

MEMO# 15707

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TREASURY RELEASES FINAL TAX SHELTER REGULATIONS AND RELATED REVENUE PROCEDURES

[15707] March 7, 2003 TO: 529 PLAN ADVISORY COMMITTEE No. 14-03 ACCOUNTING/TREASURERS MEMBERS No. 13-03 ADVISER DISTRIBUTOR TAX ISSUES TASK FORCE No. 5-03 TAX MEMBERS No. 15-03 UNIT INVESTMENT TRUST MEMBERS No. 9-03 RE: TREASURY RELEASES FINAL TAX SHELTER REGULATIONS AND RELATED REVENUE PROCEDURES The Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") have released final regulations (attached) under sections 6011, 6111 and 6112 of the Internal Revenue Code (the "Code"). As discussed below, these regulations reflect several suggestions made by the Institute.¹ Most importantly, the regulations provide an express exception from reporting any transaction, other than a listed transaction, under the section 6011 disclosure regulations for regulated investment companies ("RICs") and investment vehicles owned 95 percent or more by one or more RICs at all times during the course of the transaction. In addition, the regulations significantly narrow the definition of a material advisor subject to the list maintenance requirements. The final regulations provide rules relating to the disclosure of reportable transactions by certain taxpayers on their Federal income tax returns under section 6011, including conforming changes to the rules regarding the registration of confidential corporate tax shelters under section 6111.² The final regulations under section 6112 generally require organizers and sellers (collectively called "material advisors") of tax shelters to maintain lists of persons who participated in transactions required to be registered under section 6111 and who participated in reportable transactions subject to disclosure under section 6011. 1 See Institute Memorandum to Accounting/Treasurers Members No. 55-02, Advisor Distributor Tax Issues Task Force No. 4-02, Tax Members No. 56-02 and Unit Investment Trust Members No. 41-02, dated December 31, 2002; and Institute Memorandum to 529 Plan Advisory Committee No. 4-03, dated January 23, 2003. 2 The final regulations also provide rules for purposes of estate, gift, employment, pension and exempt organizations excise taxes requiring the disclosure of listed transactions by certain taxpayers on their Federal tax returns under section 6011. 2 I. Tax Shelter Disclosure Statements A. Transactions Subject to Disclosure The disclosure regulations under Code section 6011 require that taxpayers disclose any transaction that falls under any one of the following six categories unless the taxpayer, such as a RIC, is expressly provided with a disclosure exemption: 1. listed transactions – a transaction that is the same as or substantially similar to one of the types of transactions that the Internal Revenue Service (IRS) has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction. 2. confidential transactions – a transaction that is offered under condition of confidentiality, i.e., where disclosure of the structure or tax aspects of

the transaction is limited by an express or implied understanding or agreement with or for the benefit of any person who makes or provides a statement as to the potential tax consequences that may result from the transaction. Transactions will not be deemed to be confidential if conditions are only imposed to comply with certain securities laws, certain mergers and acquisitions, or if every person who provides a statement regarding tax consequences that may result from the transaction provides express written authorization to taxpayers permitting the taxpayers to disclose, without limitation, information about the transaction. The regulations provide sample authorization language.

3. transactions with contractual protection - a transaction for which the taxpayer or a related party has the right to a full or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained or where fees are contingent on the taxpayer's realization of tax benefits from the transaction. A transaction is not considered to have contractual protection solely because a party to the transaction has the right to terminate the transaction upon the happening of an event affecting the taxation of one or more parties to the transaction.

4. loss transactions - any transaction resulting in, or that is reasonably expected to result in, a taxpayer claiming a loss under section 165 of at least - \$10 million in any single taxable year or \$20 million in any combination of taxable years for corporations; \$10 million in any single taxable year or \$20 million in any combination of taxable years for partnerships that have only corporations as partners (looking through any partners that are themselves partnerships), whether or not any losses flow through to one or more partners; or \$2 million in any single taxable year or \$4 million in any combination of taxable years for all other partnerships, whether or not any losses flow through to one or more partners; \$2 million in any single taxable year or \$4 million in any combination of taxable years for individuals, S corporations or trusts, whether or not any losses flow through to one or more shareholders or beneficiaries; or \$50,000 in any single taxable year for individuals or trusts, whether or not the loss flows through from an S corporation or partnership, if the loss arises with respect to a section 988 transaction (as defined in section 988(c)(1) relating to foreign currency transactions). In determining whether a transaction results in a taxpayer claiming a loss that meets the threshold amounts over a combination of taxable years, only losses claimed in the taxable year that the transaction is entered into and the five succeeding taxable years are combined.

