the same third parties or promoters and regardless of whether each was itself a reportable transaction.[22] On the other hand, the New List Maintenance Regulations appear to treat each transaction separately (*e.g.,* for determination of the fee threshold) except that an additional list must be maintained of substantially similar

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[22] For example, one transaction might be subject to conditions of confidentiality and would therefore be a reportable transaction, while other similar transactions might not have been subject to such a condition. Nevertheless, all of the transactions may be required to be included on a single Form 8886.

transactions that are potentially abusive tax shelters. Clarification is needed as to the meaning of "transaction" for these and other purposes under the New Regulations.

Meaning of "Participate". In order to determine which taxpayers must attach Form 8886 to their tax returns and who must be listed under the New List Maintenance Regulations, it is necessary to establish what constitutes direct or indirect participation in a reportable transaction. For purposes of the disclosure rules, a participant is presumably a taxpayer to whom one of the reportable transaction applies and whose tax liability is affected by such transaction itself (as opposed, for instance, to material advisors whose tax liability may be affected by fees earned with respect to a transaction).[23]

The list maintenance requirements appear to use a somewhat different concept of what it means to participate in a reportable transaction. Specifically, a "material advisor" is required to list each person to whom the advisor provides a statement of tax consequences of a transaction that is a potentially abusive tax shelter *if* the advisor knows or has reason to know that the such person (or a related person) "*participated in or will participate in* the transaction (or a substantially similar transaction that is a potentially abusive tax shelter)."[24] For this purpose, the advisor must "treat a person ... as *having participated* in a transaction that is a potentially abusive tax shelter if the material advisor knows or has reason to know that the person sold or transferred, or will sell or transfer, to another person (*subsequent participant*) an *interest* in that type of transaction that, if entered into, would be a potentially abusive tax

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23 The New Regulations are not clear on this point. See the discussion below under "Disclosure Requirement".

24 Temp. Treas. Reg. § 301.6112-1T(e)(2)(i).

shelter."[25] An "interest" in a transaction includes not only interests in property such as partnership interests, but, among other things, "information or services regarding the organization or structure of the transaction if the information or services are relevant to the potential tax consequences of the transaction."[26]

Thus, for instance, if a law firm sells a tax structuring idea to a bank, which in turn sells it (in a transaction of which the law firm has, or should have had, knowledge) to a customer of the bank that engages in the transaction, the law firm would be required to list both the bank and its customer, because, for purposes of the listing rules, both are deemed to have participated in the transaction.[27] Yet, as we understand it, only the customer of the bank and not the bank itself would be required to file a Form 8886. Assuming we have interpreted the intent of the regulations correctly, we believe it would be helpful to confirm in the final regulations (or the preamble) that a party that (by virtue of selling an interest in a potentially abusive tax shelter to a subsequent participant) is treated as participating in a potentially abusive tax shelter for purposes of the New List Maintenance Regulations may not be required to file a Form 8886.

Treatment of Flow-Throughs. While the New Regulations provide specific rules for the treatment of flow-through entities (*e.g.*, partnerships, trusts and estates) in certain circumstances, we believe that they leave some issues unclear and also

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25 Temp. Treas. Reg. § 301.6112-1T(e)(2)(ii). The material advisor must also list any subsequent participant if the material advisor knows or has reason to know that the subsequent participant will participate in, or sell to another subsequent participant, an interest in the transaction. *Id.*

26 Temp. Treas. Reg. § 301.6112-1T(d)(1).

27 *See* Temp. Treas. Reg. § 301.6112-1T(e)(2)(iii), Example 2. As we understand the listing rules, the bank "participates" by selling the tax structuring idea (which constitutes an "interest" in the transaction) to its customer, which is a "subsequent participant." For further discussion of issues arising under the listing rules, see "List Maintenance Requirements," below.

provide for what in some cases is unnecessary duplication of reporting. As discussed below under "Disclosure Requirements," we believe that where a partnership, S corporation or trust files a Form 8886, indirect participants should not also be required to file the form, but should have available a simplified procedure for indicating that their tax liability was affected by a reportable transaction.

Shareholders of Foreign Corporations. For persons who are "reporting shareholders,"[28] the book-tax difference category provides a look-through of foreign entities. However, the New Regulations otherwise seem to require that the determination be made at the foreign corporation level, with the reporting shareholder becoming subject to the disclosure rules if the foreign corporation has engaged in one of the reportable transaction categories or "the transaction . . . reduces or eliminates an income inclusion ...."[29] As regards the list maintenance requirement, the foreign corporation itself and all shareholders whose Federal income tax liability could be affected by a reportable transaction entered into by the foreign corporation may be listable participants, although that is not clear.[30]

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28 The "reporting shareholder" category includes all U.S. shareholders of a foreign personal holding company ("FPHC"), all "United States shareholders" (as defined in section 951(b)) of a controlled foreign corporation ("CFC"), and all 10 percent shareholders (by vote or value) of a passive foreign investment company ("PFIC") that is a qualified electing fund ("QEF"). Temp. Treas. Reg. § 1.6011-4T(c)(3)(ii)(B).

29 Temp. Treas. Reg. § 1.6011-4T(c)(3(ii)(A). The quoted language has been a source of considerable confusion. Read literally, every reporting shareholder would be required to report every transaction of the foreign corporation if the transaction reduced or eliminated income inclusions under section 551, 951 or 1293. We believe that it was intended to relate to the book tax difference category in which case the provision should read:

> .... and the transaction either is described in any of the paragraphs (b)(2) through (5) or in paragraph (b)(7) of this section, or is described in (b)(6) of this section and reduces or eliminates an income inclusion that otherwise would be required under section 551, 951 or 1293.

30 For instance, assume that, in connection with a reportable transaction entered into by a pre-existing foreign corporation that is a FPHC, CFC, or QEF, a material advisor makes a statement to a representative of the foreign corporation and receives a fee in excess of $250,000. The foreign corporation is a "person" within

We are concerned about the application of the rules with regard to PFICs with shareholders who have elected qualified electing fund ("QEF") treatment. These entities can significantly affect the U.S. tax liability of a U.S. taxpayer. In such cases the 10% threshold may miss many if not most shareholders who have elected QEF treatment. One possible approach to this issue would be to require the PFIC Annual Information Statement required pursuant to Treas. Reg. § 1.1295-1 to include notification that the PFIC had engaged in one or more reportable transactions and to require this fact to be noted on the Forms 8621 filed by all electing shareholders. To avoid burdensome and duplicative reporting , we do not necessarily suggest that all shareholders making a QEF election should have to file a Form 8886. However, it does not seem unreasonable to require that someone file a Form 8886. This could be handled in many cases by having any party filing Form 5471 with respect to the corporation in question to file the Form 8886.[31]

Effective Date. The New Regulations are generally effective for transactions entered into on or after January 1, 2003 but can, in the case of the New List Maintenance Regulations, relate back in the case of transactions entered into after February 28, 2000 that become Listed Transactions after January 1, 2003. While we can

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the meaning of Temp. Treas. Reg. § 301.6112-1T(d)(3) that directly participates in the transaction, and would therefore appear to be listable. It is not clear, if the material advisor makes no statement to any pre-existing reporting shareholders of the foreign corporation, but knows of their existence, whether it should treat them as "subsequent participants." If, on the other hand, the material advisor knows of the existence of a shareholder that acquires an interest in the foreign corporation in connection with the reportable transaction, it would apparently be required to treat the shareholder as a listable subsequent participant, but it is not clear if this is intended if the shareholder is not a "reporting shareholder" (*e.g.*, a shareholder that makes a QEF election but has an interest of less than 10%). It would be useful if additional examples were provided in the regulations to address such questions.

