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Tax Shelter Angst

Reporting requirements bring many transactions under scrutiny.

BY MARK WEINSTEIN AND SARAH LAWSKY

UNCLE SAM is getting serious about tax shelters, and not just the kind your grandmother used to bake. Grandma, for certain, thought a FLIP (foreign-leveraged investment program) was what she did with her pancakes and that a SOS (short-option strategy) was the distress signal she learned in Morse Code. But corporate counsel, particularly in the current climate of corporate scandal and management insecurity, cannot afford to be so naive.

In late 2005, 19 accountants and lawyers were indicted for marketing what the Internal Revenue Service has deemed tax shelters, even though no court has ever held the underlying transactions to be illegal. Furthermore, even a company that would never consider buying a tax shelter might get caught up in the government's campaign, because the government has a new weapon in its arsenal: reporting.

The effects of the Sarbanes-Oxley legislation on tax administration are far from clear, but the separate tax rules in the spirit of Sarbanes-Oxley have created a tax environment of excessive reporting. For example, in 2003, in an attempt to root out tax shelters, the U.S. Department of the Treasury issued final regulations that require companies to tell the government about all kinds of tax transactions, such as transactions that contain certain types of contractual protection or transactions that result in a large tax loss. And at the end of 2004, as part of the American Jobs Creation Act, Congress passed legislation that imposes penalties for failing to report one of these transactions.

There are increasingly serious penalties if the unreported transaction ends up lowering the taxpayer's tax liability in a way that the IRS thinks is not right, or, worse yet, if the taxpayer engaged in the transaction with the intent to avoid or evade federal income tax. New York has jumped on board too, creating new reporting requirements that piggyback on the federal reporting.

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Reportable Transactions

So what kind of transactions is the IRS interested in hearing about? One thing that makes this reporting complicated is that there is no simple definition of a tax shelter. So, in Treasury Regulation §1.6011-4, the IRS demarcated five types of transactions that it feels warrant concern: listed transactions, transactions that are offered to the company under a condition of confidentiality, transactions that contain certain types of contractual protection, transactions that result in a large loss to the company, and transactions that involve holding an asset for a short period and claiming a tax credit related to that asset. (Before Jan. 6, 2006, certain large companies and publicly traded companies were also required to report transactions that resulted in a large difference between book reporting and tax reporting.)

Each of these categories has a complicated definition, and exceptions to that definition, and then exceptions to the exceptions. The IRS's underlying goal, though, is to root out transactions whose value lies in the tax savings they provide.

• A company must report its participation in listed transactions. Listed transactions create the greatest angst at the IRS. These are transactions that the IRS has decided are abusive, and there is an actual list of them, which is posted on the IRS Web site. The IRS also describes each transaction in some detail, usually in a revenue ruling or notice.

For the most part these are transactions that a company would not happen onto by chance. Rather, they often resemble a stereotypical tax shelter: clever, complicated arrangements that can result in substantial tax savings and that have often been marketed by various accounting firms or law firms, sometimes with a catchy name (including "BOSS," which stands for Bond and Option Sales Strategy, and "Son of BOSS," two of the more widely reported transactions). The IRS also wants companies to report any transaction that is substantially similar to a listed transaction. This can be a little more difficult to determine, because it requires a close comparison of the company's transaction and of the listed transaction.

