

**RECENT TAX SHELTER  
AND CIRCULAR 230  
DEVELOPMENTS<sup>©</sup>**

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# RECENT TAX SHELTER AND CIRCULAR 230 DEVELOPMENTS\*

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## I. TAX SHELTER REGULATIONS

### A. Overview

- Disclosure requirements for participants in “reportable transactions.”
- List-maintenance requirements for “material advisors” with respect to reportable transactions.
- Registration requirements for “confidential corporate tax shelters.”

### B. Penalties for Non-Compliance

- Currently, except for failing to register a confidential corporate tax shelter, there are no significant penalties for failure to comply with the tax shelter regulations.<sup>1</sup> However, the

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\* The authors are grateful to Karen Gilbreath and David Miller for their contributions to this outline.

<sup>1</sup> Currently, there is no specific penalty for failing to disclose a reportable transaction, although such failure may affect the ability to establish a defense to the accuracy-related penalties. T.D. 8877 (Mar. 13, 2000). Willful failure to disclose a reportable transaction is subject to criminal penalties up to \$100,000 (or \$25,000 for noncorporate taxpayers), and/or imprisonment. I.R.C. § 7203. The current penalty for failing to maintain a list and make the list available to the IRS upon request will result in a \$50 penalty for each person required to be listed at the time of the request (with a maximum penalty of \$100,000), unless it is shown that the failure is

Administration's fiscal year 2005 revenue proposals include several provisions that would significantly increase the penalties for failing to comply with the regulations.<sup>2</sup>

## II. TAX SHELTER DISCLOSURE REQUIREMENTS FOR PARTICIPANTS

### A. Overview

- Six Categories of Reportable Transactions<sup>3</sup>
  - Listed Transactions

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due to reasonable cause and not willful neglect. I.R.C. § 6708(a); Temp. Treas. Reg. § 301.6708-1T. The current penalty for failing to register a confidential corporate tax shelter is generally the greater of \$10,000 or 50% (75% in the case of intentional disregard) of the fees payable to any promoter with respect to offerings prior to the late registration date. I.R.C. § 6707(a)(3). However, no penalty is imposed on a person for failure to register a confidential corporate tax shelter if the failure is due to reasonable cause. I.R.C. § 6707(a)(1); Temp. Treas. Reg. § 301.6707-1T, Q&A-1.

<sup>2</sup> The Administration's proposals provide that failing to disclose a reportable transaction would subject an individual to a \$10,000 penalty (\$100,000 for a listed transaction, plus 5% of any underpayment resulting from the transaction) and all other taxpayers to a \$50,000 penalty (\$200,000 for a listed transaction, plus 5% of any underpayment resulting from the transaction). In addition, corporate taxpayers would be required to disclose in their SEC filings any disclosure penalty and any accuracy-related penalty resulting from an undisclosed listed transaction. Moreover, failing to provide the IRS with a list within 20 days after receipt of the IRS's written request would result in a penalty of \$10,000 for each additional business day that the requested information is not provided, and failing to register a listed transaction would result in a penalty of the greater of 50% of the fees paid to the promoter (75% in the case of intentional disregard) or \$200,000. The penalty for failure to register reportable non-listed transactions would be capped at \$50,000. See "General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals," Department of the Treasury (Feb. 2, 2004).

<sup>3</sup> The fact that a transaction is a reportable transaction does not affect the legal determination of whether the taxpayer's treatment of the transaction is proper. Treas. Reg. § 1.6011-4(a).

- Confidential Transactions
- Loss Transactions
- Contractual Protection Transactions
- Transactions Giving Rise to a Significant Book-Tax Difference
- Brief Holding Period Tax Credit Transactions
- Participant Reporting Obligations
  - Every taxpayer “participating” in a reportable transaction that is required to file a U.S. tax return must:<sup>4</sup>
    - Mail IRS Form 8886 to the IRS Office of Tax Shelter Analysis for the first year the taxpayer participates in the transaction,
    - Attach IRS Form 8886 to its tax return for each year in which the taxpayer participates in the transaction,<sup>5</sup> and
    - Retain a copy of all documents and other records related to the reportable transaction that are material to an understanding of the tax treatment and tax structure of the transaction until the statute of limitations runs.<sup>6</sup> However, taxpayers are not required

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<sup>4</sup> Treas. Reg. § 1.6011-4(a), (d).

<sup>5</sup> If a reportable transaction results in a loss which 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. Treas. Reg. § 1.6011-4(e)(1).