31 Consideration should also be given to allowing similar procedures to avoid duplicative reporting with respect to CFCs or FPHCs (as to which a Form 5471 should always be filed by at least one shareholder).

understand and sympathize with the relation-back concept for Listed Transactions, looking back before the New Regulations were first made public seems unduly burdensome for those not previously subject to list keeping obligations.[32]

Some of the issues mentioned above under "Meaning of 'Transaction'" also relate to the effective date provisions. For example, do transactions which occurred before 2003 (and, therefore, by themselves would not be covered by the New Regulations) become subject to the New Regulations if they are similar to post-2003 transactions and occur in the same taxable year of a fiscal year taxpayer? Also, are transactions that are deemed to occur for tax purposes in 2002 but have elements that are deemed to occur for book purposes in 2003 subject to the book-tax difference category? In addition, when does an action taken after January 1, 2003, with respect to a transaction entered into before that date constitute a separate reportable transaction?[33] It would be helpful if the New Regulations or some other pronouncement clarified these and similar issues.

Penalties. Penalties are clearly a weak link in the effectiveness of the New Regulations. As regards disclosure, recently proposed regulations under sections 6662

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32 We assume that, as a general matter, a transaction entered into prior to January 1, 2003 and that becomes a listed transaction after that date should have been subject to list-keeping by one or more organizers pursuant to the Prior List Maintenance Requirements. In any event, we have no concern regarding the obligation of such organizers to maintain a list with respect to such a transaction. The issue, rather, is whether a party not required to maintain a list under the prior regime (because, for instance, it did not participate in the entrepreneurial risks or benefits of the transaction, *see* A-5 of the Prior List Maintenance Requirements) should be required to become a list-keeper if the transaction becomes a listed transaction after January 1, 2003. At a minimum, if such a requirement is imposed, it would seem that the obligation to provide information should be relaxed, in view of the fact that the party in question may not have obtained or retained all of the information required for list-keeping.

33 An example would be a sale or cash payment made after January 1, 2003 under a pre-existing contractual arrangement, which sale or payment produces, or is expected to produce, a book-tax difference after January 1, 2003 (for instance, a sale of credit card receivables to an existing trust, or a payment of life insurance premiums under an existing corporate-owned life insurance policy).

and 6664[34] address this concern by, among other things, precluding a taxpayer from establishing reasonable cause by relying on an opinion of counsel regarding a reportable transaction that is not properly disclosed by the taxpayer. While we have not had an opportunity to review the proposed regulations in detail, we agree that some rule along this line is desirable.

While there are penalties for failure to comply with the list maintenance requirements, those penalties are limited to $50 for each person not listed, with the maximum penalty limited to $100,000 a year for all failures.[35] For many material advisors, this would be insignificant. In contrast, the penalty for failure to register is substantial—the greater of $10,000 or 50% of fees (75% if intentional).[36] Adding teeth to the listing requirement will require legislation.

Excluded Transactions. The New Regulations list 13 types of transactions that are to be excluded from the book-tax difference category, and we understand that the IRS is compiling an "angel list" of additional transactions excluded from one or more categories of reportable transactions.[37] As noted above, we are not inclined to suggest a wholesale revision of the New Regulations at this point, but we do have serious concerns about their breadth unless significant additional exclusions are provided. The following section provides more specific suggestions.

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34 *See* Prop. Treas. Reg. §§ 1.6662-3, 1.6664-4, 67 Fed. Reg. 79894 (Dec. 31, 2002).

35 *See* Section 6708(a).

36 *See* Section 6707(a)(3).

37 *See* New York State Bar Ass'n Tax Section, *Letter to Treasury Department and Internal Revenue Service presenting proposed exceptions to the tax shelter disclosure requirements of Treas. Reg. § 1.6011-4T*, No. 1023 (Dec. 11, 2002) (representing comments by individual members of New York State Bar Association Tax Section and not approved by the Tax Section's Executive Committee).

C. Reportable Transactions

Six categories of reportable transactions form the common foundation for the disclosure and list maintenance rules. The categories reflect the attempt to describe types of situations that can give rise to abusive tax transactions, without any determination of whether a particular transaction is tax-motivated or provides a taxpayer with potentially unwarranted tax benefits. As a result, disclosure and list maintenance will be required for a great number of wholly innocent transactions in which the IRS will have no interest and for which taxpayers will see no justification for the reporting and list maintenance burdens. Thus, it is imperative that the six categories be as limited as possible, consistent with the need for information, and that they be clear in the manner of their application.

1. Listed Transactions. The listed transaction category serves as a backup to the other five categories by providing the IRS a means to identify specific types of transactions that should be disclosed. This category can be used to deal with transactions not otherwise described in the other five categories, particularly if our recommendation to narrow these other categories is adopted.

The listed transaction category could be made more effective. First, the IRS should regularly (*e.g.*, quarterly) prepare a composite list of the transactions that are included. The IRS released a composite list on August 3, 2001 in Notice 2001-51. However, it has not released a general update of that notice.[38] Periodic updates would

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38 The IRS has added individual transactions to the category of listed transactions in subsequent notices. *See e.g.*, Notice 2003-6 (ESOP transaction by S corporation), Notice 2002-70 (reinsurance transaction); Notice 2002-65 (transaction utilizing a straddle, an S corporation or a partnership, and one or more transitory shareholders or partners); Notice 2002-50 (transaction involving a straddle, a tiered partnership, a transitory partner and the absence of a section 754 election); Notice 2002-35 (transaction using notional principal contracts); Notice 2002-21 (transaction generating tax losses based on an inflated basis in assets acquired from another party).

have the benefit of providing taxpayers and their advisors with a ready list of the transactions listed by the IRS and would also serve regularly to remind taxpayers and their advisors of the IRS's attention to such matters.

We also recommend that the IRS consider more regularly including in published guidance identifying a Listed Transaction a description of "substantially similar" characteristics. While the New Regulations have improved on previous regulations in making it clear that the IRS intends to interpret the term "substantially similar" broadly, more detail would be helpful to taxpayers and advisors who are in good faith trying to deal with the ever expanding list. Additional detail would also make it more difficult for aggressive taxpayers and their advisors to rationalize the inapplicability of the listed transaction category.

2. Confidential Transactions. We recognize the IRS's interest in transactions that are offered in a manner that limits disclosure of their underlying Federal income tax aspects. While such limitations do not necessarily indicate abuse, at the very least they raise a bona fide governmental interest in learning more about the transactions. We are concerned, however, by the breadth of the definition of "conditions of confidentiality" under the New Regulations.