- A company must report its participation in transactions that are offered to it under conditions of confidentiality, if it pays a fee of at least $250,000 ($50,000 for some non-corporate entities). For example, a tax advisor might propose a transaction that will save the company on its taxes, but will agree to divulge the specifics to the company only if the company promises not to tell anyone else how the transaction works. (The tax advisor might put this condition on the transaction if he makes money by selling the transaction and doesn't want anyone else to get it for free.)
- A company must report its participation in transactions for which it has contractual protection—a transaction for which the company has the right to a refund, in whole or in part, of the fees it has paid for advice about the transaction if the intended tax consequences of the transaction are not fully realized. For example, a tax advisor might come to a company and propose a tax-saving transaction. "My fee is $50,000," the tax advisor might say, "but if this transaction is not accepted by the IRS, and you don't get the tax savings, I'll refund your money."
- A company must report its participation in transactions that result in a substantial loss, that is, a loss of at least $10 million in one year, or $20 million in any combination of years (for corporations and certain partnerships); and $2 million in one year or $4 million in any combination of years for other partnerships, S corporations, and trusts. Obviously there are a lot of non-abusive situations that result in large losses, so the IRS periodically issues revenue procedures that list exceptions to this reporting requirement. For example, a company does not need to report a large loss that results from selling an asset if the company bought the asset for cash, and the basis of the asset is determined solely by reference to the amount it paid in cash, plus any improvements that the company has made to the asset. That's not a tax shelter; it's just a bad investment.
- A company must report its participation in transactions that involve a short holding period, which the IRS defines as holding an asset for 45 days or less, if the asset generates a tax credit (including a foreign tax credit) greater than $250,000.

Reporting a Transaction

Once a company has determined that it has engaged in a reportable transaction it must, perhaps unsurprisingly, report that transaction. The IRS wants to know about the transaction twice: generally, the company must file a particular form with its tax return for the year in which the reportable transaction took place and send a copy of that form to the part of the IRS that focuses on tax shelters.

New York state is also involved in the reporting game, although it entered a bit on the late side and is playing catch-up. With the first New York state tax return that a company files after June 13, 2005, the company must disclose both its current and past reportable transactions (that is, transactions that were or are required to be reported to the IRS). The company must then disclose, on future returns, any reportable transactions that it participates in prior to July 1, 2007. (Of course, New York's reporting law may be extended past that date at some point.) The New York tax commissioner can also create its own list of reportable transactions that aren't included on the IRS's list (though he hasn't done so yet).

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Failure to Report

All this reporting may seem unappealing and may suggest that a company should not draw a tax authority's attention to a transaction that it believes is benign. But serious penalties can attach to not reporting a reportable transaction. In fact, the penalties are too extensive to enumerate in this article, but a few of the highlights, so to speak, follow. In general, as the below list suggests, it is bad not to report a reportable transaction, and worse not to report a listed one.

- If a company does not report a reportable transaction, it must pay a penalty of $50,000 to the IRS, and $10,000 to New York state. If that reportable transaction is a listed transaction (that is, one of the really egregious reportable transactions), the penalty goes up to $200,000 to the IRS, and $25,000 to New York. The company must pay this penalty even if there was no understatement of taxes due to the reportable transaction.
- Federal legislation passed in 2004 expands the accuracy-related penalty to include "reportable transaction understatements"—an understatement of tax due to the difference between the proper tax treatment of a transaction and the company's treatment of the transaction on its return, if the transaction is either a listed transaction, or another category of reportable transaction that was entered into to avoid or evade federal taxes. The penalty will be 20 percent in general, but if the company did not report the transaction, the penalty will be increased to 30 percent. New York has passed legislation that similarly expands its accuracy-related penalty.
- If a company has to pay either of the two federal penalties above, and it also is required to file reports with the Securities and Exchange Commission, it must disclose the fact that it was required to pay the penalty to the SEC. So, for example, a public company that has to pay a penalty for failing to disclose a reportable transaction must disclose that penalty in a report to the SEC, and it must do so even if it considers the penalty amount not material to the reports.
- If a company does not report a listed transaction, the statute of limitations for assessing a tax with respect to that transaction won't expire until one year after the IRS receives the required information, either from the company or from a material advisor of the company.

In short: report.

What Now?

Tax shelter reporting requirements are extremely complex. Every key word in this description—"transaction," "participation," and so forth—has its own definition in the context of reportable transactions. Moreover, the IRS is constantly updating its list of listed transactions, both adding items and removing them, and its revenue procedures—"angel lists"—that describe transactions that fall into one of the reportable categories but do not need to be reported.

For general information and guidance, the IRS's Web site, www.irs.gov, has a section devoted to abusive and listed transactions. But general counsel who run across a transaction that might be reportable should always let a tax advisor, whether in-house or an outside counsel, review the transaction to determine whether it should be reported. The reality is that the era of excessive reporting is here to stay.