
# THE NEW DISCLOSURE AND LISTING REGULATIONS FOR TAX SHELTERS

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This article discusses the new temporary and proposed regulations that will replace the existing rules requiring (i) disclosure by taxpayers of certain "reportable transactions" and (ii) maintenance by promoters of "potentially abusive tax shelters" of lists of taxpayers participating in these shelters. The article describes the provisions of the new regulations and highlights the major differences between the new regulations and the current regulations. The article also explores some of the practical implications of the new regulations for taxpayers, tax advisers, and financial intermediaries. Finally, the article considers certain areas of ambiguity in the new regulations and suggests interpretations to resolve them in a manner consistent with the underlying purpose and scheme of the new regulations.

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On October 22, 2002, the Internal Revenue Service and the Treasury Department issued new temporary and proposed regulations (the New Regulations) that will replace the existing rules requiring (a) disclosure by taxpayers on their tax returns of certain "reportable" transactions entered into by the taxpayer (the Disclosure Rules),[1] and (b) the maintenance of lists by organizers and sellers of any "potentially abusive tax shelter" of persons engaging in these transactions, which lists must be made available to the IRS on request (the Promoter Listing Rules).[2] The new Disclosure and Promoter Listing Rules generally will apply to transactions entered into on or after January 1, 2003, although listing under the new rules will be required in some cases for transactions entered into before that date.

The New Regulations represent the first major step by the IRS and Treasury to implement the proposals made by the Treasury Department in March 2002 to rewrite the rules relevant to taxpayers engaging in tax-

[1]Current Treasury regulation section 1.6011-4T. Unless otherwise indicated, all section references contained herein are to the Internal Revenue Code of 1986, as amended, or to the Treasury regulations promulgated thereunder. References to the "new" Treasury regulations are to the regulations that will become effective on January 1, 2003, and references to the "current" Treasury regulations are to the regulations that are effective before January 1, 2003.

[2]Current Treasury regulation section 301.6112-1T.

motivated transactions (the March 2002 Proposals).[3] The March 2002 Proposals are based on certain principles that represent a shift in approach to shutting down the "tax shelter" industry. Those principles include:

- Extremely broad and objectively defined categories of transactions subject to the new rules, *including many transactions that would not ordinarily be viewed as tax shelters;*
- Early *disclosure* of transactions to the IRS, in a manner that is easy for the IRS to understand and that takes place shortly after a transaction has been entered into; and
- Substantial *penalties* for noncompliance with disclosure rules.

In furtherance of these objectives, the New Regulations amend the existing Disclosure and Promoter Listing Rules in several fundamental respects.

***The New Regulations represent the first major step by the IRS and Treasury to implement the proposals made by Treasury in March to rewrite the rules relevant to taxpayers engaging in tax-motivated transactions.***

First, the definition of a "reportable transaction" that is subject to the Disclosure and Promoter Listing Rules will be more objective but far broader in scope, and the Disclosure and Promoter Listing Rules will apply generally to the same categories of transactions.

Second, the new Disclosure Rules will apply to all taxpayers.

Third, the new Promoter Listing Rules will require all persons that discuss the potential tax consequences of a "potentially abusive tax shelter" with a participant therein and that satisfy certain other requirements to maintain a list. As a result, the new Promoter Listing Rules will apply to persons that generally are not viewed as promoters of tax shelters, including a taxpayer's own tax adviser (subject to certain limitations).

The New Regulations do not change the penalties currently applicable to failure to comply with disclosure and promoter listing obligations, as legislation will be required to accomplish that part of the March 2002 Proposals.

The Promoter Listing Rules are closely related to rules requiring organizers of some "tax shelters" to register those transactions with the IRS (the Registration Rules), and the preamble to the New Regulations states that the Registration Rules will be revised to conform to the new Promoter Listing Rules once certain legislation pending in Congress is passed.[4]

The new Disclosure Rules and Promoter Listing Rules are described below.[5]

## I. Highlights of the New Regulations

### A. The New Disclosure Rules

As under current law, the new Disclosure Rules require taxpayers to attach a summary of certain transactions to their tax return for any year in which the transaction affects the taxpayer's tax liability. Disclosure is required for (a) a list of specified transactions found by the IRS to be tax-avoidance transactions (Listed Transactions) and (b) other transactions with specified characteristics (other reportable transactions).[6]

Under the new Disclosure Rules, transactions in the other reportable transactions category are as follows:

1. Transactions offered under conditions of *confidentiality,*
2. Transactions with *contractual protection* against loss of tax benefits,
3. Transactions resulting in *losses* in excess of specified thresholds,
4. For SEC-reporting companies and certain other large business enterprises, transactions with a *book-tax difference* in excess of $10 million in any tax year (subject to enumerated exceptions), and
5. Transactions involving *brief holding periods* for certain assets that generate tax credits in excess of $250,000.

This list is similar in some respects to the definition of "other reportable transactions" under current law, which requires disclosure if a transaction satisfies two out of five characteristics (including confidentiality, contractual protection, and book-tax differences), subject to some exceptions.[7] Taxpayers have disclosed substantially fewer transactions than the IRS expected under the current Disclosure Rules, however, as a result of interpreting the "two out of five" test narrowly and the exceptions broadly. The new Disclosure

[3]Available at http://www.ustreas.gov/press/releases/po3542.htm. A more limited set of amendments implementing the March 2002 Proposals was made in June 2002. Treasury Decision 9000, IRB 2002-28, 87, *Doc 2002-14566 (6 original pages), 2002 TNT 121-72* (June 14, 2002).

[4]*See* H.R. 5095, "American Competitiveness and Corporate Accountability Act of 2002"; the Staff of the Joint Committee on Taxation's "Description of the Small Business and Farm Economic Recovery Act," (Sept. 17, 2002; JCX-88-02). Both bills would revise the Registration Rules, impose significant penalties for failure to disclose or list transactions, and implement other parts of the March 2002 Proposals. Further regulatory steps to implement the March 2002 Proposals will include amendments to the regulations under the rules governing the imposition of penalties on taxpayers that understate their tax liability and to the rules governing tax opinions provided in connection with "tax shelter" transactions.

[5]Appendix A contains a one-page diagram of the new Promoter Listing Rules.

[6]New Treasury regulation section 1.6011-4T(b).

[7]Current Treasury regulation section 1.6011-4T(b)(3).

Rules have been revised to reflect that experience, and will apply very broadly, as summarized below:

- There are no general exceptions to the definition of "other reportable transactions." *In particular, the "no reasonable basis" and "customary commercial practice" exceptions of current law will not apply.*[8] As a result, in practice, taxpayers generally will not be able to rely on the opinion of a tax adviser to conclude that a transaction is outside the scope of the Disclosure Rules.
- The five categories of "other reportable transactions" cast a wide net, and will include many transactions with no tax-specific motivation or with tax benefits that are clearly permitted by law or long-sanctioned by IRS practice. Examples could include:
  - many privately negotiated transactions, because the definition of a "confidential" transaction includes a transaction in which disclosure of the *structure* is limited in any way, subject to limited exceptions;
  - purchasing conventional preferred stock or entering into many standard form cross-border financial instrument transactions (other than debt instruments), because those transactions contain tax indemnities, tax gross-ups and similar provisions, unless the indemnities fall within an exception for some principal-to-principal transactions;
  - book-tax differences arising from the different consolidated reporting rules for book and tax; and from structured finance transactions treated as "true sales" for accounting purposes and as financings for tax purposes; and
  - the disposition of a business or investment asset at a real economic loss, under the loss transactions category.
- There is no across-the-board minimum tax benefit threshold that must be met before disclosure is required, although there are individualized dollar thresholds for the loss transaction, book-tax difference and brief holding period categories of other reportable transactions.[9]
- The new Disclosure Rules will apply to all taxpayers, including individuals and S corporations.[10] By contrast, the current Disclosure Rules apply primarily to corporations.[11] The new Disclosure Rules also contain explicit rules requiring certain U.S. shareholders of foreign corporations subject to certain income inclusion rules (for example, subpart F) to disclose Listed Transactions or other reportable transactions entered into by those corporations.
- The new Disclosure Rules will apply to Listed Transactions involving estate, gift, employment, and pension and exempt organization excise taxes as well as income tax.[12]
- The new Disclosure Rules will apply only to U.S. federal income tax returns filed for transactions entered into on or after January 1, 2003. Taxpayers also will be required to disclose a transaction entered into on or after January 1, 2003, that is initially not a reportable transaction, if the transaction becomes reportable under the new Disclosure Rules after that date — for example, because it becomes a Listed Transaction. Such transactions must be disclosed even if they do not affect the taxpayer's tax liability on the tax return for the year in which the transaction becomes reportable.

### B. The New Promoter Listing Rules

As under current law, the new Promoter Listing Rules require some "organizers" and "sellers" of a "potentially abusive tax shelter" to maintain a list of taxpayers that have entered into these transactions, together with certain information about the transactions and their tax benefits, and to provide that list to the IRS on request.[13] The new Promoter Listing Rules differ substantially from current law, however, by redefining the transactions that trigger a listing requirement, broadening the scope of persons required to maintain lists, and providing explicit limitations on the circumstances under which a listkeeper may refuse to provide the list to the IRS, as summarized below.