<sup>6</sup> The term “transaction” includes all of the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement, and includes any series of steps carried out as part of a plan. Treas. Reg. § 1.6011-4(b)(1).

The documents may include (i) marketing materials related to the transaction, (ii) written analyses used in transaction related decision-making, (iii) transaction related correspondence and agreements

to retain nonsubstantive emails and other documents that are not material to the tax treatment or tax structure of the transaction. Taxpayers are also not required to retain earlier drafts of a document if the taxpayer retains a copy of the final document (or, absent a final document, the most recent draft of the document), and such final document (or most recent draft) contains all the information found in earlier drafts that is material to an understanding of the purported tax treatment or tax structure of the transaction.<sup>7</sup>

- Recently enacted regulations provide that a taxpayer’s failure to properly disclose a reportable transaction is a strong indication that the taxpayer did not act in good faith with respect to the transaction for purposes of the general reasonable cause and good faith exception to the accuracy related penalty.<sup>8</sup> Moreover, a taxpayer that has not adequately disclosed a reportable transaction in accordance with the tax shelter regulations may not rely on the adequate disclosure exception to the accuracy related penalty for disregard of rules and regulations.<sup>9</sup> Finally, the new regulations deny the “realistic possibility” defense for a taxpayer that disregards a revenue ruling or notice with respect to a reportable transaction.<sup>10</sup>

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between the taxpayer and any advisor, lender, or other party to the reportable transaction, (iv) documents discussing, referring to, or demonstrating the purported or claimed tax benefits arising from the reportable transaction, and (v) any documents referring to the business purposes for the reportable transaction.

Treas. Reg. § 1.6011-4(g).

<sup>7</sup> Treas. Reg. § 1.6011-4(g).

<sup>8</sup> Treas. Reg. § 1.6664-4(d).

<sup>9</sup> Treas. Reg. § 1.6662-3(a).

<sup>10</sup> Treas. Reg. § 1.6662-3(a).

## B. Listed Transactions

- A listed transaction is defined as any transaction the IRS designates as a tax avoidance transaction and identifies in published guidance as a listed transaction (and any “substantially similar” transaction).<sup>11</sup>
- A “substantially similar” transaction is any transaction that is either factually similar or based on the same or similar tax strategy as a transaction described in published guidance and is expected to obtain the same or similar types of tax consequences. The regulations provide that the term “substantially similar” must be broadly construed in favor of disclosure. Receipt of an opinion concluding that the tax benefits from the taxpayer’s transaction are allowable is disregarded in determining whether the taxpayer’s transaction is the same as, or substantially similar to, a listed transaction.<sup>12</sup>
- A taxpayer “participates” in a listed transaction if the taxpayer’s tax return reflects tax consequences or a tax strategy associated with a listed transaction (or the taxpayer “knows or has reason to know” that its tax benefits are derived directly or indirectly from a listed transaction).<sup>13</sup> “Tax benefits” include any deduction, deferral, basis adjustment, or any other tax return achieved by affecting the amount,

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<sup>11</sup> Treas. Reg. § 1.6011-4(b)(2).

If a transaction becomes a listed transaction after the filing of a taxpayer’s return (including an amended return), but before the end of the period of limitations for the taxpayer’s final return reflecting the listed transaction, the taxpayer must file a disclosure statement as an attachment to the taxpayer’s first tax return filed after the date the transaction is listed, even if the taxpayer did not participate in the transaction in that year. Treas. Reg. § 1.6011-4(e)(2)(i).

<sup>12</sup> Treas. Reg. § 1.6011-4(c)(4). The regulations also contain examples of transactions that are the same or substantially similar to listed transactions.

<sup>13</sup> Treas. Reg. § 1.6011-4(c)(3)(i).

timing, character, or source of any item of income, gain, expense, loss, or credit.<sup>14</sup>

### C. Confidential Transactions

- Prior regulations broadly defined a confidential transaction to include any transaction offered to a taxpayer under conditions of confidentiality, but also presumed that a transaction was not a confidential transaction if the transaction documents contained a “tax confidentiality waiver.”<sup>15</sup>
- In response to significant criticism regarding the breadth of the confidential category of reportable transactions,<sup>16</sup> the new final regulations significantly narrow the definition of a confidential transaction.<sup>17</sup>
- The preamble to the new regulations provides that a transaction will no longer be treated as a confidential reportable transaction solely by reason of confidentiality limitations imposed by a principal to a transaction acting as such.<sup>18</sup> Instead, a transaction will be treated as a confidential reportable transaction only if (i) an “advisor” limits the taxpayer’s ability to disclose the tax treatment, or the tax structure, of the transaction, (ii) the advisor imposing the limitation is paid a fee of at least \$50,000 (\$250,000 if the taxpayer is a corporation or a partnership or trust with solely corporate owners or beneficiaries), and (iii) the limitation on

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<sup>14</sup> Treas. Reg. § 1.6011-4(c)(5).