5. transactions with a significant book-tax difference - a transaction where the amount for tax purposes of any item or items of income, gain, expense, or loss from the transaction differs by more than \$10 million on a gross basis from the amount of the item or items for book purposes in any taxable year. For purposes of this determination, offsetting items shall not be netted for either tax or book purposes. This category is only applicable to the following entities: taxpayers that are reporting companies under the Securities Exchange Act of 1934 (15 USCS 78a) and related business entities; or business entities that have \$250 million or more in gross assets for book purposes at the end of any financial accounting period that ends with or within the entity's taxable year in which the transaction occurs (for purposes of this determination, the assets of all related business entities must be aggregated).

6. transactions involving a brief asset holding period - a transaction resulting in the taxpayer claiming a tax credit exceeding \$250,000 (including a foreign tax credit) if the underlying asset giving rise to the credit is held by the taxpayer for 45 days or less. Transactions resulting in a foreign tax credit for withholding taxes or other taxes imposed in respect of a dividend that are not disallowed under section 901(k) (including transactions eligible for the exception for securities dealers under section 901(k)(4)) are excluded from this category. A transaction will not be considered a reportable transaction, or will be excluded from any individual category of reportable transaction under these regulations, if the Commissioner makes a determination by published guidance (including an individual ruling) that the transaction is not subject to the reporting requirements of this section.

4 B. Exemptions For

Regulated Investment Companies We are pleased to inform you that, as requested by the Institute³, the final regulations provide that RICs and investment vehicles owned 95 percent or more by one or more RICs at all times during the course of the transaction are excluded from all disclosure requirements except with respect to listed transactions. A taxpayer has participated in a listed transaction if the taxpayer's tax return reflects tax consequences or a tax strategy described in published guidance.⁴ A taxpayer also has participated in a listed transaction if the taxpayer knows or has reason to know that the taxpayer's tax benefits are derived directly or indirectly from tax consequences or a tax strategy described in published guidance. Published guidance may identify other types or classes of persons that will be treated as participants in a listed transaction. The final regulations regarding transactions with contractual protection also reflect Institute comments.⁵ Specifically, the final regulations provide that a taxpayer has participated in a transaction with contractual protection if the taxpayer's tax return reflects a tax benefit from the transaction and the taxpayer has the right to the full or partial refund of fees or the fees are contingent on the taxpayer's realization of tax benefits from the transaction. The regulations' new focus on refundable and contingent fees addresses the Institute concerns.

C. Form 8886 and Record Retention A taxpayer required to disclose a reportable transaction under this section must complete a Form 8886 disclosure statement and attach it to the taxpayer's tax return for each taxable year for which a taxpayer participates in the reportable transaction. In addition, a copy of the disclosure statement must be sent to the Office of Tax Shelter Analysis at the same time that any disclosure statement is first filed with the taxpayer's tax return. If a reportable transaction results in a loss that is carried back to a prior year, the disclosure statement for the reportable transaction must be attached to the taxpayer's application for tentative refund or amended tax return for that prior year. In the case of a taxpayer that is a partnership or S corporation, the disclosure statement for a reportable

3 Specifically, the Institute comment letter requested that certain entities, in addition to RICs, be exempt from the disclosure requirements for loss transactions and transactions with significant book-tax differences, including partnerships held exclusively by RIC partners and investment vehicles that invest exclusively in RICs. The letter reiterated a previous Institute request that RICs be exempt from the disclosure requirements with respect to transactions involving brief asset holding periods.

4 The definition of "participation" with respect to the other categories of reportable transactions generally requires that a taxpayer's tax return reflect a tax benefit from the transaction. A "tax benefit" includes deductions, exclusions from gross income, nonrecognition of gain, tax credits, adjustments (or the absence of adjustments) to the basis of property, status as an entity exempt from Federal income taxation, and any other tax consequences that may reduce a taxpayer's Federal income tax liability by affecting the amount, timing, character, or source of any item of income, gain, expense, loss, or credit.