The new Promoter Listing Rules also provide several important rules intended to ensure that only those persons actually engaged in the tax structuring or tax marketing of transactions are required to maintain lists, and to limit the number of transactions required to be listed, as summarized below.

- Under the new Promoter Listing Rules, a "material adviser" generally is required to list the names of persons that have participated in a transaction if the transaction is required (a) to be disclosed under the new Disclosure Rules, or (b) to be registered under the Registration Rules.[14] Under the New Regulations, therefore, unlike under current law, transactions that must be disclosed generally must also be listed, and vice versa. Moreover, because the transactions subject to the Disclosure Rules are objectively defined, *the opinions of tax advisers will no longer protect promoters from liability for failing to maintain a list.*
- A "material adviser" is defined as any person that makes or provides any statement, orally or in writing, as to the potential tax consequences of a potentially abusive tax shelter, and receives

[8]Current Treasury regulation section 1.6011-4T(b)(3)(ii).

[9]New Treasury regulation sections 1.6011-4T(b)(5)-(7).

[10]New Treasury regulation section 1.6011-4T(a).

[11]Current Treasury regulation section 1.6011-4T(a). The Disclosure Rules applied solely to corporations until June 2002, when the rules were amended to require individuals and other noncorporate taxpayers to disclose Listed Transactions.

[12]New Treasury regulation sections 20.6011-4T; 25.6011-4T, 31.6011-4T, 53.6011-4T, 54.6011-4T, and 56.6011-4T.

[13]New Treasury regulation section 301.6112-1T(a).

[14]New Treasury regulation section 301.6112-1T(b).

at least a specified minimum fee from that transaction.[15]

- Under this definition, a person that merely implements or executes a transaction, without more, would not be a "material adviser," even if the transaction is a Listed Transaction or otherwise required to be disclosed by the taxpayer engaging in the transaction.
- The definition of "material adviser" will include persons generally not considered to be promoters of tax shelters, such as a taxpayer's own tax adviser.
  - The preamble to the new Promoter Listing Rules states that the *name* of a person who engages in a transaction of the kind referred to above is not protected by the attorney-client privilege (or the tax practitioner privilege available to other tax advisers), and warns of penalties for unreasonable claims of privilege. Government officials have been quoted as going considerably further, and stating that *none* of the information required to be listed (which includes any written tax analyses or opinions) is subject to those privileges. The New Regulations provide procedures to be used for asserting claims of privilege.[16]
- The definition of "material adviser" also will sweep in nontax specialists who refer to well-known tax rules or the tax advice of others in the course of a discussion.
  - As a practical matter, since it will be difficult to monitor whether investment bankers, marketers, and persons with similar functions make tax-related statements, many "promoters" in practice are likely to look primarily to the fee thresholds and the nature of the transaction in deciding whether listing is required.
- Tax advisers to promoters, such as outside counsel, also are likely to qualify as material advisers, and can be expected to seek to reach agreements with the promoter designating the promoter as the party responsible for maintaining the list.
- While the new Promoter Listing Rules are not a model of clarity in this regard, we believe they generally should not apply if tax advice about a transaction is given only to parties who are not required to disclose the transaction (and are not themselves making tax statements about the transaction to others or selling the transaction to others), even if another taxpayer is required to disclose the transaction (a reporting taxpayer). If there are negotiations between the parties that involve discussion of the tax benefits to the reporting taxpayer, however, under a literal reading of the rules, it is possible that all persons participating in that discussion may be required to list the reporting taxpayer.
- The minimum fee threshold is $250,000 for a transaction if all persons that acquire an interest in it are corporations, other than S corporations, and otherwise $50,000. All fees for advice, whether or not tax advice, or for implementation of a transaction are taken into account in determining whether a threshold is met.[17] This definition has been written broadly to eliminate the possibility of characterizing a fee for tax-related advice as something else.
- Unlike current law under the Registration Rules, the fee threshold applies on a transaction-by-transaction basis, so that a promoter that receives different fees from two taxpayers that enter into separate but identical transactions may be required to list one taxpayer but not the other.[18]
- The new Promoter Listing Rules generally will apply to transactions entered into on or after January 1, 2003. They will also apply to some transactions that become "Listed Transactions" on or after January 1, 2003.[19]

## II. The New Disclosure Rules

### A. Wider Scope of Reportable Transactions

The new Disclosure Rules define six categories of "reportable transactions" — Listed Transactions (as under the current rules) and five stand-alone categories of transactions with certain characteristics, which the IRS has generally found to be elements in abusive transactions to date. These five categories cover a wide range of transactions. We expect that as the IRS gains experience with these new rules, the IRS may narrow the scope of these five categories, and may also add new categories to the definition of "reportable transactions."

The six categories of "reportable transactions" are:

**1. Listed transactions.** As under current law, the first category includes transactions that are the same or "substantially similar" to any of the transactions identified and announced by the IRS to be tax-avoidance transactions.[20] Under the new Disclosure Rules, however, disclosure also will be required of Listed Transactions involving federal estate, gift, employment, and pension and exempt organization excise taxes.

[15]New Treasury regulation section 301.6112-1T(c)(2). This definition of a "material adviser" represents a fundamentally different approach from the one taken by the proposed legislation referred to in note 4, above, which follows an approach outlined in the March 2002 Proposals. The proposed legislation defines "material adviser" more broadly to include any person that provides any material aid, assistance, or advice in respect of organizing, promoting, selling, or implementing a reportable transaction (and that meets minimum fee thresholds).

[16]New Treasury regulation section 301.6112-1T(e)(3)(ii).

[17]New Treasury regulation section 301.6112-1T(c)(3).

[18]*See* the preamble to new Treasury regulation section 301.6112-1T.

[19]New Treasury regulation section 301.6112-1T(j).

[20]New Treasury regulation section 1.6011-4T(b)(2). *See* Appendix B hereto for a summary description of all Listed Transactions to date.

As under current law, for purposes of determining whether a transaction is "substantially similar" to a listed transaction, the term "substantially similar" includes "any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy." The term "substantially similar" is construed broadly in favor of disclosure. An opinion regarding the tax consequences of the transaction is not relevant to determining whether the transaction is the same or substantially similar to another transaction.[21]

**2. Confidential transactions.** A transaction falls into this category if it is offered under conditions of confidentiality. Current law provides a very broad definition of "confidentiality" — including any express or implied understanding that would preclude a taxpayer from disclosing the *structure* of a transaction — that generally is carried over into the new Disclosure Rules. As a practical matter, under current law taxpayers rely on a presumption that a transaction is not treated as offered under conditions of confidentiality if some explicit waivers of confidentiality are stated in writing. The new Disclosure Rules narrow the scope of that presumption.[22]

A transaction is presumed to be a confidential transaction if a taxpayer's disclosure of the structure or tax aspects of the transaction is limited by an understanding or agreement with any person who makes or provides a statement, oral or written, regarding the potential tax consequences of the transaction, or for whose benefit the discussion takes place, regardless of whether the understanding is legally binding. A transaction also is presumed to be a confidential transaction if the taxpayer knows or has reason to know that its use or disclosure of information relating to the structure or tax aspects of the transaction is limited in any other manner (for example, where the transaction is claimed to be proprietary or exclusive).[23] These rules are applied under a facts and circumstances test that takes into account the existence of any implied understanding or agreement and the prior conduct of the parties.[24]

As under current law, a transaction is not treated as a confidential transaction solely by reason of privileged communications by the taxpayer (for example, with an attorney), or as a result of restrictions on disclosure of the structure or tax aspects of the transaction that are imposed by securities laws.[25] Recent cases have held that the scope of the attorney-client privilege is narrower than many advisers have understood it to be, however,[26] and in any event the privilege is intended for the benefit of a taxpayer, not for the benefit of a promoter (regardless of whether the promoter is an attorney or otherwise subject to privilege rules), so that this exception does not appear to provide any meaningful benefit to promoters for purposes of the new Disclosure Rules.

Also, as under current law, a transaction is presumed not to be a confidential transaction if the tax shelter promoter authorizes the taxpayer in writing to disclose to any person, without any limitation of any kind, (i) the structure and tax aspects of the transaction and (ii) all materials of any kind (including tax opinions or analyses) that are provided to the taxpayer related to such structure and tax aspects of the transaction.[27] Because this presumption also takes a transaction outside the scope of the Registration Rules under current law,[28] it has become common market practice for promoters to include such an authorization in any written materials provided to a potential client for a transaction that has novel or unresolved tax issues.

***Significantly, the new Disclosure Rules will expand the scope of transactions for which nonconfidentiality authorizations will be important.***

The new Disclosure Rules narrow this presumption in two respects: The written authorization must be made by *every* person that discusses the potential tax consequences of the transaction, and the authorization must be effective from the commencement of discussions. As a result, we anticipate that promoters will broaden the scope of their nonconfidentiality authorizations to include their affiliates, to the extent not already included, and all persons acting on behalf of the promoter, including any tax adviser to the promoter whose advice might be conveyed to a potential client.