<sup>15</sup> Treas. Reg. § 1.6011-4(b)(3) (revised Dec. 29, 2003).

<sup>16</sup> *See e.g.*, Bond Market Association’s comments on the Final Tax Shelter Regulations (May 14, 2003).

<sup>17</sup> For comments addressing the revisions to the confidentiality provisions, *see* NYSBA Tax Sec., “Comments on Disclosure Regulations,” 2004 TNT 33-18 (Feb. 18, 2004); Udrys, Reeder and Church, “The Revised Confidentiality Filter: Top 12 Practical Implications,” 2004 TNT 46-8 (Mar. 8, 2004).

<sup>18</sup> T.D. 9108, 68 Fed. Reg. 75128 (Dec. 30, 2003).

disclosure protects the confidentiality of the advisor's "tax strategies."<sup>19</sup>

- Query: What is a "tax strategy?" For example, Government representatives have observed that a tax strategy may include routine statements made in tax disclosure, or made to principals (*e.g.*, a partnership will be treated as a partnership for tax purposes).
- Because the term "advisor" is not defined in the final regulations and has the potential to be interpreted quite broadly, many law firms and financial intermediaries continue to include tax confidentiality waivers in their documents to ensure non-confidentiality.
- Query: What is an "advisor?" Presumably an advisor includes any attorney, accountant, investment banker, or other individual that is paid a fee for advice regarding a "tax strategy." Can it include a principal who discusses a tax strategy that affects deal pricing with other parties?
- Query: Will some or all fees received by an advisor that also participates in the transaction as a principal be considered received in that person's capacity as principal?<sup>20</sup> Will a specific allocation of

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<sup>19</sup> Treas. Reg. § 1.6011-4(b)(3). The "tax treatment" of a transaction is the purported or claimed federal income tax treatment of the transaction, and the "tax structure" of a transaction is any fact that may be relevant to understanding the tax treatment of the transaction. Treas. Reg. § 1.6011-4(c)(8), (9).

The final regulations do not define the terms "tax strategies" or "tax advisor."

<sup>20</sup> The regulations provide that:

. . . [a]ll fees for a tax strategy or for services for advice (whether or not tax advice) or for the implementation of a transaction that is a potentially abusive tax shelter are taken into account . . . . A fee does not include amounts paid to a person, including an advisor, in that

fees be respected? When will a person with two roles be treated as imposing confidentiality as an advisor rather than as a principal?

- A proprietary or exclusive transaction will not be treated as confidential if the advisor confirms to the taxpayer that there is no limitation on disclosure of the tax treatment or tax structure of the transaction.<sup>21</sup>
- Query: What does it mean to “impose” confidentiality by limiting disclosure? Government representatives have agreed that if an advisor confirms to the taxpayer that there is “no limitation on disclosure of the tax treatment or tax structure of the transaction, other than limitations imposed by the SEC, other regulatory bodies, or under the law,” that confirmation should satisfy the regulations since the advisor has only referenced (but has not personally imposed) third party limitations on such disclosure.
  - Note that these caveats may often be included in advisors’ confidentiality waivers because they are permitted under the registration regulations, creating a trap for the unwary.
- Query: What result obtains if an advisor imposes confidentiality on an opposing principal party, but not on its own client acting as a principal?

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person’s capacity as a party to the transaction. For example, a fee does not include reasonable charges for the use of capital or the sale or use of property. Treas. Reg. § 1.6011-4(b)(3)(iv).

Corresponding revisions were made to the material advisor fee requirements of the tax shelter listing regulations.

<sup>21</sup> Treas. Reg. § 1.6011-4(b)(3)(ii).