The New Regulations provide that all the facts and circumstances relating to a transaction are considered when determining whether a transaction is offered under conditions of confidentiality. Furthermore, the New Regulations specifically state that a transaction is offered under conditions of confidentiality if "a taxpayer'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 person who provides a

statement, oral or written, (or for whose benefit a statement is made or provided) as to the potential tax consequences that may result from the transaction".[39]

We believe that the New Regulations could be more clearly focused on conditions of confidentiality of the kind that signal potential abuse (the paradigm being confidentiality agreements designed to protect a marketed tax avoidance strategy). Proscribed confidentiality should only relate to the Federal income tax aspects and structural elements relevant to the Federal income tax aspects of a transaction. This, for example, should not include the identity of the parties to a transaction or the dollar amounts involved (items frequently kept confidential in commercial transactions for non-tax reasons). We recommend that the New Regulations confirm that a limitation on a taxpayer's ability to disclose such items would not constitute a condition of confidentiality, and provide other examples illustrating limitations on the scope of the confidential transaction category. As we have previously suggested, one means of identifying elements of a transaction that are not essential to an understanding of its tax benefits is to look at those items that could be redacted from a publicly released version of an IRS private letter ruling.[40]

In order to avoid sweeping almost all transactions involving an acquisition, disposition, or substantial investment in an active trade or business ("M&A transactions") into the confidentiality category, we believe that one or more special rules may be required (or, alternatively, a reformulation or illustration of what constitutes conditions of confidentiality that makes clear that standard M&A practice is not

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39 Temp. Treas. Reg. § 301.6011-4T(b)(3).

40 *See* New York State Bar Ass'n Tax Section, *Report on the Temporary and Proposed Tax Shelter Regulations*, at p. 33 (Nov. 16, 2000).

problematic).[41] Discussions regarding any potential M&A transaction typically begin with execution of a broadly phrased confidentiality agreement, designed both to protect confidential business information and to prevent disclosure of the existence or terms of the discussions.[42] We do not believe it would be appropriate to try to force inclusion in such a preliminary agreement of a carve-out permitting disclosure of the structure and tax aspects of the transaction.[43] Instead, we propose that such a transaction not be deemed entered into under "conditions of confidentiality" for purposes of the New Regulations if any initial confidentiality agreement is amended not later than the earlier of (i) the public announcement of the transaction, and (ii) 10 days following the entry into a binding agreement relating to implementation of the transaction, to permit disclosure of the Federal income tax aspects of the transaction and the structural elements relevant thereto. In addition, it would be helpful to have an example in the regulations confirming that standard provisions designed to protect confidential business information may remain in

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41 We believe that such an exception should be available without regard to whether either of the parties "promotes" the transaction, because we do not believe that the concept of "promotion" can be defined in a way that is both consistent with the objective approach of the New Regulations and sufficiently narrow not to sweep in many if not most M&A transactions. To the degree that there is concern that this might permit abuse, the exception could be limited by the requirement that the trade or business have been actively conducted for some period (*e.g.*, one year) prior to the investment. Similar requirements could be considered for other M&A transaction exceptions suggested in this report.

42 While such agreements are most frequently executed by the "buyer" in favor of the "seller," it is not uncommon for both parties to execute such agreements (*e.g.*, when both are subject to "due diligence" in a stock-for-stock merger).

43 For one thing, the structure of the transaction is often not settled in the early stages of discussion. More importantly, the parties to initial confidentiality agreements would have legitimate cause for concern that disclosure of structural or tax aspects of a transaction might give undesirable clues regarding the existence of the discussions, even if the identity of the parties was not disclosed.

force after this stage of the transaction without constituting "conditions of confidentiality."[44]

The New Regulations provide that a transaction is not considered offered 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. Many cross-border transactions will be subject to disclosure restrictions necessary to comply with foreign securities law, and the New Regulations should treat such transactions similarly. Thus, we propose expanding this exception so that it applies to all securities laws.

In order to satisfy the presumption against conditions of confidentiality, every person who makes or provides a statement as to the potential tax consequences that may result from a transaction must provide express written authorization to the taxpayer to disclose the structure and tax aspects of the transaction. The New Regulations have substantially expanded the category of persons who must provide this written authorization; under the Prior List Maintenance Regulations, only tax shelter promoters was required to do so.[45] We are concerned that the written authorizations required under

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44 For an illustration of the kind of confidentiality agreement that we believe should not be problematic, see the confidentiality provisions in the sample acquisition agreement presented in Ginsburg and Levin's *Mergers, Acquisitions, and Buyouts*. These provisions require that the seller treat all "Confidential Information", defined as "any information concerning the business and affairs of Target and its Subsidiaries that is not already generally available to the public", as such, including refraining from using any Confidential Information except in connection with the agreement and delivering all "tangible embodiments" and related copies of the Confidential Information to the buyer upon request. The confidentiality provision also sets forth requirements for the seller if disclosure of Confidential Information is requested and/or required in a legal proceeding or other similar process. Ginsburg & Levin, *Mergers, Acquisitions, and Buyouts*, vol. 4, pp 22-128, -163 (June 2002 Ed.).

45 *See* Temp. Treas. Reg. § 1.6011-4T (referencing Temp. Treas. Reg. § 301.6111-2T(c). Thus, persons that did not participate in the entrepreneurial risks or benefits of a tax shelter were not required to provide such authorization.

the new regime are unnecessarily burdensome.[46] We believe that it should be sufficient, as a general matter, that the authorization to disclose be provided in the documents relating to the transaction.[47]

Under the New Regulations, written authorization to disclose must now be effective without limitation from the commencement of discussions. We are concerned that this "commencement of discussions" test will be difficult, if not impossible, to satisfy from a practical perspective. Preliminary discussions about a potential transaction are often informal, and may not be accompanied by any written materials. In our view, requiring written authorization to disclose at this early juncture would be unduly burdensome. In addition to the special rule discussed above with respect to M&A transactions, we propose that written authorization not be required until the earlier of (i) the delivery to the taxpayer of written materials relating to the transaction, or (ii) some reasonable period (*e.g.*, 30 days) after commencement of discussions.

Under the New Regulations, it is not clear whether an exclusivity agreement with a promoter (under which the taxpayer has to pay a fee if it engages in the transaction without the promoter) would in and of itself constitute a condition of confidentiality. While such an agreement does not limit a taxpayer's ability to disclose

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46 Assume, for example, that a taxpayer sells business assets at a loss in a transaction that has no tax avoidance motive but falls within the "loss transaction" category. To come within the safe harbor, interpreted literally, it would appear that written authorization to disclose the tax aspects of the transaction would have to be provided to the taxpayer by each of its own advisors, the buyer, and each of the buyer's advisors who mentioned, even in passing, the tax consequences of the transaction, whether or not such statement was communicated to the taxpayer or its representatives or was even pertinent to the tax consequences to the taxpayer.

47 This would include, for instance, not only definitive documentation implementing the transaction, but any marketing materials or tax opinions or analyses delivered to the taxpayer or its representatives. We note that the presumption of non-confidentiality is only a presumption, and that to the extent that the facts and circumstances indicate that a condition of confidentiality is in fact present, notwithstanding written authorizations to disclose, the presumption would be overridden.

the tax structure, and therefore would not be a condition of confidentiality in the colloquial sense of the term, it does seem to constitute a limitation on "the taxpayer's use ... of information relating to the structure or tax aspects of the transaction,"[48] and therefore could be construed as a "condition of confidentiality" for purposes of the New Regulations. In general, we do not object to this interpretation. However, we are concerned that treating exclusivity agreements as conditions of confidentiality will sweep in arrangements legitimately used in M&A transactions (*e.g.*, break-up and/or topping fees payable on failure to complete a sale to the contracting buyer, or as a result of engaging in a transaction with another). Thus, if exclusivity agreements are generally treated as a "condition of confidentiality," we recommend that an exception be provided for exclusivity agreements between principals in M&A transactions.