More significantly, the new Disclosure Rules will expand the scope of transactions for which nonconfidentiality authorizations will be important, because the new rules will make a transaction — regardless of how well-established its tax consequences are — reportable *solely* by virtue of being offered under con-

[21]New Treasury regulation section 1.6011-4T(c)(4).

[22]New Treasury regulation section 1.6011-4T(b)(3). The New Regulations make conforming changes to the confidentiality provisions of the existing Registration Rules. New Treasury regulation section 301.6111-2T(c)(3).

[23]The IRS apparently believes that the use of the word "proprietary" is meant to convey some notion of an enforceable intellectual property right.

[24]New Treasury regulation section 1.6011-4T(b)(3)(i).

[25]New Treasury regulation section 1.6011-4T(b)(3)(ii).

[26]*See United States v. Ackert*, 169 F.3d 136, *Doc 1999-9119 (8 original pages), 1999 TNT 45-26* (2nd Cir. 1999) (attorney-client privilege does not cover communications between an investment banker (who was an attorney) and taxpayer's in-house tax counsel intended to help the counsel better understand the details of a proposed transaction); *Saba Partnership v. Commissioner*, 78 T.C.M. 684, *Doc 1999-34675 (133 original pages), 1999 TNT 208-8* (1999), *rev'd on other grounds* 273 F.3d 1135, *Doc 2001-31675 (12 original pages), 2001 TNT 249-5* (D.C. Cir. 2001) (privilege does not cover factual content of communication between taxpayer and its in-house tax counsel regarding the transaction at issue).

[27]New Treasury regulation section 1.6011-4T(b)(3)(iv).

[28]Current Treasury regulation section 301.6111-2T(c)(3).

ditions of confidentiality, subject to limited exceptions for confidentiality reasonably necessary to comply with securities laws.[29] Moreover, because a transaction is treated as confidential if discussion of its *structure* is limited in any way, many transactions that are confidential for valid business reasons could potentially be reportable, if the limitation is for the benefit of a person making statements about potential tax consequences to the taxpayer. These transactions could include many privately negotiated transactions where confidentiality is required for nontax reasons.[30]

**3. Transactions with contractual protection.** A transaction with contractual protection is a transaction in which a taxpayer is protected against the possibility that part or all of the intended tax consequences of the transaction will not be sustained.[31] This category is also contained in the current Disclosure Rules, but without much elaboration.

Like the confidentiality category and some of the other categories discussed below, this category will take on new importance under the new Disclosure Rules, because "contractual protection" is defined so broadly that it appears to sweep in many ordinary-course transactions, and because contractual protection alone will now make a transaction reportable. The exceptions to the term "contractual protection" thus will play a critical role.

"Contractual protection" includes, but is not limited to, rescission rights, the right to a full or partial refund of fees paid in connection with the transaction, fees that are contingent on the taxpayer's realization of tax benefits of the transaction, or a tax indemnity, other than a customary tax indemnity provided by a principal that did not participate in the promotion or offering of the transaction to the taxpayer.

The new Disclosure Rules provide that contractual protection does not include the obligation of an issuer of a debt instrument to pay additional interest to compensate a holder for withholding tax imposed on interest (a "gross-up" provision) or the issuer's right to call the debt if the withholding tax is imposed.[32] However, other commonplace transactions with gross-up provisions may give rise to a reportable transaction, including gross-ups for noninterest payments made in cross-border transactions, such as payments made under securities loans and derivative financial instruments such as swaps; and an earnings and profits gross-up for conventional preferred stock in the event of changes to the dividends-received deduction.

The carve-out for a customary tax indemnity provided by a principal that did not participate in marketing the transaction to the taxpayer presumably was intended to cover many conventional transactions in which it is routine for one principal to provide a tax indemnity to another principal, such as a tax indemnity provided by the acquiror of a company to the seller thereof in a stock acquisition agreement.[33] It appears, however, that the carve-out for tax indemnities provided by a principal to a transaction may not apply, for example, to tax indemnities commonly provided in leveraged leases and sale-leaseback transactions. Because brokers or agents of lessees often structure transactions and seek lessors on behalf of lessees, their activity on behalf of the lessees may constitute promotion or offering on the part of the lessees for purposes of the carve-out. Consequently, we expect that many of these leasing deals will be reportable transactions. Many tax-structured transactions that include a gross-up for noninterest withholding tax or earnings and profits, in which a principal approaches potential counterparties directly, also are likely to fall outside the scope of the carve-out.

**4. Loss transactions.** This category is new and very broad, and was presumably added by the IRS and Treasury because many of the Listed Transactions to date have involved the generation of tax losses without corresponding economic losses. As noted earlier, government officials have indicated informally that they may be willing to narrow this and other categories of reportable transactions as they gain experience with them. Since the scope and timing of those future amendments are uncertain, many nonabusive transactions will be required to be reported.

Under the new Disclosure Rules, a loss transaction is any transaction that results, or is reasonably expected to result, in a taxpayer claiming a loss in excess of specified thresholds under section 165.[34] The loss is measured on a gross basis, without offset for gains

[29]The new Disclosure Rules state that disclosure restrictions imposed for securities law purposes do not constitute conditions of confidentiality. An example would be disclosure restrictions imposed on recipients of offering documents in a private placement of securities, to ensure that the offering is exempt from registration with the SEC. In addition, in view of the fact that the securities law imposes restrictions on disclosure of material nonpublic information under insider-trading principles and under the "fair disclosure" rules (requiring public disclosure of the information, if the information has been selectively disclosed to only certain persons, unless those persons are under a duty or contractual obligation to keep the information confidential), we expect that in many cases the securities law exception would apply even if a transaction otherwise would be considered offered under conditions of confidentiality.

[30]In some cases, strategic corporate transactions such as mergers and acquisitions could be treated as offered subject to conditions of confidentiality. In many such cases, however, we expect that the exception for disclosure restrictions required to comply with securities laws would apply. *See* note 29, above.

[31]New Treasury regulation section 1.6011-4T(b)(4).

[32]New Treasury regulation section 1.6011-4T(b)(4).

[33]This exception also suggests that the term "contractual protection" generally is aimed at indemnification against the loss of expected tax benefits (based on, for example, the expected characterization of the transaction), as opposed to indemnification against unexpected tax costs from a transaction (for example, from breach of representations regarding a target company's outstanding tax liabilities).

[34]New Treasury regulation section 1.6011-4T(b)(5)(i).

from related transactions.[35] A transaction that is profitable overall may still be required to be reported, therefore, if one part of it gives rise to a loss. A loss transaction is reportable even if the taxpayer does not realize current tax benefits from the loss as a result of limitations on the deductibility of the loss.

### *The scope of the 'reasonably expected loss' rule is not wholly clear.*

The minimum loss threshold for any single tax year is $10 million for corporations, $5 million for partnerships and S corporations, and $2 million for individuals and trusts.[36] These thresholds are doubled for any combination of tax years. The threshold is $50,000 in any single tax year for individuals and trusts, if the loss results from a section 988 transaction (that is, foreign currency losses).[37]

A taxpayer's "loss" includes any amount deductible by virtue of a provision that treats a transaction as a sale or other disposition or otherwise results in a loss deductible under section 165.[38] The preamble to the regulations refers in particular to a loss resulting from a sale or exchange of a partnership interest and a loss resulting from some foreign currency-linked transactions. Other provisions would include the rules dealing with liquidations of corporations in the case of less-than-80-percent shareholders, losses of securities dealers from marking their securities positions to market, and the constructive sale rules for some hedging transactions. More generally, because section 165 is the primary code provision that provides for the deduction of losses, the type of losses covered by this definition is very broad, and includes capital losses (from, for example, the sale of securities).[39]

The scope of the "reasonably expected loss" rule is not wholly clear. Given the purpose of the disclosure rules, the "reasonably expected" standard presumably is intended to require disclosure of transactions that are considered likely to result in a loss even if that loss is not certain. Transactions that are expected to be profitable, or that may or may not give rise to losses based on unpredictable market movements, such as a short-term hedge of the value of stock, thus ought to be outside the scope of the disclosure rules. Transactions will need to be monitored on an on-going basis, however, to determine whether any part of the transaction actually gives rise to a loss in excess of the relevant threshold.

The preamble to the regulations indicates that the IRS is considering providing an exception for losses from the sale of securities on a stock exchange or interdealer quotation system, but only if the taxpayer's basis in computing the loss is equal to the amount of cash paid for the securities.[40]

The preamble also indicates that the IRS is considering providing exceptions for mark-to-market losses under the rules governing dealers in securities and under an elective provision permitting owners of marketable shares in a "passive foreign investment company" to mark those shares to market. These exceptions would be welcome and should cover other mark-to-market rules like those governing regulated futures contracts and some other exchange-traded financial instruments. However, until these exceptions are added to the regulations, taxpayers will be required to report these types of loss transactions.