- Query: If an advisor permits the disclosure of the tax treatment and tax structure of a transaction, but imposes confidentiality on all other facts, including, for example, the advisor's investment strategy, will the transaction be considered confidential for purposes of the regulations?
- Query: Does a limitation on opinion reliance (*e.g.*, only the addressee is permitted to rely) constitute confidentiality?
- Query: Will confidentiality imposed by an advisor for only a limited period of time, *i.e.*, during initial negotiations, now cause a transaction to be considered confidential?
- Ordinary course transactions such as debt and equity offerings, cash purchases and sales of stock and assets, and executive compensation arrangements should not be considered confidential transactions reportable by the participants, because they do not involve tax advice provided for a fee by an advisor imposing confidentiality. This result should obtain even if the tax consequences of such a transaction are set forth in disclosure, as long as no fee is paid for advice regarding a tax strategy. However, more complicated transactions, including certain M&A deals, joint ventures, and investment fund offerings, may include advisory fees (including fees embedded in returns paid to principals) and if so, those transactions should also include confidentiality waivers.
- Notably, the new regulations do not modify the broader definition of "confidential" for purposes of the "confidential corporate tax shelter" rules.<sup>22</sup> Accordingly, as discussed in more

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<sup>22</sup> The Administration has repeatedly lobbied Congress to delete the corporate and confidential requirements of the tax shelter registration regulations. The Treasury Department has indicated that it will not

detail below, the tax confidentiality waiver rules will continue to provide a presumption that a transaction is not confidential for those rules.<sup>23</sup>

#### **D. Loss Transactions**

- A loss transaction is defined as any transaction that results in a loss of at least:<sup>24</sup>
  - \$10 million in a single year or \$20 million in any combination of years for corporations and partnerships (all of whose partners are corporations).
  - \$2 million in a single year or \$4 million in any combination of years for all other taxpayers.
  - \$50,000 in any single year for individuals or trusts that recognize a foreign currency loss.
- A taxpayer participates in a loss transaction if the taxpayer's tax return reflects a loss equal to or greater than the applicable threshold.<sup>25</sup> In

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revise the tax shelter registration regulations until the registration statute is changed. *See* Sheppard, "Shelter Penalties: Or Else What?," 102 Tax Notes 188 (Jan. 12, 2004).

<sup>23</sup> Our standard tax confidentiality waiver provides as follows:

Notwithstanding anything to the contrary contained in this Agreement, all persons may disclose to any and all persons, without limitations of any kind, the U.S. federal, state or local tax treatment of the Transaction, any fact that may be relevant to understanding the U.S. federal, state or local tax treatment of the Transaction, and all materials of any kind (including opinions or other tax analyses) relating to such U.S. federal, state or local tax treatment, other than the name of the parties or any other person named herein, or information that would permit identification of the parties or such other persons, and any pricing terms or other nonpublic business or financial information that is unrelated to the U.S. federal, state or local tax treatment of the Transaction to the taxpayer and is not relevant to understanding the U.S. federal, state or local tax treatment of the Transaction to the taxpayer.

<sup>24</sup> Treas. Reg. § 1.6011-4(b)(5)(i)(A)-(D).

<sup>25</sup> Treas. Reg. § 1.6011-4(c)(3)(i)(D).

determining whether a transaction results in a loss that exceeds a threshold, only losses claimed in the first taxable year the transaction occurs and the five succeeding taxable years are combined.<sup>26</sup>

- If a transaction becomes a loss transaction because the losses equal or exceed the threshold amounts, a disclosure statement must be filed as an attachment to the taxpayer's tax return for the first taxable year in which the threshold amount is reached and to any subsequent tax return that reflects any amount of loss from the transaction.<sup>27</sup>
- A safe harbor excepts transactions involving assets in which the taxpayer has "qualifying basis."<sup>28</sup>
  - The safe harbor is not available if the asset is a "pass-through entity" (e.g., partnerships, PFIC and FPHC equity interests, and REMIC residual interests).<sup>29</sup>

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<sup>26</sup> Treas. Reg. § 1.6011-4(b)(5)(ii). In addition, in determining whether a transaction results in a loss in excess of a threshold, loss amounts are adjusted for any salvage value, insurance or other compensation received, but are not adjusted to reflect offsetting gains, or other income or limitations. The full amount of a loss is taken into account for the year in which the loss is sustained, regardless of whether all or part of the loss creates a net operating loss or a net capital loss that is carried back or carried over to another year. A loss does not include any portion of a loss attributable to a capital loss carryback or carryover from another year that is treated as a deemed capital loss. However, a loss does include an amount deductible pursuant to a provision that treats a transaction as a sale or other disposition, or otherwise results in a deduction under section 165. Treas. Reg. § 1.6011-4(b)(5)(iii).