3. Contractual Protections. Under the New Regulations, reportable transactions include those that provide taxpayers with contractual protection against the possibility that part or all of the intended tax consequences from the transaction will not be sustained. Contractual protection includes, but is not limited to, rescission rights, the right to a full or partial refund of fees paid to any person, fees contingent upon the taxpayer's realization of tax benefits from the transaction, insurance protection for the tax treatment of the transaction, and a tax indemnity other than a customary indemnity provided by a principal to the transaction that did not participate in the promotion or offering of the transaction to the taxpayer. A transaction will not be considered to have contractual protection solely because the issuer of a debt instrument agrees to make additional payments to a holder to compensate for withholding tax imposed on interest

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[48] Temp. Treas. Reg. § 1.6011-4T(b)(3).

payments or because the issuer can call a debt instrument if such rights to payment are triggered.

Although contractual protection against loss of tax benefits has been present in some abusive tax shelters, we believe that the New Regulations reach far beyond the contractual protection provided to participating taxpayers by tax shelter promoters. Contractual risk shifting permeates many transactions and is properly used to allocate the risk of unexpected tax costs.[49] This circumstance is recognized in the New Regulations in the exception for a customary indemnity provided by a principal to a transaction, but we are concerned that the exception is too narrowly crafted. Principals to a transaction will almost always have some role in the promotion or offering of the transaction. We believe that this provision should not place unnecessary pressure upon legitimate tax-related contractual protections. We suggest that an exception be provided for customary indemnities provided by a principal to a transaction, or a shareholder of a principal, in connection with M&A transactions and public offerings.

We believe that additional technical guidance is necessary to clarify certain other aspects of the contractual protection provision. First, a strict reading of the exceptions for additional payments and tax call rights might limit their scope solely to instances when they appear in debt instruments. The application to debt instruments should be illustrative rather than exclusive. We believe that exceptions should also apply to equity and derivative instrument transactions. Swap and notional principal contract transactions are typically documented on forms of the International Swaps and

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[49] For example, the distributed corporation in a spinoff qualifying under section 355 will typically indemnify the distributor corporation for subsequent transactions that affect such qualification. Also, a seller of a subsidiary (or the shareholder of a subsidiary in which a significant equity investment is being made) will often indemnify the purchaser for certain taxes arising from tax audits of the subsidiary.

Derivatives Association, Inc., which provide for additional payments and tax call rights if withholding is imposed. Similar provisions appear in standard documentation for securities lending transactions. Preferred stock transactions often include gross-up provisions related to a change in law and an issuer's earnings and profits. Cross-border equity financing transactions sometimes provide for additional payments in the event of a withholding tax due to a change in law in a foreign jurisdiction. We believe that clarification should be provided that none of the foregoing types of contractual protections cause a transaction to be a "reportable transaction" (irrespective of whether the party providing the contractual protection has promoted the transaction).

More generally, we request clarification as to whether a contractual right to terminate a transaction if there is a change in law or if the transaction is successfully challenged is a contractual protection triggering a disclosure obligation. This type of "tax call" right can be distinguished from contractual rescission rights, which are noted in the text of the New Regulations. We understand a rescission right to be a provision that reverses all aspects of a transaction, including the payment of fees, so that the transaction is treated as never having occurred at all.[50] An early termination right that does not include the right to a repayment of fees from the promoter is less indicative of potential abuse.

4. Loss Transactions. Under the New Regulations, disclosure is required for a transaction in which the taxpayer has participated that results in, or is reasonably expected to result in, a loss for the taxpayer under section 165 in excess of a specified threshold. The amount of the loss under section 165 is calculated on a gross basis, not

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[50] *See* New York State Bar Ass'n Tax Section, *Report on the Temporary and Proposed Tax Shelter Regulations*, at p. 39 (Nov. 16, 2000).

offset by gains or other income from related transactions, and without regard to any limitations on deductibility of the loss. A loss for this purpose includes any amount deductible by reason of a provision that deems a sale or disposition to occur or otherwise results in a loss for purposes of section 165 (*e.g.*, a sale or exchange of a partnership interest under section 741 or a loss resulting from a section 988 transaction). Losses resulting from fire, storm, shipwreck, other casualty, or theft, or losses from compulsory or involuntary conversion are not loss transactions under the New Regulations.

The minimum loss threshold for any single taxable year is generally $10 million for corporations, $5 million for partnerships and S corporations, and $2 million for individuals and trusts. The thresholds are doubled when losses occur over any combination of taxable years.

A significant number of tax shelters are structured to generate tax losses without corresponding economic losses, and we understand the desire to have bright line rules for disclosing loss transactions. To avoid unnecessary administrative complications for taxpayers and the government, however, we suggest that modifications are in order to clarify the application of this provision and to insure that it is administrable.[51]

As an initial matter, guidance is needed as to the meaning of the term "reasonably expected" in the context of the loss transaction provision. We interpret "reasonably expected" to connote a probability of more than 50%.[52]. If that is the case,

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51 We note that transactions that produce deductions claimed under other sections of the Code (e.g., section 162) do not give rise to reportable transactions. While this excludes a broad category of transactions, we do not at this time suggest the incorporation of other deduction provisions in the "loss" category, because we do not have any ready suggestion as how this could be done (in keeping with the objective approach of the New Regulations) without further exacerbating the problem of overbreadth.

52 If the intent is to communicate a significantly higher level of certainty, a clarification to that effect would address a number of the concerns discussed in the text that follows. In any event, we believe that a standard lower than 50% would be unreasonably broad.

troublesome results can occur under an expansive reading of the provision. For example, an investor (including an investment fund) that employs a diversified investment strategy fundamentally assumes that there will be some losses among a pool of investments.[53] However, despite this expectation of losses, the investor purchases the diversified investment portfolio with the intention of realizing overall economic profits. This type of loss expectation should not give rise to an obligation to disclose under the New Regulations.

Additionally, speculative investments may have a significant probability of declining in value, and this will be reflected in the pricing. For example, a purchaser of an out-of-the-money option on a stock is willing to take the risk that it is likely that the relatively modest option premium will be lost because of the possibility of a substantial return if the stock goes up significantly. We see no reason why the IRS would be interested in such transactions, and therefore believe that disclosing or listing them should not be necessary.

Transactions that result in the realization of losses also are subject to the New Regulations regardless of expectations at the time of the initial investment. Due to the vast number of securities transactions, the administration of the loss transaction provision will be impracticable if the scope is not narrowed, particularly with respect to dealers in securities. Moreover, the loss transaction provision, as currently drafted, will create undue burdens for financial enterprises with substantial securities positions and will result in a flood of disclosure with limited utility. We considered suggesting a

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[53] While the loss provisions do not apply to regulated investment companies within the meaning of section 851, no such exception is currently provided for other investment funds, such as typical merchant banking, venture capital, or real estate funds, or for trading entities such as hedge funds.

netting of gains and losses for certain securities transactions. However, we were unable to formulate a standard that we could be confident would not be susceptible to abuse.

We support the proposal in the preamble to the New Regulations to add an additional exception for losses resulting from the sale of securities on an established market if the basis used to compute the loss is equal to the cash paid by the taxpayer to purchase the securities.[54] Particularly in light of the substantial declines suffered in the global securities markets in recent years, we believe that a limitation to the loss transaction provision for publicly traded property is necessary. The preamble to the New Regulations suggests that the exception apply to sales of securities on an established securities market within the meaning of what is presumably Treas. Reg. § 1.7704-1(b) (the reference given contains a typo). Since sales of most debt instruments are not effected on an exchange, we suggest that the exception be expanded to include sales of debt instruments as to which there exists a "debt market" within the meaning of Treas. Reg. § 1.1092(d)-1(b)(2)(ii). It may also be appropriate to increase the scope of excepted transactions to other types of publicly traded property.[55] However, we recognize the difficulty in creating an exception that distinguishes abusive transactions from legitimate transactions, and, in this case, it may be impossible to strike a better balance.