**5. Transaction with a significant book-tax difference.** While book-tax differences are part of existing law's "two out of five" test, they will take on new importance under the new Disclosure Rules because a significant book-tax difference alone will now require disclosure. In recognition of this fact, the New Regulations limit the scope of this category in several ways, including by narrowing the types of taxpayers for whom the category is relevant and by listing many exclusions from the rules for everyday book-tax differences.[41] The exclusions do not cover every such commonplace book-tax difference, however. Accordingly, this category also will cover many routine transactions with well-established tax treatment. As with the loss transaction category, we anticipate that the IRS will likely narrow the scope of this category over time.

Determining whether a transaction falls into this category will require coordination between a taxpayer's financial accounting and tax advisers, as tax advisers in many cases will not have the detailed knowledge of financial accounting required to determine whether a book-tax difference arises or, if so, the size of that difference. Furthermore, because generally accepted accounting principles in some cases permit multiple treatments of the same item, it is possible that a transaction that gives rise to a significant book-tax difference for one taxpayer will not do so for another. These issues may be of greater concern to persons required to maintain lists of participants in reportable transactions under the Promoter Listing Rules, because they will have less information about a particular taxpayer's financial accounting policies than would the taxpayer's in-house tax department.

The new Disclosure Rules define a transaction with a "significant book-tax difference" as a transaction in which the treatment of any item for federal income tax purposes differs, or is reasonably expected to differ, by

[35]New Treasury regulation section 1.6011-4T(b)(5)(ii). Salvage value, insurance, and other similar compensation may be taken into account in determining the amount of a loss, however.

[36]Mutual funds are not required to disclose transactions falling into this "loss transaction" category.

[37]New Treasury regulation section 1.6011-4T(b)(5)(i).

[38]New Treasury regulation section 1.6011-4T(b)(5)(ii)(B).

[39]Loss transactions do not, however, include losses from theft, casualties, and compulsory or involuntary conversions. New Treasury regulation section 1.6011-4T(b)(5)(iii).

[40]The preamble refers in this regard to a definition of "established securities market" that appears to be intended to be a reference to the definition of that term for purposes of the rules governing publicly traded partnerships.

[41]New Treasury regulation section 1.6011-4T(b)(6).

more than $10 million in any tax year from its treatment for book purposes. The term "item" is not defined, but the $10 million determination is made on a gross basis, without netting of offsetting items. Book income is determined by applying U.S. generally accepted accounting principles to worldwide income. Adjustments to any reserves for taxes are disregarded.[42]

This category applies only to companies with publicly offered debt or equity in the United States and companies with at least $100 million in gross assets, and their affiliates.[43] Special rules, summarized below, apply to certain taxpayers subject to special tax rules.

- In the case of foreign persons doing business in the United States, only transactions affecting U.S. net income taxes and, for purposes of the $100 million gross asset test, only assets connected to their U.S. business are taken into account.[44]
- Transactions solely among members of a consolidated group are disregarded. If members of a consolidated group engage in a transaction with an unaffiliated person, items of each member relating to the transaction will be aggregated as if the members of the group were a single taxpayer, but offsetting items will not be netted for this purpose.[45]
- Special rules for U.S. shareholders of foreign corporations and for partners and owners of other passthrough entities are discussed in Sections II.B and II.C, below.

The new Disclosure Rules provide a list of specific exceptions to the book-tax difference category as follows:[46]

- items generating a book loss or expense before or without a tax loss or expense,
- items generating a tax gain or income before or without a book gain or income,
- depreciation, depletion, and amortization relating solely to differences in methods, lives, or conventions,
- bad debts or cancellation of indebtedness income,
- federal, state, local, and foreign taxes,
- compensation of employees and independent contractors,
- items that for federal income tax purposes cannot be deducted or capitalized (for example, some fines and penalties),
- charitable contributions of cash or tangible property,
- tax-exempt interest, including municipal bond interest,
- dividends (including distributions of previously taxed income under the rules applicable to controlled foreign corporations and passive foreign investment companies, and deemed dividends for purposes of those rules and the foreign personal holding company rules),
- items resulting from involuntary conversions,
- gains and losses resulting from transactions to which the mark-to-market rules for dealers in securities or marketable passive foreign investment company stock apply, and
- adjustments under section 481 for changes in a taxpayer's method of tax accounting.

The list above does not include many common transactions giving rise to book-tax differences. Examples of book-tax differences *not* excluded from this category are those resulting from:

- the differences between book consolidated reporting (for controlled entities, on a worldwide basis) and tax consolidated returns (for 80-percent-owned subsidiaries that are U.S. corporations only);[47]
- leveraged lease transactions in which income is recognized for book purposes, while losses are recognized for tax purposes;
- structured finance transactions treated as sales for book purposes and financings for tax purposes;
- mark-to-market treatment for book purposes, such as in the case of marketable securities or derivative positions not eligible for hedge accounting treatment, except to the extent that the first two exceptions listed above apply;
- the retirement of debt at a premium in a noncash transaction, such as in a debt-for-debt exchange;
- structured notes and other contingent debt instruments, including convertible debt instruments with contingent interest payments; and
- the sale of stock in a subsidiary, to the extent that any of the book-tax difference resulting therefrom does not fall in any of the first three categories of exceptions on the list above.[48]

[42]New Treasury regulation section 1.6011-4T(b)(6)(i).

[43]New Treasury regulation section 1.6011-4T(b)(6)(ii)(A). Mutual funds are not required to disclose transactions falling into this "book-tax difference" category.

[44]New Treasury regulation section 1.6011-4T(b)(6)(ii)(C).

[45]New Treasury regulation section 1.6011-4T(b)(6)(ii)(B).

[46]New Treasury regulation section 1.6011-4T(b)(6)(iii).

[47]The preamble to the new Disclosure Rules states that the mere fact that an item may be reported by different persons for tax and book purposes does not in and of itself create a significant book-tax difference. This statement is made only for U.S. shareholders of foreign corporations and other "indirect" U.S. participants in foreign entities, however. The preamble and new Disclosure Rules do not address the mismatch arising from differences in the control thresholds for book and tax consolidation.

[48]In addition, the book and tax treatment of certain financial instruments linked to a corporation's own stock may differ, such as the book treatment of warrants or convertible debt (prior to exercise or conversion) as stock for purposes of calculating earnings per share of the issuer. Generally, however, we believe that the differences between book and tax treatment should not give rise to a book-tax difference for purposes of this category of reportable transactions, to the extent that the different treatment does not result in a difference between book and tax *income*.

**6. Transactions involving a brief asset holding period.** This category includes transactions that result in, or are reasonably expected to result in, a tax credit, including a foreign tax credit, exceeding $250,000, if the asset giving rise to the credit is held unhedged for less than 45 days.[49] This category is an expanded version of section 901(k), which applies to foreign tax credits in respect of foreign withholding taxes imposed only on dividends, and would require disclosure of foreign tax credit trades of the kind litigated in *Compaq Computer Corporation v. Commissioner*[50] and *IES Industries Inc. v. United States*.[51] The category would also apply to transactions involving streams of payments other than dividends, such as interest and royalty payments, and to tax credits other than foreign tax credits.

Unlike the exception for securities dealers provided in section 901(k)(4), however, this category provides no exceptions. Accordingly, securities dealers will be required to disclose their transactions falling into this category, including those to which the section 901(k)(4) exception applies.

## B. U.S. Shareholders of Foreign Corporations[52]

A shareholder of a foreign corporation that is a direct participant in a reportable transaction will be subject to the new Disclosure Rules — as an "indirect participant" — if (a) the shareholder's federal tax liability is affected by the transaction and (b) the shareholder is a "reporting shareholder."[53] For this purpose, a shareholder is a "reporting shareholder" if it is a "United States shareholder" of a foreign personal holding company (FPHC) or a controlled foreign corporation (CFC), as the term is defined under those rules, respectively, or 10 percent shareholder (by vote or value) of a passive foreign investment company that is a qualified electing fund (QEF).[54]

In the case of a transaction giving rise to a book-tax difference, special rules apply. First, the transaction is subject to the new Disclosure Rules only if the transaction reduces or eliminates income inclusions otherwise required under the rules dealing with FPHCs, CFCs, and QEFs.[55] Second, if there is such a reduction or elimination, all book and tax items of the foreign corporation are treated as items of the shareholder.[56] According to the preamble to the new Disclosure Rules, the fact that an item is reported by different persons for tax and book purposes (for example, by the reporting shareholder for U.S. tax purposes and by the foreign corporation for book purposes), without more, will not be treated as a significant book-tax difference. In addition, only an allocable share of the federal tax items of the foreign corporation is to be treated as an item of the reporting shareholder.

The precise manner in which the rules relating to the other categories of reportable transactions are intended to apply to transactions carried out by a foreign corporation is not wholly clear. The scope of the general rule that a shareholder is treated as an indirect participant in a reportable transaction only if the transaction affects the shareholder's federal tax liability will be important. Many transactions at the level of a foreign corporation may have no current effect on a shareholder's U.S. tax liability, but have a potential effect at a later date — for example, by affecting the foreign tax credits that would be available to the shareholder if a dividend were paid.