<sup>27</sup> Treas. Reg. § 1.6011-4(e)(2)(ii).

<sup>28</sup> Rev. Proc. 2003-24, 2003-11 I.R.B. 1 (Feb. 27, 2003). A taxpayer has "qualifying basis" in an asset only if the basis of the asset is equal to, and is determined solely by reference to, the amount (including any option premium) paid in cash by the taxpayer to acquire or improve the asset.

<sup>29</sup> The safe harbor is also not available if (i) the loss from the sale or exchange of the asset is an ordinary foreign currency loss, (ii) the asset has been separated from any portion of the income it generates,

- Bonds issued with OID, purchased with amortizable bond premium, or that have accrued market discount do not have qualifying basis.
- Revenue Procedure 2003-24 exempts certain other losses.<sup>30</sup> It is likely that additional items will be added to the list of exempted losses.<sup>31</sup>

### **E. Contractual Protection Transactions**

- Contractual protection transactions include any transaction for which:<sup>32</sup>
  - The taxpayer has the right to a full or partial refund of fees paid to a tax advisor if some or all of the intended tax consequences from the transaction are not sustained, or
  - The tax advisor's fees are contingent on the taxpayer's realization of the tax benefits from the transaction.<sup>33</sup>

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or (iii) the asset is or has in the past been part of a straddle, other than a mixed straddle under Temporary Regulation section 1.1092(b)-4T. Rev. Proc. 2003-24, 2003-11 I.R.B. 1 (Feb. 27, 2003).

<sup>30</sup> See Rev. Proc. 2003-24, 2003-11 I.R.B. 1 (Feb. 27, 2003). However, because of the limitations placed on the exemptions, taxpayers may be surprised at some situations that are not exempt. See Braithwaite, Geils and Church, "Section 165 Losses: Top 12 Unexpected Disclosures," Tax Notes (April 19, 2004).

<sup>31</sup> According to Eric Solomon, Treasury Deputy Assistant Secretary for Regulatory Affairs, expanding the exceptions to the book-tax difference and significant loss categories is the government's highest priority. See Stratton, "Disclosure Angel Lists to be Expanded Solomon Says," 2004 TNT 91-4, (May 10, 2004).

<sup>32</sup> Treas. Reg. § 1.6011-4(b)(4).

<sup>33</sup> The regulations provide that refundable or contingent fees will not be taken into account in determining whether the transaction has contractual protection if the statement is made after the taxpayer has entered into and reported the transaction on a filed tax return, and the person making the statement has not previously received fees from the taxpayer relating to the transaction. Treas. Reg. § 1.6011-4(b)(4)(iii)(B). This exception permits an attorney to receive

- A taxpayer participates in a contractual protection transaction if the taxpayer's tax return reflects a tax benefit from the transaction and the taxpayer has the right to a refund of fees paid or the taxpayer's obligation to pay fees is contingent.

#### **F. Transactions Giving Rise to a Significant Book-Tax Difference**

- A transaction giving rise to a significant book-tax difference is defined as any transaction involving an SEC reporting company or a company with \$250 million or more in gross assets that gives rise to a book-tax difference under U.S. GAAP of more than \$10 million in any year, other than certain exempted transactions.<sup>34</sup>
- A taxpayer participates in a significant book-tax difference transaction if the taxpayer's tax treatment of an item differs from the book treatment of the item by an amount in excess of \$10 million in any year (on a gross basis).
- The Treasury Department and IRS recently released a new proposed draft form, Schedule M-3, "*Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More*," for use by corporate taxpayers with total assets of \$10 million or more filing a U.S. corporate income tax return on Form 1120.<sup>35</sup> The new Schedule M-3 would expand the current Schedule M-1, which reconciles a corporation's financial accounting income or loss with the taxable income or loss reported on Form 1120. The Treasury

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contingent fees with respect to a tax controversy without causing the underlying transaction to be a reportable transaction.

<sup>34</sup> Treas. Reg. § 1.6011-4(b)(6)(i), (ii)(A).

<sup>35</sup> Although taxpayers have complained that the \$10 million threshold is too low, the Treasury Department has indicated that it does not expect this threshold to be raised. See Gray, "Treasury Official Gives Schedule M-3 Status Update," 2004 TNT 100-3 (May 21, 2004).