The preamble to the New Regulations also raises the possibility of a general exception for losses claimed under the mark-to-market rules of sections 475(a)

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54 We note that in the case of securities held by a partnership that does not make a 754 election, a purchaser of a partnership interest may be allocated losses that, while based on the cash invested by the partnership, do not necessarily reflect the price paid by the purchaser. However, a partner's deduction of losses is already subject to a number of potential limitations, and limiting the exception to the loss category so that it is not available for partnerships could produce serious compliance burdens for entities such as hedge funds that regularly trade securities.

55 In this case, a general reference to the definition of an "established financial market" within the meaning of Treas. Reg. § 1.1092(d)-1(b) would be an appropriate.

and 1296(a). We support this proposal, and see no reason why the exception should not include all mark-to-market situations (*e.g.*, 1256 contracts, losses under section 475(c)). Consideration might also be given to expanding this exception to include situations where losses are already limited or subject to special reporting regimes, such as losses from straddle positions under section 1092 (which are limited and already subject to reporting on Form 6781) and losses from transactions that are properly identified and accounted for as hedging transactions within the meaning of Treas. Reg. § 1.1221-2. Like the various mark-to-market regimes, the straddle and hedging regimes already provide rules that constrain a taxpayer's ability to claim losses, and thus to some degree already address the concerns that justify treatment as a reportable transaction.[56] Any such exception should be limited to cases where the taxpayer's basis used in determining loss is equal to the amount of cash paid for the investment, accounting for prior mark-to-market adjustments and amounts required to be capitalized under section 263(g).

Finally, we deliberated over a general exception for transactions entered into with no intention to produce a loss or not reasonably expected to produce a tax loss that would exceed the economic loss. It is difficult to escape the conclusion that the loss transaction provision will require disclosure of a disproportionately large number of legitimate transactions without this subjective limitation. However, we ultimately recognized that introducing this subjective element runs contrary to the interest in reducing the discretionary aspects of the New Regulations and do not propose it at this time.

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[56] We recognize that straddle-type transactions have played a part in a number of listed transactions. *See, e.g.,* Notices 2002-65, 2002-50. These transactions both involved pass-through entities. Thus, it would probably be appropriate to limit any exception involving straddle losses to those properly reported by a "C" corporation or individual. The same might be true for hedging transactions.

5. Significant Book-Tax Differences. The New Regulations require disclosure of a transaction if the federal income tax treatment of any item or items from the transaction differs, or is reasonably expected to differ, by more than $10 million on a gross basis from the treatment of the item or items for book purposes in any taxable year. Book income is determined by applying U.S. generally accepted accounting principles ("U.S. GAAP"). The disclosure requirement applies only to taxpayers that are reporting companies under the Securities Exchange Act of 1934 and related business entities, and business entities that, aggregated with all related business entities, have $100 million or more in gross assets.

Special rules are provided for a number of taxpayers. For example, foreign persons must only report with respect to effectively connected income, and the $100 million threshold only applies to their assets that produce effectively connected income. In addition, book items of a disregarded entity are treated as book items of the entity's owner, and partnership items are treated similarly.

Foreign corporations that are flow-through entities (CFCs, PFICs that are treated as QEFs, and FPHCs) are also subject to special rules. If one of those corporations enters into a transaction with a significant book-tax difference, and the transaction reduces or eliminates an income inclusion that otherwise would be required by a shareholder with a 10% interest (by vote or value) in the foreign corporation (or *any* U.S. shareholder in the case of a FPHC), that shareholder will be considered an indirect participant in the transaction. As a result, all items from the transaction that are otherwise considered book or tax items of the foreign corporation will be treated as items of the shareholder.

We understand the desire to capture book-tax differences in an organized fashion. However, this provision of the New Regulations will impose a significant burden on many taxpayers. Accounting expertise will be a necessary part of a broader range of transactions than would otherwise be the case, and access to accountants will be an ongoing requirement, particularly with respect to the determination of when book and tax treatment are reasonably expected to differ. For large reporting companies, this presumably will not present a huge burden. However, for many smaller companies, the requisite accounting knowledge likely will not be in-house and readily available.

Foreign corporations will face a larger burden here, because most do not keep U.S. GAAP books in the ordinary course of their business and thus will need to create such books for their effectively connected assets and income, or for all of their assets and income in the case of PFICs subject QEF elections with 10% U.S. shareholders.[57] Many partnerships, both U.S. and non-U.S., have a similar issue. Partnerships often keep their books using section 704(b)-style book accounting (or other methods) rather than U.S. GAAP.

The book-tax difference category is likely to be the most complicated and burdensome category of all. It may also be the one that misses the mark most often. Accordingly, we strongly urge that this burden be imposed in a limited fashion until the IRS and taxpayers have experience with its effects. We initially considered a suggestion limiting application of this category only to companies subject to the Securities Act of 1934, but concluded this might exclude too many transactions. However, we do offer one proposal to narrow the category that we believe is consistent with the rationale for

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[57] FPHCs and CFCs will also be required to use U.S. GAAP, but that is less likely to present a problem.

the category. This category is focused on the potential for abuse when taxpayers are telling two different stories to describe their business performance. Thus, we recommend that in determining book treatment taxpayers should use the financial reporting provided to shareholders or third parties for purposes of determining the results of business operations.[58] Thus, taxpayers that do not use U.S. GAAP book reporting would not be required to do so.

Recognizing that a number of book-tax differences have little tax avoidance potential, the New Regulations exclude certain items from the reporting requirement. The list of excluded items currently includes (1) accelerated book loss or expense; (2) accelerated taxable income or gain; (3) depreciable, depletable and amortizable life, method, or convention differences; (4) bad debts or cancellation of indebtedness income; (5) taxes; (6) compensation; (7) non-deductible and non-capitalizable tax items; (8) charitable contributions; (9) tax-exempt interest; (10) dividends; (11) income inclusions from flow-through foreign corporations; (12) distributions of previously taxed income; (13) items arising from like-kind exchanges; (14) tax mark-to-market items; and (15) section 481 adjustments.

The current list is a start. We suggest that book-tax differences attributable to the following also be considered:[59]

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58 For a precedent in determining book income of an entity, see Treas. Reg. § 1.56-1. Incidentally, this precedent should serve as a warning regarding the potential pitfalls of focusing on the difference between book and taxable income, because it relates to AMT adjustments that proved to be unworkably complicated.