Turning to the individual reportable transactions, the loss category would appear to be relevant if the loss deductible under section 165 reduces the earnings and profits of a foreign corporation and thereby reduces any subpart F income inclusions of a U.S. shareholder. Under a literal reading of the regulations, the confidentiality and contractual protection (and brief asset holding period) categories conceivably could apply even if the taxes that were affected by the relevant transactions were foreign taxes only, as the regulations do not limit those categories to transactions affecting U.S. taxes.

## C. Passthrough Entities; Transferees

Indirect participation in a reportable transaction includes any other form through which a taxpayer's federal tax liability is affected. Indirect participation includes, for example, being a partner in a partnership, a shareholder in an S corporation, or an owner of a trust or a controlled entity, if that partnership, S corporation, trust, or entity engages in a reportable transaction. In the case of a partnership or S corporation, there is indirect participation if the partner's or shareholder's U.S. tax liability is "reasonably expected" to be affected.[57] As a result, taxpayers that own interests in investment funds, hedge funds, investment trusts of the kind used in some structured finance transactions, or entities carrying on business operations such as joint ventures and check-the-box entities will be subject to the new Disclosure Rules in respect of transactions entered into by such noncorporate entities.

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[49]New Treasury regulation section 1.6011-4T(b)(7).

[50]277 F.3d 778, *Doc 2002-184 (14 original pages), 2002 TNT 1-5* (5th Cir.2001).

[51]253 F.3d 350, *Doc 2001-16769 (16 original pages), 2001 TNT 116-12* (8th Cir. 2001).

[52]U.S. persons that own interests in foreign business operations through entities not treated as corporations for U.S. federal income tax purposes, such as joint ventures or so-called "check-the-box" entities, are subject to the more general rules applicable to indirect participants described in Section II.C, below.

[53]New Treasury regulation section 1.6011-4T(c)(3)(i) and (c)(3(ii)(A).

[54]Treasury regulation section 1.6011-4T(c)(3)(ii)(B). These rules generally require U.S. shareholders of a foreign corporation to take into account on a current basis certain types of passive income earned by the foreign corporation, in a manner intended to approximate roughly the tax treatment of the U.S. shareholder had it earned the income directly.

The regulations do not explicitly provide that only U.S. persons will be treated as 10 percent shareholders of QEFs for this purpose, but presumably that is the category of shareholders intended to be covered.

[55]New Treasury regulation section 1.6011-4T(c)(3)(ii)(A).

[56]New Treasury regulation section 1.6011-4T(b)(6)(ii)(F).

[57]New Treasury regulation section 1.6011-4T(c)(3)(i).

The new Disclosure Rules provide for partnerships and disregarded entities (but not trusts or S corporations) that items of income, loss, expense, or deduction otherwise considered items of the entity for book purposes are treated as items of the taxpayer for purposes of the book-tax difference rules.[58] The preamble to the New Regulations provides more broadly that the fact that an item is reported by different persons for tax and book purposes (for example, by a partner for U.S. tax purposes and by a partnership for book purposes), without more, will not be treated as a significant book-tax difference. Instead, the taxpayer must test these items in the same manner as items from a transaction in which the taxpayer participated directly.

The new Disclosure Rules treat taxpayers that are not direct participants in a transaction, such as a transferee of an interest created by a Listed Transaction, as indirect participants subject to the new Disclosure Rules, if the taxpayer knows or has reason to know that its tax benefits are derived from a reportable transaction.[59] An example illustrates this point regarding the acquiror of high-basis, low-value property in a carryover basis transaction, where the acquiror has reason to know that the high basis derives from a reportable transaction.[60]

### D. Disclosure Requirements

**1. In general.** A taxpayer that has directly or indirectly participated in a "reportable transaction" is required to attach a disclosure statement to its return for each tax year in which the taxpayer's tax liability is affected by the reportable transaction, or to its return for the first tax year in which a previously nonreportable transaction becomes reportable. A transaction may become reportable because it becomes a Listed Transaction, or as a result of a change of facts (for example, where the change results in an actual or expected loss or book-tax difference in excess of the relevant threshold). These transactions must be disclosed even if they do not affect the taxpayer's tax liability on the tax return for the year in which the transaction becomes reportable. A taxpayer must also file a copy of the disclosure statement with the IRS Office of Tax Shelter Analysis at the time the transaction is first disclosed on its tax return. For purposes of making the required disclosure, the IRS will release a new Form 8886, "Reportable Transaction Disclosure Statement."[61]

If a reportable transaction results in a loss that is carried to a prior year, the transaction must be disclosed in a taxpayer's application for a tentative refund or amended federal income tax return for that year.[62]

**2. Protective disclosure.** A taxpayer that is uncertain about the application of the new Disclosure Rules may disclose the transaction while indicating that it is uncertain whether the transaction must be disclosed.[63]

**3. Exceptions.** A transaction will not be a reportable transaction if it is excluded from any of the foregoing categories by published guidance from the IRS or an individual ruling. A taxpayer that is uncertain about the application of the disclosure requirements may request a ruling from the IRS on whether a transaction is a reportable transaction.[64]

**4. Recordkeeping.** A taxpayer is required to retain a copy of all records for any reportable transaction, as defined above, that are material to an understanding of the facts of the transaction, the transaction's expected tax treatment or the taxpayer's decision to participate in the transaction. These documents must be retained until the date that statute of limitations expires for the first year in which disclosure was required, or as otherwise required for U.S. federal income tax purposes, whichever is later. The documents that must be retained include: marketing materials; written analyses of the transaction; correspondence and agreements between the taxpayer and the promoter, adviser, lender, or other party to the transaction; documents discussing the tax benefits of the transaction; and documents discussing the business purposes of the transaction.[65]

### E. Penalties

The new Disclosure Rules do not change the existing lack of explicit penalties for failure to disclose.[66] The preamble to the current Disclosure Rules provides that the disclosure statement "is a required part of the return to the same extent as information required pursuant to prescribed forms," and as such is verified by the taxpayer under penalties of perjury. In addition, the preamble to the current Disclosure Rules states that a failure to provide disclosure may indicate that the taxpayer has not acted in good faith regarding any underpayment, and, accordingly, may not be able to avail itself of the "reasonable cause" exception to the imposition of the "substantial understatement" penalty under section 6662, even if the taxpayer has relied on a legal opinion.[67]

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[58]New Treasury regulation sections 1.6011-4T(b)(6)(ii)(D) and (E).

[59]New Treasury regulation section 1.6011-4T(c)(3)(i).

[60]New Treasury regulation section 1.6011-4T(c)(3)(iii).

[61]New Treasury regulation sections 1.6011-4T(a), (d) and (e)

[62]New Treasury regulation section 1.6011-4T(e).

[63]New Treasury regulation section 1.6011-4T(f)(2).

[64]New Treasury regulation sections 1.6011-4T(b)(8)(i) and (f)(1).

[65]New Treasury regulation section 1.6011-4T(g).

[66]Under legislative proposals made earlier this year (and referred to in note 4, above), the penalties for failure to disclose a reportable transaction would be increased substantially, as well as penalties for the understatement of tax attributable to undisclosed reportable transactions.

[67]Treasury's basis for this view is unclear, because there is no necessary connection between a failure to disclose a transaction and lack of good faith on the part of the taxpayer in evaluating the correct tax treatment of the transaction.

### F. Effective Date

The new Disclosure Rules will apply to transactions entered into on or after January 1, 2003.[68] Transactions entered into before January 1, 2003, will continue to be subject to the current Disclosure Rules, including the requirement to disclose a transaction that becomes reportable under those Rules on or after January 1, 2003.[69]

## III. The New Promoter Listing Rules

The new Promoter Listing Rules fundamentally change the current rules in several important respects, primarily (i) by defining the term "material adviser" by reference to the provision of tax advice, thus changing the types of persons required to maintain a list and (ii) by defining the types of the transactions that may require that a person be listed to conform to those subject to the new Disclosure Rules.[70] The new Promoter Listing Rules also broaden the category of persons whose names must be listed, for example to include persons who do not participate directly in a transaction but are part of the marketing of the transaction, and they include various rules intended to ensure that promoters in fact comply with their obligations to maintain lists and to make them available to the IRS.

### A. Material Adviser

A "material adviser" is defined as any person that:

- provides a written or oral statement regarding the potential tax consequences of a "potentially abusive tax shelter" to any person, *and*
- receives, or expects to receive, a fee of at least $250,000, if all persons acquiring an interest in such shelter are corporations, other than S corporations, or $50,000 if otherwise, in connection with that transaction.[71]

**1. Making tax statements.** The first prong of the definition of "material adviser" shifts the focus of the Promoter Listing Rules in a very significant manner. Current law imposes listing requirements on persons that create, carry out, or sell a tax shelter, and exempts from those requirements legal advisers paid on an hourly basis, such as a taxpayer's tax advisers.[72] The new definition reflects frustration on the part of the IRS with promoters claiming that their activities fall outside the scope of the activities listed in the current regulations, and a deliberate attempt to write a sweeping rule to prevent further disputes of that kind. The new definition also, however, reflects a recognition by the IRS that promoter listing requirements should not be imposed on all persons who come into contact with an abusive transaction, but rather only those that are promoting it by providing tax advice.