Department has indicated they may consider scaling back the book-tax filter once the Schedule M-3 is in place.<sup>36</sup>

- Revenue Procedure 2003-25 exempts the following book-tax difference items and transactions.<sup>37</sup>
  - Exempt items and transactions include (i) items resulting in a book loss or expense before or without a tax loss or deduction,<sup>38</sup> (ii) dividends, deemed dividends and income inclusions under the CFC, PFIC, and FPHC regimes, (iii) a dividends paid deduction by a publicly traded real estate investment trust, (iv) items resulting from tax-free contributions, reorganizations, mergers, acquisitions and spin-offs, (v) items resulting from like-kind exchanges under section 1031, (vi) transactions that are treated as a financing for tax purposes, but as a sale, purchase, or lease for book purposes (including transfers to a REMIC in exchange for a regular or residual REMIC interest), and (vii) transactions that are subject to hedge or mark-to-market treatment for tax purposes, but not for book purposes (or vice versa).

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<sup>36</sup> The Treasury and IRS expect the proposed Schedule M-3 to be finalized for use with federal income tax returns for tax years ending on or after December 31, 2004. *See* Stratton, "Treasury Official Addresses SILOs, Schedule M-3, and Disqualified Advisers," 2004 TNT 24-3 (Feb. 4, 2004). Many taxpayers have expressed concern that they will not be able to comply with the effective date of the required disclosures. *See* Gray, "Treasury Official Gives Schedule M-3 States Update," 2004 TNT 100-3 (May 21, 2004).

<sup>37</sup> Rev. Proc. 2003-25, 2003-11 I.R.B. 1 (Feb. 27, 2003).

<sup>38</sup> By contrast, a taxpayer that reports an item of income for book purposes before reporting the item for tax purposes (as is generally the case for a taxpayer holding a market discount bond) will experience a book-tax difference.

- It is likely that additional items will be added to the list of exempted book-tax differences.<sup>39</sup>

### **G. Brief Holding Period Tax Credit Transactions**

- A tax credit transaction involving a brief holding period is defined as any transaction in which the taxpayer claims tax credits exceeding \$250,000 and holds the underlying asset for 45 days or less (disregarding days for which the taxpayer is hedged).<sup>40</sup>
- Query: Would a transaction involving an asset held since inception, albeit for less than 45 days, constitute a reportable transaction under this provision?
- A taxpayer participates in a brief asset holding period transaction if the taxpayer's tax return reflects a tax credit exceeding \$250,000 from a brief asset holding period transaction.<sup>41</sup>

### **H. Effect of Rules on Shareholders of Foreign Corporations**

- If a "foreign personal holding company" enters into a transaction that would be a reportable transaction if the FPHC were a domestic corporation, any United States person that owns shares in the FPHC is treated as participating in a reportable transaction.<sup>42</sup>

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<sup>39</sup> According to Eric Solomon, Treasury Deputy Assistant Secretary for Regulatory Affairs, expanding the exceptions to the book-tax difference and significant loss categories is the government's highest priority. Stratton, "Disclosure Angel Lists to be Expanded Solomon Says," 2004 TNT 91-4, (May 10, 2004).

<sup>40</sup> Treas. Reg. § 1.6011-4(b)(7).

<sup>41</sup> Treas. Reg. § 1.6011-4(c)(3)(i)(F).

<sup>42</sup> Treas. Reg. § 1.6011-4(c)(3)(i)(G). A FPHC is a foreign corporation of which five or fewer U.S. individuals own more than 50% of the vote or value of its shares and has 50% passive income.

- If a “controlled foreign corporation” enters into a transaction that would be a reportable transaction if the CFC were a domestic corporation, any United States person that owns 10% of the voting stock in the CFC is treated as participating in a reportable transaction.<sup>43</sup>
- If a “passive foreign investment company” enters into a transaction that would be a reportable transaction if the PFIC were a domestic corporation, any United States person that owns 10% of the stock (by vote or value) of a PFIC with respect to which it has made a “qualified electing fund” election is treated as participating in a reportable transaction.<sup>44</sup>

### III. TAX SHELTER LISTING REQUIREMENTS FOR MATERIAL ADVISORS

- Each “material advisor” is subject to listing requirements. Material advisors include any person or entity that:<sup>45</sup>
  - Is required to register a transaction as a tax shelter, or
  - Knows or reasonably expects that a transaction will become a reportable transaction, makes any oral or written statement regarding a tax aspect of a transaction that causes it to be a reportable transaction, and expects to receive at least a \$50,000 fee (\$10,000 for a listed transaction) for advising on or implementing a transaction, or a \$250,000 fee (\$25,000 for listed transactions) if every person to

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<sup>43</sup> Treas. Reg. § 1.6011-4(c)(3)(i)(G). A CFC is any foreign corporation in which U.S. persons holding 10% of the voting stock together own more than 50% of the vote or value of its stock.