5 The Institute requested specific exceptions for transactions in which (1) a bondholder has a right to an increased yield on a purported tax-exempt bond if the bond is determined to be taxable and (2) a synthetic municipal instrument (of the type described in Revenue Procedure 2002-68) includes a put feature where the put right is intended largely to ensure that the instrument may be held by a tax-exempt money market fund.

5 transaction must be attached to the partnership's or S corporation's tax return for each taxable year in which the partnership or S corporation participates in the transaction. If a transaction becomes a listed transaction after the filing of the taxpayer's final tax return reflecting either tax consequences or a tax strategy described in the published guidance listing the transaction (or a tax benefit derived from tax consequences or a tax strategy described in the published guidance listing the transaction) and before the end of the statute of limitations period for that return, then a disclosure statement must be filed as an attachment to the taxpayer's tax return next filed after the date the transaction is listed. A taxpayer must retain a copy of all documents

and other records related to a transaction subject to disclosure under this section that are material to an understanding of the tax treatment or tax structure of the transaction.⁶ The documents must be retained until the expiration of the statute of limitations applicable to the final taxable year for which disclosure of the transaction was required under this section. Taxpayers may request a ruling as to whether a transaction is subject to the disclosure requirements. They may also elect to disclose a transaction that they are unsure about and indicate on the disclosure statement that the taxpayer is uncertain whether the transaction is required to be disclosed and that the disclosure statement is being filed on a protective basis.

D. Effective Date The regulations apply to Federal income tax returns filed after February 28, 2000. However, part of these regulations (paragraphs (a)-(g), relating to reportable transactions) generally applies to transactions entered into on or after February 28, 2003. All the rules in paragraphs (a) through (g) of these regulations may be relied upon for transactions entered into on or after January 1, 2003, and before February 28, 2003. Otherwise, the proposed regulations apply to transactions entered into before February 28, 2003.

II. List Maintenance Requirements

A. General Rules The final regulations require that each organizer and seller of a transaction that is a potentially abusive tax shelter prepare and maintain a list of persons who participated in the transaction and upon request shall furnish such list to the IRS. A potentially abusive tax shelter is (1) any transaction that is required to be registered with the IRS under section 6111, regardless of whether that tax shelter is properly registered pursuant to section 6111; (2) any listed transaction; (3) any transaction that a potential material advisor (at the time the transaction is entered into or an interest is acquired) knows is or reasonably expects will become

6 Documents that must be maintained during the applicable limitations period generally include, but are not limited to, (i) marketing materials related to the transaction; (ii) written analyses used in decision-making related to the transaction; (iii) correspondence and agreements between the taxpayer and any advisor, lender, or other party to the reportable transaction that relate to the transaction; (iv) documents discussing, referring to, or demonstrating the tax benefits arising from the reportable transaction; and (v) documents, if any, referring to the business purposes for the reportable transaction.

6 a reportable transaction; or (4) any interest in a type of transaction that is transferred if the transferor knows or reasonably expects that the transferee will sell or transfer an interest in that type of transaction to another transferee (subsequent participant), and the type of transaction would be a listed transaction or a reportable transaction. A person is an organizer of, or a seller of an interest in, a transaction that is a potentially abusive tax shelter if that person is a material advisor with respect to that transaction.

B. ICI Comments The Institute's comment letter expressed concern regarding the potential treatment of a RIC's investment advisor as a material advisor. Thus, we recommended that, if an investment advisor to RICs and other 1940-Act registered investment vehicles is treated as a material advisor, the investment advisor should be required to include an investor on a reportable transaction list only if the advisor knows or has reason to know that the investor is required to disclose that transaction.

C. Material Advisor We are pleased to inform you that the final regulations provide that a person is a material advisor with respect to a transaction that is a potentially abusive tax shelter only if (1) the person is required to register the transaction under section 6111 or (2) the person (a) receives or expects to receive at least a minimum fee⁷ with respect to the transaction⁸ and (b) makes a tax statement to or for the benefit of one of the following: (1) A taxpayer who is required to disclose the transaction because the transaction is a listed transaction or who would have been required to disclose a listed transaction if the transaction had become a listed transaction within the statute of limitations period; (2) A taxpayer who the potential material advisor (at the time the transaction is entered into) knows is or reasonably expects to be required to disclose the transaction because the transaction is or is reasonably