**a. Taxpayer's tax advisers; claims of privilege.** Tax statements that satisfy the first prong obviously include statements made by any tax experts advising on the tax consequences of a potentially abusive tax shelter, including statements made by a taxpayer's own tax advisers. Requiring a taxpayer's own tax adviser to provide information directly to the IRS about the taxpayer's activities has raised concern among many practitioners that compliance will put them in conflict with ethical rules governing the practice of law or will require them to violate the attorney-client privilege or the statutory tax practitioner privilege available to other tax advisers. Government officials have responded by vigorously contesting that any such privileges are compromised.

***In recognition of the fact that privilege issues are likely to be contested, the new Promoter Listing Rules provide detailed steps that must be taken to make a claim of privilege.***

The preamble to the new Promoter Listing Rules states that the *name* of a person who engages in a potentially abusive tax shelter is not protected by privilege. Senior government officials have been quoted as going considerably further, and stating that *none* of the information required to be listed (which includes any written tax analyses or opinions) is subject to privilege. The theory underlying this approach appears to be (a) that taxpayers who engage in potentially abusive tax shelters are required themselves to disclose those transactions on their tax returns, and can have no expectation of confidentiality regarding the information required to be disclosed to the IRS, and/or (b) that taxpayers who engage in these transactions know that their tax advisers are required to comply with the Promoter Listing Rules, and therefore again can have no expectation of confidentiality in that regard. The second argument may be viewed as a questionable restriction of the attorney-client privilege, absent direct authorization by Congress.

In recognition of the fact that privilege issues are likely to be contested, the new Promoter Listing Rules provide detailed steps that must be taken to make a claim of privilege.[73] The rules limit the availability of this procedure to persons with a "reasonable belief" that information required to be provided to the IRS is protected by a privilege, and the preamble to the New Regulations warns that penalties may be imposed for unreasonable claims of privilege.

**b. Nontax experts.** Tax statements that satisfy the first prong may be made by persons without any claim to tax expertise, including investment bankers, marketers, and others with similar functions, who refer

[68]New Treasury regulation section 1.6011-4T(h).

[69]Current Treasury regulation section 1.6011-4T(d).

[70]For a diagram of the Promoter Listing Rules, see Appendix A hereto.

[71]New Treasury regulation sections 301.6112-1T(c)(2) and (3).

[72]Current Treasury regulation section 301.6112-1T (Q&A-5 and Q&A-6).

[73]New Treasury regulation section 301.6112-1T(e)(3)(ii).

to well-known tax rules or the tax advice of their tax advisers in the course of discussing a potential transaction. As a practical matter, since it will be difficult to monitor whether and when these persons are making tax-related statements, many "promoters" in practice are likely to look primarily to the fee thresholds and the nature of the transaction in deciding whether listing is required.

**c. Other tax advisers.** Tax advisers to promoters, such as outside counsel, also are likely to qualify as material advisers, regardless of whether they come into direct contact with the taxpayers participating in a transaction, provided that the advisers' compensation meets the minimum fee thresholds. It is sufficient, under the new Promoter Listing Rules, to make a tax statement regarding a potentially abusive tax shelter, to *any person*, if the person making the statement knows or has reason to know that the person to whom the statement was addressed, or a related party, will participate in the transaction or will in turn sell or transfer an "interest" — including information or services — in the transaction to a taxpayer that will participate in the transaction.[74] The issue of which taxpayers should be treated as "participating" in a potentially abusive tax shelter is discussed further in Section III.C, below.

As under current law, in a situation where multiple persons must maintain lists for a particular transaction, the new Promoter Listing Rules permit those persons to designate by written agreement one of their number to maintain the list.[75] Accordingly, promoters' tax advisers can be expected to seek to enter into these agreements with their promoter clients. The new Promoter Listing Rules make clear, however, that any such agreement does not relieve the nondesignated parties from compliance with listing obligations, regardless of their ability to police the designated party.

More sweepingly, the new Promoter Listing Rules may also impose listing obligations on tax advisers to parties who are not themselves required to disclose a transaction and who are not involved in the structuring or marketing of a transaction, if those tax advisers become involved in tax discussions with other parties to the transaction who do fall into those categories. This possibility arises because the new Promoter Listing Rules apply, in general, if tax statements are made to any "participant" in a reportable transaction. See Section III.C, below, for a more detailed discussion of this issue.

**d. 'Execution' exception.** By definition, a person that merely implements or executes a transaction, without making any statements relating to tax issues, will not be a "material adviser." This aspect of the new Promoter Listing Rules reflects the reality that financial institutions frequently are asked by their clients to execute transactions, or parts of transactions, such as the sale of a debt or equity security or entering into an option or swap, that may be part of a larger transaction for which the financial institution has played no role in structuring or advising. The new Promoter Listing Rules sensibly draw the line in this regard by reference to what the financial institution itself has done or not done.

**2. Fees.** As described above, the second prong of the definition of a "material adviser" is that the adviser receives a fee of at least $250,000, if all persons acquiring an interest in such shelter are corporations, other than S corporations, or $50,000 if otherwise, in connection with a potentially abusive tax shelter.[76] We understand that these thresholds are intended to avoid the need to maintain a list for routine tax planning advice. The preamble to the New Regulations states that the IRS is considering eliminating the thresholds for Listed Transactions, presumably on the theory that discussion of these transactions never constitutes routine tax planning.

***In view of the many ways in which compensation for tax advice may be structured in a complex transaction, the IRS is likely to take an expansive view of what may be considered a fee.***

For purposes of the minimum fee thresholds, fees include (a) consideration in whatever form paid, (b) fees for any kind of advice regarding a potentially abusive tax shelter, regardless of whether it is denominated as a fee for tax advice, and (c) fees for implementing such a transaction, for example for preparation of documentation.[77] The New Regulations state that the IRS will carefully scrutinize whether consideration received in connection with these transactions constitutes fees for this purpose. While intended as a warning, this statement implicitly acknowledges that consideration may be received that does not constitute a "fee."

In general, however, in view of the many ways in which compensation for tax advice may be structured in a complex transaction, the IRS is likely to take an expansive view of what may be considered a fee. We anticipate that taxpayers generally will be presumed to earn all amounts paid to them as a "fee" — including, for example, any amounts recognized as income in the pricing of any securities that form part of the transaction by a securities dealer under the mark-to-market rules — unless they can demonstrate otherwise.

Unlike current law under the Registration Rules, the fee threshold applies on a transaction-by-transaction basis, so that a promoter that receives different fees from two taxpayers that enter into separate but identical transactions, or the same fee from two different clients where one is a corporation and the other is not,

[74]New Treasury regulation section 301.6112-1T(e)(2).
[75]New Treasury regulation section 301.6112-1T(h).
[76]New Treasury regulation section 301.6112-1T(c)(3)(i).
[77]New Treasury regulation section 301.6112-1T(c)(3)(ii).

may be required to list one taxpayer but not the other.[78] An example in the New Regulations suggests, however, that if promoter M provides tax statements to promoter N, and promoter N provides tax statements to multiple clients, promoter M must treat the full amount of the compensation received from promoter NB as fees for each of promoter N's clients, at least where promoters M and N have not allocated the compensation otherwise.[79]

### B. Transactions Covered

The new Promoter Listing Rules define a "potentially abusive tax shelter" as:[80]

- a Listed Transaction, including Listed Transactions involving federal estate, gift, employment, and pension and exempt organizations excise taxes, and transactions "substantially similar" to a Listed Transaction;
- a transaction that a material adviser knows, or has reason to know, falls into one of the other five categories of transactions subject to the Disclosure Rules, when the transaction is entered into or an "interest" is acquired;[81] or
- a transaction that is subject to the Registration Rules.

### C. Persons Required to Be Listed

A material adviser must list any person to whom the material adviser made or provided a statement, oral or written, as to the potential tax consequences of a potentially abusive tax shelter, if the material adviser knows, or has reason to know, that the person or a related party "participated in" or will participate in the transaction.[82] The requirement that the material adviser know or have reason to know that a person will participate in a transaction in most cases will limit the listing requirement to executed transactions, as is the case under current law. A single list must be maintained for all substantially similar transactions.[83]

A critical aspect of this rule is the question of who is treated as "participating" in a transaction. Neither the new Disclosure Rules nor the new Promoter Listing Rules define this term, so that it is possible that the universe of participants for purposes of the new Promoter Listing Rules could be different from the universe of participants for purposes of the new Disclosure Rules. In view of the fact that a fundamental purpose of Treasury's approach to the new tax shelter regime, as articulated in the March 2002 Proposals, is to provide the government with different avenues for obtaining information about a single universe of transactions, we think the core meaning of the term "participant" should be the same for the purposes of both sets of Rules.