<sup>44</sup> Treas. Reg. § 1.6011-4(c)(3)(i)(G). A PFIC is a foreign corporation 75% or more of the income of which is passive or 50% or more of the assets of which generate passive income.

<sup>45</sup> Treas. Reg. § 301.6112-1(c)(2)(iii)(B).

whom the material advisor makes a tax statement is a corporation.

- A statement that includes only information contained in publicly available documents filed with the SEC by the close of a transaction will not be considered a tax statement for this purpose.<sup>46</sup>
- Material advisors must maintain a list for 7 years for possible inspection by the IRS of those persons to whom the advisor made tax statements, together with certain other information, as described below.<sup>47</sup>
- A material advisor that is responsible for registering a confidential corporate tax shelter, and is therefore required to maintain a list, must also list each person who acquires an interest in the transaction.<sup>48</sup>
- Multiple material advisors that are required to maintain a list may designate a single material advisor to maintain the list.<sup>49</sup> However, the designation of one material advisor to maintain a list does not relieve the other material advisors from their obligation to furnish the list to the IRS if the designated list keeper fails to do so.
- In light of the potential for continuing liability, non-designated material advisors should consider obtaining a copy of the listing materials described below, perhaps on electronic media.
- The following items must be included on material advisors' lists:<sup>50</sup>

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<sup>46</sup> Treas. Reg. § 301.6112-1(c)(2)(iv)(B).

<sup>47</sup> Treas. Reg. § 301.6112-1(f).

<sup>48</sup> Treas. Reg. § 301.6112-1(c)(2)(i), (e)(2)(iii).

<sup>49</sup> Temp. Treas. Reg. § 301.6111-1T, Q&A-38.

<sup>50</sup> Treas. Reg. § 301.6112-1(e)(3)(i).

- Identifying information about the taxpayer (*e.g.*, name, address, TIN, etc.) and identifying information about the transaction (*e.g.*, name, registration number, TIN).
- Detailed description of each transaction, including the tax structure and its expected tax treatment.
- Amount of money invested in the transaction and the number of units acquired by the taxpayer (if known).
- Name of person from whom the interest was acquired.
- Summary or schedule of intended or expected tax treatment to be derived from the transaction (if known).
- Copies of any additional written materials, including tax analyses or opinions.

#### **IV. REGISTRATION OF CONFIDENTIAL CORPORATE TAX SHELTERS**

##### **A. Overview of Rules**

- A “confidential corporate tax shelter” is any transaction involving a direct or indirect corporate participant and offered under conditions of confidentiality, in which:<sup>51</sup>
  - Shelter promoters and organizers may receive aggregate fees in excess of \$100,000, and
  - The transaction is either (i) a listed transaction, or (ii) is reasonably expected to be presented to more than one investor and is structured to produce federal income tax benefits that constitute an “important part” of the intended results.

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<sup>51</sup> I.R.C. § 6111(d)(1); Treas. Reg. § 301.6111-2(a), (b).

- Notably, the definition of confidentiality for registration purposes was not modified to conform with the new narrower confidentiality definition in the disclosure and list-maintenance regulations. “Tax confidentiality waivers” continue to provide a presumption of non-confidentiality, and the securities law and M&A exceptions to confidentiality waivers continue to apply, under the registration rules.
- Government representatives have indicated that the confidential definition in the registration regulations was not amended to conform with the new definition for reportable transactions in part because the Treasury Department’s legislative proposals to amend the registration rules would require more extensive changes to these regulations if enacted.
- A safe harbor provides that a non-listed transaction will not constitute a confidential corporate tax shelter if:<sup>52</sup>
  - The transaction is entered into in the ordinary course of business, is consistent with customary commercial practice, and the expected tax benefits are generally understood to be allowable,
  - There is no reasonable basis for denying tax benefits, or
  - The IRS lists the transaction as excepted from registration, or the taxpayer receives an IRS ruling excepting the transaction.

## **B. Registration Obligations**

- Treasury Regulations impose the following order of responsibility for registering confidential corporate tax shelters with the IRS on Form 8264:<sup>53</sup>

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<sup>52</sup> Treas. Reg. § 301.6111-2(b)(3)(i), (ii).