59 The suggestions that follow are by no means comprehensive, in that we routinely encounter book-tax differences in a variety of other non-abusive cases, such as conventional leases and securitizations. We did not list such categories because we recognize that some leasing and securitization transactions may be appropriate candidates for listing, and we cannot readily suggest a formulation (consistent with the objective approach of the New Regulations) that distinguishes "vanilla" transactions from those that merit scrutiny. It might be worthwhile considering published guidance in these areas that provides guidelines for

- dispositions of assets with different tax and book basis resulting from specified circumstances, including (i) U.S. GAAP purchase accounting for a transaction that is treated as a stock acquisition or a tax-free reorganization for tax purposes, (ii) different methods, lives or conventions for depreciation, amortization or depletion[60] or (iii) fresh-start accounting for a debtor that undergoes a bankruptcy organization;

- dispositions of subsidiaries that are treated as stock sales or tax-free reorganizations for tax purposes;[61]

- hedging transactions for tax or book purposes;

- transactions marked-to-market for book but not tax purposes, or vice versa;

- partnership remedial allocations, which create phantom tax income and deductions;

- leases treated as loans for tax purposes;

- contingent debt transactions, in which the tax "comparable yield" accruals and positive or negative adjustments differs from U.S. GAAP treatment;

- transactions with imputed interest for tax purposes, such as loans under section 7872 and debt instruments subject to section 1274 that have an interest rate less than the AFR;

- disparities created by the difference between consolidated reporting for book purposes and the consolidated return for tax purposes;

- deemed reissuances of debt securities for tax purposes, such as those arising under section 108(e)(4) or on account of "material

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transactions that do not need to be listed. We would be happy to comment further in this regard if such a project would be of interest.

60 While differences relating to different book and tax depreciation, *etc*, are already excepted, subsequent dispositions of assets subject to such methods are not.

61 This category relates to the difference in the book and tax treatment of a disposition of a subsidiary. The prior category includes dispositions of *assets* that have different bases for tax and book purposes due to a prior acquisition of a subsidiary.

modifications" within the meaning of Treas. Reg. § 1.1001-3;[62] and

- section 1031 exchanges that produce book gain (*e.g.*, where an unrelated third party acquires the relinquished property for cash from a qualified intermediary in a multi-party exchange).

We hope that accountants will comment on other transactions in which book-tax differences are routinely encountered. Fully expanding this list will contribute to a more administrable disclosure program, thereby addressing our concern that an inundation of unnecessary filings may render the program ineffective. [63]

Finally, we have a couple of technical questions about this category of reportable transactions. First, the New Regulations provide that the treatment of any item or items for income tax purposes must differ from the book treatment under U.S. GAAP. This suggests that the New Regulations are focused on income and expense items, but it is possible to read the term "item" to cover basis differences resulting from a transaction as well.[64] The New Regulations should clarify that this result is not intended.

Second, reporting is required if the book-tax difference is "reasonably expected" to differ by at least the threshold amount. As noted above, most of our members read this as a more likely than not standard, and this should be confirmed (or a higher standard of likelihood should be indicated). We note that this subjective inquiry is

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62 While the cancellation of indebtedness produced for tax purposes by such transaction is already excepted, the exception as currently phrased does not cover the subsequent accrual of OID on the reissued debt instrument.

63 We recognize that some of the categories we have suggested are overlapping. For instance, hedging transactions may be derivatives that are marked to market for book purposes under FAS 133. Likewise, the difference in book-tax treatment of contingent debt results not only from the tax "comparable yield" method but also from the requirement in FAS 133 that embedded derivatives be separately accounted for at fair value, which entails marking to market.

64 For instance, the purchase of a subsidiary typically results in differences in book and tax basis.

at odds with the objective approach generally taken by the New Regulations and will in some cases add significant uncertainty and complexity to a taxpayer's compliance attempts, particularly if the list of exceptions to the book-tax category is not substantially expanded. We are concerned that both tax lawyers and accountants may now have to reach conclusions about a possible range of results and their likelihood of occurrence. In our experience, few professionals can make such determinations.

6. Brief Asset Holding Period.

Under the New Regulations, any transaction resulting in tax credits exceeding $250,000 is a reportable transaction if the underlying asset giving rise to the credits was held by the taxpayer for less than 45 days (applying the principles in section 246(c)(3) and (c)(4)). While we agree in principle with this category, we believe it would be appropriate to create an exception for foreign tax credits claimed by securities dealers if such credits qualify for the special rule under section 901(k)(4) (allowing certain foreign tax credits for withholding taxes paid with respect to stock held for 15 days or less). We also recommend considering whether all securities dealers (as defined under section 901(k)(4)(A)) who claim a foreign tax credit for withholding taxes paid on securities held in the ordinary course of their business should be exempt from the disclosure requirement with respect to such credits.

D. Disclosure Requirements

The New Regulations require Form 8886 to be attached to the taxpayer's return for each taxable year for which the taxpayer's federal income tax liability is affected by its participation in the transaction. The implication of this language is that only a participant to whom one of the reportable transaction categories is applicable and whose tax liability is affected by the transaction itself (as opposed to a material advisor

whose tax liability is affected by fees earned with respect to the transaction) is subject to the disclosure requirement. The New Regulations are ambiguous, however, in that they require "*[e]very* taxpayer that has participated, directly or indirectly, in a reportable transaction" to file a disclosure statement.[65]

We are concerned that this requirement could be interpreted to suggest that advisors such as lawyers and accountants participate in a transaction by offering advice and thus have a disclosure obligation. Based on informal consultation with IRS officials, we believe that this is not the intent of the New Regulations, and a careful reading of the rules would seem to confirm this. Nevertheless, regulatory clarification would be helpful. Thus, we suggest that the New Regulations explicitly provide (by example, or by specifically stating the rule, or both) that the only taxpayers required to file a disclosure statement with respect to a reportable transaction are those whose tax liability is affected by the transaction itself and to whom one of the reportable categories is applicable, not those who earn fees in connection with the transaction or who are investors but to whom none of the reportable transaction categories are applicable.

Although we support the IRS's efforts in collecting disclosure statements from direct participants in reportable transactions, we are concerned that the application of the New Regulations to flow-through entities such as partnerships, trusts and S corporations will lead to unnecessary duplication of efforts. If a partnership, trust, or S corporation participates in a reportable transaction, that entity, as a taxpayer, generally has an obligation to prepare and file a Form 8886.[66] It seems unnecessary to require the

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65 Temp. Treas. Reg. § 301.6011-4T(a).

66 We recognize that foreign entities may not file a Form 8886, and the suggestion that follows takes account of this fact.

partners or beneficiaries or shareholders to file a full disclosure statement as well if the IRS will have already received the disclosure statement filed by the direct participant.

Therefore, we suggest that the partnership or trust or S corporation supply the disclosure statement (or a simplified summary thereof) to its partners or beneficiaries or shareholders as an attachment to the tax return information provided to such persons for the taxable year in question, and that the partners or beneficiaries or shareholders, instead of preparing their own Forms 8886, simply indicate that they have received one from the partnership or trust or S corporation (perhaps by filling out a simplified form requiring only limited identifying information, such as the name and tax identification number of the partnership or trust or S corporation and the date the disclosure statement was filed with the IRS).[67] As a result, the IRS will be put on notice and will be able to examine the disclosure statement filed by the direct participant without requiring the indirect participants to supply the same information.[68] Should the indirect participant be audited, the existence of the information will be apparent from the tax return, and the auditor could request the information from the taxpayer (or the OTSA) at that time.[69] An indirect participant would be required to file its own Form 8886 if it knew (or should

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67 We do not mean to suggest that this simplified procedure should relieve a taxpayer that has indirectly participated in a reportable transaction from retaining any information it possesses that would be required to be retained by a taxpayer filing a Form 8886.

68 We note that if the procedure we are suggesting is not followed, the information that partnerships are required to supply their partners on Schedule K-1 will have to be very substantially expanded in some cases (*e.g.,* investment or trading partnerships).