At its broadest, the term "participant" conceivably might mean any person who in any way is affected economically (in terms of its tax liability or otherwise) by a potentially abusive tax shelter. The new Disclosure Rules, however, clearly take a narrower view of the core meaning of the term, as they contain special rules for "indirect" participants that are intended to broaden the group of taxpayers that would otherwise be required to disclose. Those indirect participant rules generally require disclosure only by a taxpayer whose U.S. tax liability is affected by a transaction.[84] Furthermore, taxpayers that are direct participants in a reportable transaction generally are required to report the transaction only for tax years in which the taxpayer's federal income tax liability is affected by the taxpayer's participation in the transaction.[85]

An interpretation of the core meaning of the term "participant" for listing purposes that is consistent with the scope of the new Disclosure Rules and the policy linkage between those Rules and the new Promoter Listing Rules would limit the term to a person who is required to disclose a transaction on its tax return under the new Disclosure Rules. Those persons generally would be those (a) whose U.S. tax liability is or may be affected, (b) by a transaction that the person directly enters into or acquires an interest in, (c) where the potential effect on that person's U.S. tax liability is a result of the features of the transaction that make it a potentially abusive tax shelter (or where the transaction is marketed under conditions of confidentiality or contains contractual protection for tax benefits).

To take a simple example of this rule, if A sells high-basis, low-value property to unrelated party B for

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[78]This transaction-by-transaction approach to measuring the fees is new; it is not contained in Treasury's March 2002 Proposals or in the legislation proposed earlier this year (referred to in note 4, above).

[79]New Treasury regulation section 301.6112-1T(e)(2)(iii), Example 2. This example is discussed in note 87, below.

[80]New Treasury regulation section 301.6112-1T(b).

[81]For this purpose, an "interest" includes not only an economic, proprietary interest in a transaction, but also any interest that purports to entitle the direct or indirect holder to any of the tax consequences of the transaction. Oddly, the term "interest" is not explicitly defined to include entering into a derivative financial instrument, although the definition as a whole is broad enough to cover these transactions. As under current law, the term "interest" includes the receipt of 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.

[82]Treasury regulation section 301.6112-1T(e)(2).

[83]New Treasury regulation section 301.6112-1T(e)(1). The term "substantially similar" is discussed in Section II.A.1, above.

[84]The Disclosure Rules provide special rules treating owners — shareholders, partners, etc. — of entities that engage in reportable transactions as "indirect" participants under certain circumstances. The definition of the term "indirect participant" for this purpose focuses on whether a taxpayer's federal tax liability is affected by a transaction. Under these rules, a shareholder whose federal tax liability is not affected by a transaction carried out at the corporate level is not a "participant" in the transaction, even if the shareholder benefits economically from a reduction in tax at the level of the corporation.

[85]New Treasury regulation section 1.6011-4T(e)(1).

cash equal to the property's fair market value in a transaction that gives rise to a reportable loss to A, B would not be a "participant" simply because it bought property from A. The same result generally should be true if the property is stock and B deducts dividends received thereon for U.S. federal income tax purposes, even though B's U.S. tax liability is thereby affected.

Special rules under the new Promoter Listing Rules support this narrower interpretation. Those rules require material advisers to list a person if the adviser knows or has reason to know that a related party to that person entered into a potentially abusive tax shelter and the other requirements for listing are met.[86] The special rules also require that a material adviser treat as a participant (x) a person who sells an interest (including information or services) in a potentially abusive tax shelter (an intermediary participant) and (y) a person who purchases an interest from an intermediary participant (a subsequent participant), if the material adviser has reason to know that the subsequent participant will participate in the transaction, or sell an interest therein.[87] The related party and intermediary participant rules would not be necessary if the term "participant" included every person who benefits economically from the transaction.

Some examples illustrating the points above follow (assume that the minimum fee thresholds are met and that transactions are not marketed under conditions of confidentiality and do not contain contractual protection for tax benefits).

1. D, a dealer in securities, is asked by a client to execute a transaction that may be a reportable transaction. D does not make any tax statements to the client. D consults its outside tax advisers T as part of the process of determining whether the transaction meets D's internal standards for executing transactions.

   T is a material adviser. D is not a participant, however, because D is not required to disclose the transaction. Since D will mark the transaction to market, D's U.S. tax liability is not affected by the features of the transaction that may make it reportable. No listing is required by T or D.

2. A client calls B, its tax adviser/financial adviser/investment bank to discuss a novel transaction that the client has heard of. The transaction would be reportable if the client enters into it. B discusses the transaction with the client, including the tax aspects of the transaction, but makes no effort to persuade the client to enter into such a transaction.

   B is a material adviser. No listing is required, because B has no reason at that point to believe the client will enter into the transaction. If the client subsequently goes forward with the transaction and B is involved in executing the transaction, B must list the client's name and the transaction.

3. X, a U.S. corporation, solicits financing from F, a foreign corporation, in connection with a transaction. F hires U.S. counsel C to advise it and to negotiate on its behalf. C's tax lawyers advise F on the U.S. withholding tax consequences of the financing. The discussion includes a review of the possibility that the withholding tax consequences would change if the transaction were recharacterized in a manner that would make it a reportable transaction for X.

   C is a material adviser to F, but F is not required to disclose the transaction, because transactions affecting U.S. withholding tax (without more) are not reportable transactions. No listing is required by C or F.

4. Same facts as 3., except assume that the transaction is reportable for X and that X demands that the transaction contain certain features to preserve X's tax benefits (for example, X and F will agree to take consistent positions for U.S. tax purposes). C negotiates with X's counsel, Y, on these features. The negotiation includes a discussion between C and Y of X's tax risks.

   X must disclose the transaction. Y is a material adviser to X, and must list X. Under a literal reading of the regulations, C also may be a material adviser to X, a participant, in which case C would be required to list X. Since F is not a material adviser or participant, and C is providing tax advice only to F — and X is represented by its own tax counsel — a narrower reading of the regulations may be appropriate.

5. Same facts as 4., except that F suggested the transaction to X and made a presentation to X that refers to the potential tax benefits to X.

   X must disclose the transaction. F is a material adviser to X, a participant, and must list X. While F is not required to disclose the transaction, F is a participant, because F is receiving compensation for having provided information and/or services to X. C is a material adviser and must list both F and X.

[86]New Treasury regulation section 301.6112-1T(e)(2)(i).

[87]New Treasury regulation section 301.6112-1T(e)(2)(ii). An example in the new Promoter Listing Rules (somewhat simplified) illustrates these special rules, as follows: Material Adviser M provides a statement to Intermediary N relating to the potential tax consequences of a reportable transaction. Intermediary N sells an interest in the transaction to Taxpayer P. Taxpayer P pays Intermediary N, Intermediary N pays Material Adviser M, and all relevant fee thresholds are met. The example concludes that Material Adviser M must list Intermediary N as a "participant," because N is selling an interest in the transaction. Material Adviser M also must list Taxpayer P as a "participant," because M had reason to know that P would purchase an interest from Intermediary N. What is interesting about this example is that the fact that N is receiving an economic benefit from the transaction — the fee paid by Taxpayer P — does not cause N to be a participant. Rather, Intermediary N is a participant solely because of the special rule described in clause (x) in the text. New Treasury regulation section 301.6112-1T(e)(2)(iii), Example 2.

### D. Information to Be Listed

**1. In general.** The list to be maintained by a material adviser must include:[88]

(a) The name of the transaction, along with its tax shelter registration number and taxpayer identification number, if any;

(b) The following information regarding each person that is required to be on the list:

- Name, address, and taxpayer identification number;
- Number of units (for example, number of shares or percentage of profits) acquired and date of acquisition;
- Amount invested; and
- If the person's interest was not acquired from the person maintaining the list, the person from whom acquired.

(c) A detailed description of the transaction, describing both the structure and the intended tax benefits, and, if known by the material adviser, a summary or schedule of the tax benefits that each person is intended or expected to derive from participating in the transaction; and

(d) Copies of any additional written materials, including tax analyses and opinions, relating to the transaction that have been given to any potential participant, or to any representatives, tax advisers or agents of potential participants, by the material adviser or its affiliates or agents.

**2. Exceptions to disclosure.**

a. **Privileged information.** As under the current rules, the new Promoter Listing Rules provide an exception to the listed information that a material adviser must furnish to the IRS for information that is protected by the attorney-client privilege or the privilege for federally authorized tax practitioners.[89]

b. **Ruling request.** A taxpayer may submit a ruling request to the IRS regarding whether a particular transaction is subject to the Promoter Listing Rules and whether the taxpayer is a material adviser with respect to such transaction. If the request includes all material facts regarding the transaction, the Promoter Listing Rules are suspended for the period that the ruling request is pending and for 60 days thereafter. If it is ultimately determined, however, that the transaction is subject to the Promoter Listing Rules, the rules will apply to the taxpayer during the period that the ruling request was pending.[90]

### E. Administration; Penalties

The new Promoter Listing Rules include several rules intended to assist the IRS in obtaining lists from material advisers. The list of participants in a transaction must be maintained for 10 years from the date on which the material adviser last made a statement, oral or written, regarding the potential tax consequences of the transaction, and the list must be provided to the IRS within 20 business days of the material adviser's receipt of a request for the production of the list.[91] In addition, as discussed in Section III.A.1.c above, while a material adviser may designate another material adviser to maintain a single list for a particular transaction, any such agreement does not relieve the nondesignated material advisers from compliance with listing obligations, even if the designated adviser failed to comply with the rules.[92]

Because of statutory constraints, the new Promoter Listing Rules do not change the penalties for noncompliance. As under current law, failure to maintain a list as required by the Promoter Listing Rules will result in the imposition of a penalty of $50 for each person for whom there is a failure, not to exceed $100,000 in any year.[93]

### F. Effective Date

The new Promoter Listing Rules apply to transactions entered into, or interests therein acquired, on or after January 1, 2003. The rules also apply to (a) any transaction involving income tax that becomes a Listed Transaction subject to the Disclosure Rules on or after January 1, 2003, if the transaction was entered into or any interest in the transaction was acquired after February 28, 2000, and (b) any transaction involving nonincome taxes that becomes a Listed Transaction subject to the Disclosure Rules on or after January 1, 2003, if the transaction was entered into or an interest in the transaction is acquired on or after January 1, 2003.[94]

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[88]New Treasury regulation section 301.6112-1T(e)(3)(i).