expected to become a reportable transaction (other than a listed transaction); (3) A person who is required to register the transaction under section 6111; (4) A person who purchases (or otherwise acquires) an interest in a section 6111 tax shelter; or (5) A transferee of an interest if the transferor knows or reasonably expects that the transferee will sell or transfer an interest in that type of transaction to another 7 The minimum fee is \$250,000 (reduced to \$25,000 for certain listed transactions) for a transaction if every person to whom or for whose benefit the potential material advisor makes or provides a tax statement with respect to the transaction is a corporation. The minimum fee is \$50,000 (reduced to \$10,000 for certain listed transactions) with respect to a partnership or trust, unless all owners or beneficiaries are corporations, in which case the minimum fee is \$250,000. For all other transactions, the minimum fee is \$50,000. 8 The final regulations conform the definition of a transaction to the definitions in the disclosure regulations. 7 transferee (subsequent participant), and the type of transaction would be a listed transaction or a reportable transaction. A material advisor is required to list each person to whom (or for whose benefit) the material advisor makes or provides a tax statement with respect to a transaction that is a potentially abusive tax shelter. A separate list of persons must be prepared and maintained for each transaction that is a potentially abusive tax shelter. One list must be maintained for substantially similar transactions that are potentially abusive tax shelters. The list may be maintained using various methods, as long as the method used enables the IRS to determine without undue delay or difficulty information regarding the transaction. The regulations contain a detailed explanation of the information that must be included on the list. If more than one material advisor is required to maintain a list of persons, then the material advisors may designate by written agreement a single material advisor to maintain the list or a portion of the list. The designation of one material advisor to maintain the list does not relieve the other material advisors from their obligation to furnish the list to the IRS. Each material advisor must maintain the list for seven years following the earlier of the date on which the material advisor last made a tax statement relating to the transaction, or the date the transaction was entered into, if known. Each material advisor and person responsible for maintaining a list of persons must, upon written request by the IRS, furnish the list to the IRS within 20 days from the day on which the request is provided. A person may submit a request to the IRS for a ruling as to whether a specific transaction will be considered a potentially abusive tax shelter for purposes of this section and whether that person is a material advisor with respect to that transaction. D. Effective Date These regulations apply to any transaction that is a potentially abusive tax shelter entered into, or any interest acquired therein, on or after February 28, 2003. However, these regulations may also apply to any transaction that was entered into, or in which an interest was acquired, after February 28, 2000, if the transaction becomes a potentially abusive tax shelter on or after February 28, 2003 because it is a listed transaction. These regulations also apply to any transaction that was entered into, or in which an interest was acquired, after January 1, 2003, if the transaction becomes a listed transaction and is subject to disclosure under the disclosure regulations. The IRS will not ask to inspect any list for a potentially abusive tax shelter that is entered into, or any interest acquired therein, on or after January 1, 2003, until June 1, 2003, unless the potentially abusive tax shelter is a listed transaction or a transaction that is a section 6111 tax shelter. III. Related Revenue Procedures The IRS also has issued Revenue Procedure 2003-24 and Revenue Procedure 2003-25 (both attached), in connection with these regulations. Revenue Procedure 2003-24 provides that certain losses are not taken into account in determining whether a transaction is a reportable transaction for purposes of the disclosure regulations. Excluded losses include, but are not limited to (1) losses arising from certain mark-to-market transactions, (2) losses 8 involving section 355 and 368 transactions and (3) losses from certain hedging transactions. Rev. Proc. 2003-24 is

effective for transactions entered into on or after February 28, 2003, or after January 1, 2003 if a taxpayer applies the final disclosure rules retroactively to such transactions. Revenue Procedure 2003-25 provides that certain transactions involving book-tax differences are not taken into account in determining whether a transaction is a reportable transaction for purposes of the disclosure regulations. Excluded items include, but are not limited to (1) bad debts or cancellation of indebtedness income; (2) tax exempt interest, including municipal bond interest; (3) debt-for-debt exchanges; (4) certain items resulting from hedge accounting and (5) certain items resulting from mark-to-market accounting. Rev. Proc. 2003-25 is effective for transactions entered into on or after February 28, 2003, or after January 1, 2003 if a taxpayer applies the final disclosure rules retroactively to such transactions. Lisa Robinson Assistant Counsel Note: Not all recipients receive the attachments. To obtain copies of the attachments, please visit our members website (<http://members.ici.org>) and search for memo 15707, or call the ICI Library at (202) 326-8304 and request the attachments for memo 15707. Attachment no. 1 (in .pdf format)

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