69 We note that in the case of a partnership subject to the TEFRA audit rules, the audit of the reportable transaction would in any event occur at the partnership level. *See* section 6221.

have known) that the pass-through entity engaged in a reportable transaction as to which no Form 8886 was filed.[70]

Another fundamental question that should be clarified (and that will be particularly important if a simplified procedure along the lines described in preceding paragraph is not adopted) is how relevant dollar thresholds are applied with respect to indirect participants. Assume for instance, that a partnership has a $5 million loss in a single year with respect to a transaction that is a "reportable transaction" solely on account of the loss category. As to individual partner A, whose share of the loss exceeds $2 million, the loss clearly arises with respect to a reportable transaction. With respect to individual partner B, whose share of the loss is less than $2 million (and whose share of all losses with respect to all years affected by the transaction is expected to be less than $4 million), it is less clear that the loss should be treated as arising with respect to a "reportable transaction." A literal reading of the New Disclosure Regulations as currently drafted seems to indicate that both individuals A and B must treat the transaction as a "reportable transaction," because the transaction is a "reportable transaction" (as to the partnership), and "*every* taxpayer that has participated, directly or *indirectly*, in a reportable transaction" is required to file Form 8886 with respect to the

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[70] This could occur, for instance, in the case of a foreign partnership that does not file Form 1065. However, if a Form 8865 was filed with respect to such a foreign partnership, and a Form 8886 filed in connection therewith, a more simplified filing should be permitted for partners other than the filer of the Form 8865.

transaction.[71] It is unclear whether this literal interpretation is intended.[72] In any event, the final regulations should provide examples that resolve this and related ambiguities.[73]

E. List Maintenance Requirements

The New Regulations significantly expand the category of persons required to maintain investor lists. While section 6112 only imposes this requirement on "organizers" and "sellers" of tax shelters, the New Regulations redefine organizer or seller for these purposes to include any "material advisor," which in turn is defined as any person who receives a specified minimum fee in connection with a potentially abusive tax shelter and who makes or provides any statement, oral or written, to any person as to the potential tax consequences of that transaction. We considered whether this new definition reaches beyond the words of the statute and concluded that it probably does not.[74] We are troubled, however, by the low fee thresholds and the potentially expansive interpretation of what it means to make or provide a statement as to a transaction's potential tax consequences.

If all of the persons who acquire an interest in a transaction are corporations (other than S corporations), an advisor will only be required to maintain a

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71 Temp. Treas. Reg. §1.6011-4T(a) (emphasis added).

72 It might be inferred that it is not intended from the way the book-tax difference category works (*i.e.*, the analysis of whether the book-tax threshold is satisfied seems to be applied at the partner level, *see* Temp. Treas. Reg. 1.6011-4T(b)(6)(ii)(E)).

73 A related ambiguity arises if a partnership incurs a $4 million loss on a transaction (that is not otherwise reportable) and one individual partner's share of that loss is $2 million. In such a case, it is not clear whether the transaction constitutes a reportable transaction only as to the partner, or as to both the partner and the partnership, or as to neither.

74 However, it is not difficult to imagine cases in which it seems a stretch to call a "material advisor" to a taxpayer required to file a Form 8886 an "organizer" of the transaction in question. For instance, an entity's outside accountant may review the financial accounting implications of the transaction and may make statements as to tax in that connection, but may not have any role as an "organizer" in any common sense of the word.

list if it makes or provides the tax statement described above and receives a fee of $250,000. For all other transactions, the minimum fee is $50,000. Because most transactions will involve at least one non-corporate participant, we are concerned that the $250,000 threshold will seldom be reached. Thus, we recommend a minimum fee of $250,000 for all transactions, with an exception for transactions that only involve individuals, in which case the minimum fee could be reduced to $50,000.

We are concerned that the language of the New Regulations can be read loosely enough so that every person who mentions the word "tax" is deemed to have made a statement about a transaction's potential tax consequences. If such person also receives the minimum fee, the person will be required to maintain an investor list, even if that fee is largely, if not wholly, unrelated to the tax statement that is provided. Many advisors are often consulted in connection with a transaction. If one of those advisors (consider, for example, an environmental consultant or real estate appraiser) happens to make some tangential statement about tax that is not directly related to the advice or service that he has been hired to provide, the New Regulations, read literally, would nonetheless require that advisor to maintain an investor list.

We suggest that the New Regulations be modified so that only those persons who make "material statements" regarding the U.S. tax consequences of the transaction (or for whose benefit such material statements are made) and related parties can be material advisors. We recognize that such a standard does not lend itself to clearly identifiable bright lines. We are convinced, however, that the benefits of exempting

advisors who make immaterial statements about taxes outweighs the unavoidable imprecision of this standard.[75]

We also have concerns regarding the number of persons that material advisors will be required to list. The New Regulations require listing of (i) each person to whom the material advisor makes or provides a statement as to the transaction's potential tax consequences, provided the material advisor knows or has reason to know that the person or any related person participated in or will participate in the transaction, and (ii) subsequent participants whose identity the material advisor knows or has reason to know. As discussed earlier, we understand the term "participate" in this context to refer both to the role of a taxpayer required to file a Form 8886 (or a simplified surrogate, as suggested above), and to the role of other material advisors who transfer or sell an "interest" (including information pertinent to tax structuring) to one or more subsequent participants. We do not, however, believe the regulations should be interpreted so broadly as to require material advisors to list each and every person who is affected economically by the transaction.

Consider, for instance, the case of lawyer who is a "material advisor" to a taxpayer that engages in a reportable transaction. The lawyer makes statements regarding the tax consequences of the transaction to the taxpayer, the promoter, and the promoter's tax counsel for the transaction in question. As the New Listing Regulations now stand,

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75 To the degree that there is concern about the imprecision of the concept of a "material statement" regarding tax consequences of a transaction, we would suggest that this be addressed by a series of examples in the final regulations. One guideline that might be considered in drafting examples (and that might also be incorporated in a specific definition of what constitutes a "material statement" of tax consequences), is whether the statement in question (i) is made directly, or reasonably expected to be communicated indirectly (in whole or material part, including in summary form) to one or more persons filing a Form 8886, and (ii) is reasonably expected to be considered by at least one such person filing a Form 8886 (or by advisors to, or agents of, or by an income tax return preparer with respect to, at least one such person) in evaluating and/or reporting the anticipated tax consequences of the transaction.

the lawyer is required to list all three.[76] On the other hand, if the lawyer is aware of another party who may also be a "material advisor" (*e.g.*, an accounting firm that is retained by the promoter to provide statements regarding non-tax-related financial reporting implications of participation in the transaction) but the lawyer makes no statement of tax consequences to that party, there is no evident requirement that (or reason why) the lawyer must list that party, if we interpret the New Listing Regulations correctly. On the facts stated, it would seem like an unreasonable stretch to view the accounting firm as a "subsequent participant" with respect to any person to whom the lawyer makes a statement of tax consequences, since there are no facts to indicate that any party to whom the lawyer makes tax statements is selling or transferring an "interest" in the reportable transaction to the accountant.[77] It would be helpful, if our interpretation reflects the intent of the regulations, if this could be confirmed.

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[76] The requirement that the lawyer list the promoter and the promoter's tax counsel strikes us as overbroad, in principle, if neither is reasonably expected to make any significant use of the contents of the lawyer's statement regarding tax consequences in structuring and marketing the transaction (i.e. if the lawyer's statement to the promoter and the promoter's tax counsel is not a "material statement" of tax consequences, as discussed in the preceding footnote). To give a clear example of such a situation, assume that the lawyer's statement to the promoter and the promoter's tax counsel is something along the lines of "I told my client that this transaction is likely to be successfully challenged by the IRS, but he's decided to do it anyway." Thus, one approach that could be considered is requiring a material advisor to list only (i) those persons to whom the material adviser made a "material statement" regarding the anticipated tax consequences of the transaction and (ii) subsequent participants who receive an interest in the transaction from any of the persons to whom the material advisor has provided such a "material statement" of tax consequences. While we recognize that making this distinction in the regulation will entail some drafting complexity, we believe that this should be weighed against the burden imposed by requiring each "material advisor" to seek to obtain information that it would not normally have access to.