[89]New Treasury regulation section 301.6112-1T(e)(3)(ii). *See* Section III.A.1.a, above, for a discussion of privilege issues.

[90]New Treasury regulation section 301.6112-1T(i).

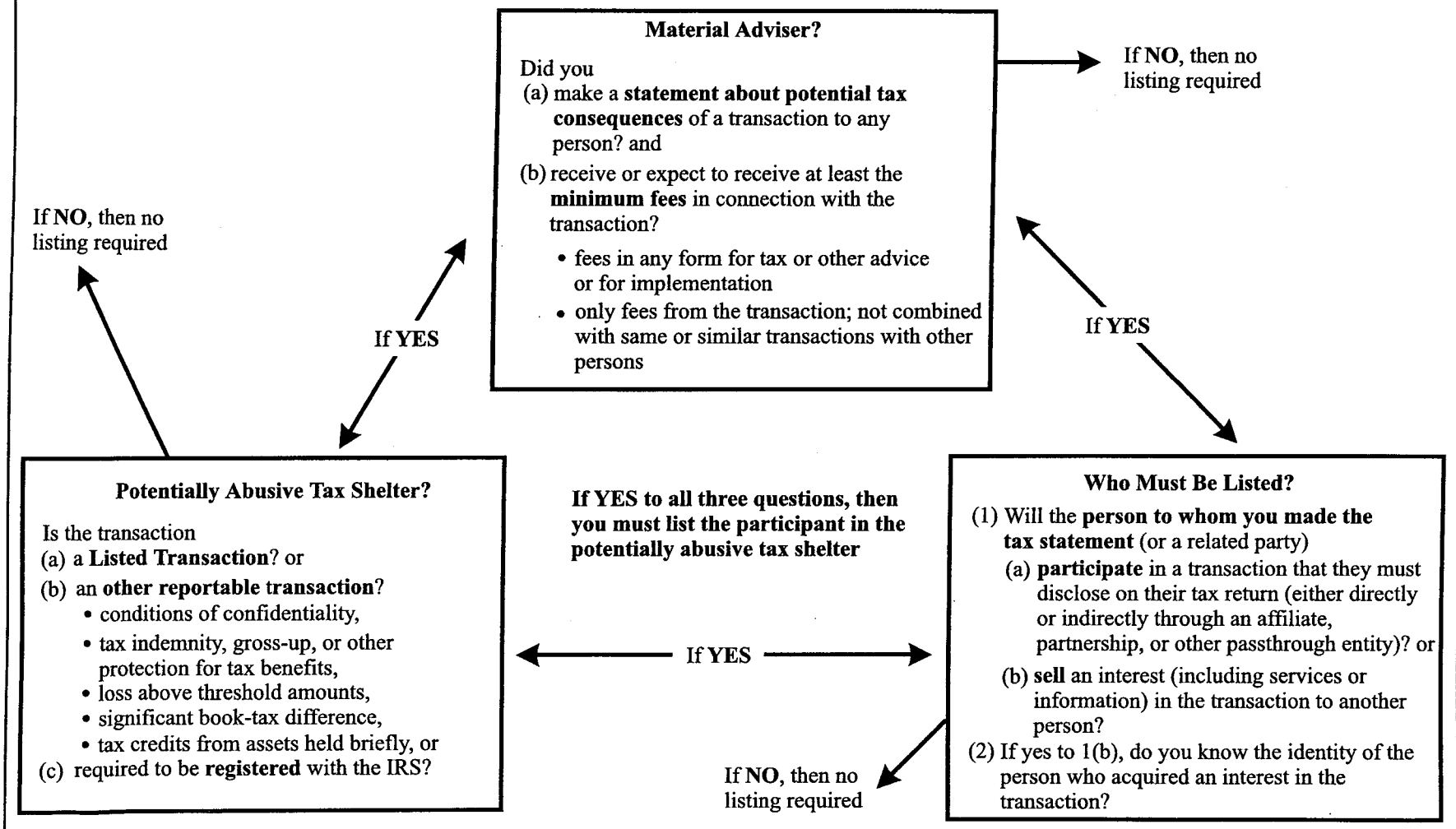
[91]New Treasury regulation section 301.6112-1T(g).

[92]New Treasury regulation section 301.6112-1T(h).

[93]Section 6708; Treasury regulation section 301.6708-1T. Under legislative proposals made earlier this year, the penalty for failure to provide the IRS with a list within 20 business days of the IRS's request (due to failure to maintain the list or otherwise, unless due to a reasonable cause) would be $10,000 per day. *See* the proposed legislation referred to in note 4, above.

[94]New Treasury regulation section 301.6112-1T(j).

# Appendix A: The New Promoter Listing Rules



## Appendix B: IRS Listed Transactions

To date, "listed transactions" include:[95]

- Transactions in which taxpayers claim deductions for contributions to qualified cash or deferred arrangement or matching contributions to a defined contribution plan where the contributions are attributable to compensation earned by plan participants after the end of the tax year;
- Trust arrangements purported to qualify as multiple employer welfare benefit funds exempt from the limits of sections 419 and 419A;
- Multiple party transactions intended to allow one party to realize rental or other income from property or service contracts and to allow another party to report deductions related to that income (so-called "lease-stripping" transactions);
- Transactions in which the reasonably expected economic profit is insubstantial in comparison to the value of the foreign tax credits expected to be obtained therefrom (so-called "Notice 98-5" transactions);
- Transactions involving contingent installment sales of securities by partnerships to accelerate and allocate income to a tax-indifferent partner and to allocate later losses to another partner;
- Transactions involving distributions from charitable remainder trusts described in proposed Treasury regulation section 1.643(a)-8;
- "Lease-in/lease-out" transactions;
- Transactions involving the distribution of encumbered property in which taxpayers claim tax losses for capital outlays that they have actually recovered;
- Transactions involving fast-pay stock arrangements;
- Transactions involving the acquisition of two debt instruments the values of which are expected to change significantly at substantially the same time in opposite directions (so-called "debt straddles");
- Transactions involving partnerships capitalized with offsetting options in which taxpayers claim a basis in their partnership interests greater than their net cost for the options contributed;
- Transactions involving partnerships that assume partner debt having an artificially low stated principal amount in which the partners claim a correspondingly low basis reduction as a result of the debt assumption;
- Transactions involving the purchase of a parent corporation's stock by a subsidiary, a transfer of the stock to the parent's employees, and an eventual liquidation or sale of the subsidiary resulting in claimed losses;
- Transactions using Guamanian trusts to avoid U.S. federal income tax liability;
- Transactions involving the sale of the assets of a corporation through an intermediary that acquires the stock of the corporation from the seller;
- Transactions involving the transfer of high basis assets to a corporation together with the transferee's assumption of a liability that the transferor has not yet taken into account for U.S. federal income tax purposes;
- Transactions involving redemptions of stock from tax-indifferent stockholders that are effected to increase other stockholders' basis in the corporation's stock;
- Transactions involving the use of a loan assumption agreement to claim an inflated basis in acquired assets;
- Transactions involving the use of notional principal contracts to claim current deductions for periodic payments made while disregarding the accrual of a right to receive the noncontingent portion of offsetting payments in the future, and also involving circular cash flows, insignificant economic risk, or no connection to a trade or business;
- Transactions involving the use of tiered partnerships and straddles to generate noneconomic losses;
- Transactions using an S corporation or a partnership and one or more transitory shareholders or partners to claim a loss while deferring an offsetting gain on a straddle position; and
- Transactions involving the use of captive insurance companies designed to take advantage of preferential tax treatment accorded to insurance companies without taking on the insurance risk.

[95]These transactions generally are enumerated in Notice 2001-51, *Doc 2001-20857 (4 original pages), 2001 TNT 150-10.* The list has subsequently been supplemented by Notices 2002-21, *Doc 2002-6738 (5 original pages), 2002 TNT 53-7,* 2002-35, *Doc 2002-11080 (4 original pages), 2002 TNT 88-12,* 2002-50, *Doc 2002-15152 (4 original pages), 2002 TNT 123-1,* 2002-65, *Doc 2002-21881 (3 original pages), 2002 TNT 187-9,* and 2002-70, *Doc 2002-23359 (8 original pages), 2002 TNT 200-8.*