[77] In this regard, we note that a literal reading of the definition of "interest" could (at least arguably) form the basis for treating the accounting firm as receiving an "interest" in the transaction from the promoter. Specifically, the definition of "interest" includes "the entry into … a consulting, management or other agreement for the performance of services." Temp. Treas. Reg. § 301.6112-IT(d)(1). It might be argued that, on the facts stated, the promoter, by retaining the accountant to provide statements regarding the financial reporting aspects of the transaction, is thereby entering into an agreement for the provision of services that gives the accountant an "interest" in the transaction. If, however, no meaningful limitation is introduced with respect to the concept of what constitutes an "interest" in a transaction , it will be all the more important to find some other means to limit the parties when a "material advisor" is required to list. Otherwise, the lists required to be maintained by "material advisors" could be expected to be quite lengthy,

We are also concerned about the requirement that the list include persons that the material advisor has reason to know will participate (or be a "subsequent participant") in the transaction. We do not read this provision to impose a general duty on every material advisor to inquire as to the identity of all those who will participate in a transaction, although this is not clear.[78] The New Regulations should confirm this.

The New Regulations preserve the ability of multiple advisors for a particular transaction to designate by written agreement a single advisor to maintain the investor list. The utility of such an agreement is not apparent, however, because the New Regulations also explicitly provide that such a designation does not relieve the other advisors from their obligation to furnish the investor list to the IRS upon demand. We believe that designation agreements should be encouraged, as they will eliminate unnecessary duplication of efforts. Without some ability to rely upon the designated list

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burdensome to compile, and of less use to the IRS than a more focused list. See the following footnote for examples illustrating this concern.

78 For example, does an attorney who prepares a tax section for an offering of preferred stock that provides for a gross-up if the dividends-received deduction is reduced by statute have an obligation to obtain the names of all purchasers of the securities? As discussed above, we recommend that the exception for "contractual protection" exclude such a transaction. If, however, the purchasers are required to be listed, we would hope that the attorney would not be required to get the names, TINs, etc., of purchasers from the underwriter (or to make arrangements to obtain such information regarding subsequent purchasers in the future). We recognize that under A-9 of the Prior List Maintenance Regulations, an organizer had certain duties of inquiry. This requirement was not unreasonably burdensome, however, in view of the facts that (i) only persons that participated in the entrepreneurial risks and benefits of the transaction were treated as organizers, (ii) the duty of inquiry was only required to be reasonable, was limited in other ways, and could be delegated to a single person in agreements that provided protection against liability, and (iii) filters were available that limited the duty of inquiry to cases where substantial indicia of tax abuse were present. If a duty of inquiry is to be imposed under the New List Maintenance Regulations, we would strongly advocate articulation of limitations to minimize what could be enormously wasteful efforts in many cases. At a bare minimum, material advisors should not be required to list a party whose only relationship to the transaction is such that it is reasonable to infer that such party will neither be required to file Form 8886 nor transfer an "interest" that could be relevant in determining whether another party is required to file Form 8886. Surely, for example, if a seller of credit card receivables to a securitization trust has a "reportable transaction" on account of a back-tax difference, there is no intent to require list-keeping with respect to all holders of securities issued by the trust!

keeper's undertaking to comply with its obligations, however, we see no advantage to their use.[79]

We suggest that (as under A-13 of the Prior List Maintenance Regulations) a signatory to a designation agreement should be insulated from penalties under section 6708 if it provides the designated list keeper with all of the information that it would require to maintain on its investor list. Material advisors (other than the designated list keeper) should only be responsible for listing the name of the transaction, the names of the relevant "participants" of whom they have knowledge, the designated list keeper and a brief description of the transaction.[80] Thus, if asked for information about a particular transaction, a material advisor could direct the IRS to the designated list keeper, who would be able to provide the complete investor list or would be subject to penalties for failing to maintain the investor list as agreed. Such a shield from liability could be subject to an anti-abuse rule that requires material advisors to maintain a shareholder list in the event that they know or have reason to know that the designated list keeper has failed to maintain the list.

The access that will be accorded others with respect to information and materials provided under the list maintenance rules should be clarified. Some form of

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79 To the extent that legislation amends the registration requirements to provide for registration of all reportable transactions, the list-keeping function would presumably be supplanted (in significant part, if not entirely) by the registration function. In that case, the ability to rely on one party to fulfill this function could be handled in the same manner as under the current registration regime. See Temp. Treas. Reg. § 301.6111-2T(g).

80 We do not mean to suggest that a material advisor should necessarily be relieved of the obligation to retain copies of the materials it has provided to the designated list-keeper. While this would be welcome, the more pressing concern is that every material advisor not be under a duty to inquire as to the identity of all participants in the transaction.

protection against inappropriate disclosure of such materials is needed. This should be addressed either in the New Regulations or some other appropriate regulation.

The items required to be listed under the New Regulations are the same as under the Prior List Maintenance Regulations. However, because the New Regulations are much broader in their application, it will be significantly more burdensome to comply with the listing requirements. Therefore, the content rule that requires maintenance of copies of written materials should be clarified. In particular, the IRS should confirm that drafts of a document do not need to be maintained for listing purposes if there is a final document that reflects the advice for the transaction. For example, it is not clear from the language of the listing requirements whether e-mails must be maintained. We propose that even if e-mails are considered to be "written materials," which is not entirely clear, they should be treated in the manner we suggest for drafts and should be retained only if the discussions in the emails are pertinent to the transaction that is consummated[81] and are not reflected in the final documents that constitute the advice for the transaction.

F. Registration Requirements

The New Regulations substantially revise the rules relating to disclosure by taxpayers and the maintenance of lists by sponsors and promoters. The registration rules have not been revised except for some minor conforming changes, although the preamble to the New Regulations expresses the intention of extending the registration requirements to all reportable transactions once authorized legislation is announced. We

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81 We see no reason why retention should be required for emails, or any other documents, that are not pertinent to the transaction that is in fact consummated. Thus, for instance, if a transaction is initially structured as a tax-free reorganization but is finally structured as a taxable transaction, retention of the initial draft documents would be both burdensome and counterproductive from an administrative standpoint.

have commented in the past on similar legislative proposals,[82] and hope to comment more specifically on any legislation that is proposed. While we are not opposed in principle to a registration requirement, we are concerned, as noted above, that the scope of reportable transactions may prove so broad as to overwhelm both taxpayers and the IRS. Enactment of legislation requiring registration of reportable transactions, and imposition of substantial penalties for failure to comply, will make it all the more important for the scope of the definition of "reportable transaction" to be appropriately clarified and narrowed. In addition, we believe the IRS should have broad discretion to grant relief against imposition of penalties to parties that demonstrate reasonable cause for failure to comply with registration requirements (*e.g.*, in cases involving good-faith misunderstandings of the applicable rules, which we believe, as things now stand, is not only possible but entirely predictable).

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82 *See* New York State Bar Ass'n Tax Section, *Report on Tax Shelter Legislation*, No. 1019 (Aug. 27, 2002).