- A principal organizer, which includes any person who discovers, creates, investigates, or initiates the investment, devises the business or financial plans for the investment, or carries out those plans through negotiations or transactions with others, is the first party responsible for registering the confidential corporate tax shelter.
- If a principal organizer fails to register the tax shelter, each other party who participated in organizing the tax shelter is responsible for registering the tax shelter.
- Participation in organizing the tax shelter includes performing any act (directly or through an agent) related to establishing the tax shelter. However, an organizer does not include a person (such as a lawyer) who merely prepares documents or negotiates provisions, but does not participate in the entrepreneurial risks or benefits of the tax shelter, including through an equity interest, and is not related to the tax shelter or to any principal organizer (*i.e.*, is not employed by, and is not a principal organizer of, the tax shelter).
  - Query: When will an advisor be considered an organizer for purposes of the confidential corporate tax shelter regulations? For example, while contingent fee arrangements would presumably cause an advisor to constitute an organizer, premium billing arrangements should not constitute the sharing of entrepreneurial risks required for organizer status.
- If no party principally responsible for organizing, or participating in the organization of, the tax shelter registers the tax shelter, each

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<sup>53</sup> I.R.C. § 6111(a)(1); Temp. Treas. Reg. § 301.6111-1T, Q&A 25-39; Treas. Reg. § 301.6111-2(g).

person managing the tax shelter becomes responsible for registering the tax shelter.

- Participation in management includes managing assets, directing business activity, and acting as a general partner.
- A party that participates in the sale of a tax shelter and knows or has reason to know that the tax shelter has not been registered is responsible for registering the tax shelter.
  - Participating in the sale of the tax shelter includes any marketing activities (directly or through an agent) with respect to an investment, including direct contact with a purchaser relating to the possible purchase of an interest, solicitation of investors, and instructing and advising sales people regarding the tax shelter.
- A group of parties who could be responsible for registering a tax shelter may designate a party principally responsible for organizing (or possibly a party participating in organizing) the tax shelter as the party responsible for registering the tax shelter.<sup>54</sup>
  - Note that a designated organizer cannot be a party who participates in the management or sale of the tax shelter or a nonresident of the United States.
  - A party (other than the designated organizer) who signs a designation agreement will not be liable for the designated organizer's failure to register the tax shelter and will not be subject to a penalty, unless such party knows or has reason to know that the designated organizer failed to register the tax shelter. However, a signatory is deemed

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<sup>54</sup> Temp. Treas. Reg. § 301.6111-1T, Q&A-38.

to know that the designated organizer has not registered the tax shelter if the organizer fails to receive a copy of the IRS registration notice containing the registration number from the designated organizer within 60 days of the later of the first sale of interests in the tax shelter or the organizer's signing of the agreement.<sup>55</sup>

## V. PROPOSED CIRCULAR 230 REGULATIONS

### A. Overview

- The proposed Circular 230 regulations<sup>56</sup> seek to accomplish three goals:

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<sup>55</sup> Treas. Reg. § 301.6011-IT, Q&A-39.

<sup>56</sup> For recent commentary on the proposed amendments to Circular 230, *see* ABA Sec. of Tax'n, "Comments on Proposed Rulemaking Circular 230," 2004 TNT 32-28 (Feb. 12, 2004); AICPA, "Comments on Proposed Regulations, REG-122379-02; Regarding Modifications to Treasury Department Circular No. 230," 2004 TNT 32-29 (Feb. 12, 2004); NYSBA Tax Sec., "Report on Proposed Amendments to Circular 230," 2004 TNT 58-46 (Mar. 25, 2004).

On May 8, 2004, at a meeting of the American Bar Association, Eric Solomon, Deputy Assistant Treasury Secretary for Regulatory Affairs, listed the following top 10 comments received by the Treasury Department and the IRS regarding Circular 230: (i) the definition of a tax shelter is too broad; (ii) legal writing covered by the rules is unclear; (iii) marketing standards should be expanded to cover all marketing; (iv) the regulations do not require identification of facts peculiar to a taxpayer to whom the transaction may be marketed, which may lead to assumptions about business purpose and economic substance that should not be permitted; (v) the rules' application to SEC documents should be clarified; (vi) the exclusion for municipal bonds should be reinstated; (vii) more direction and detail should be provided with respect to supervisory attorney procedures; (viii) the proposal that an advisory committee can make recommendations about particular practitioners is not a good idea; (ix) a transition period should be included; and (x) the treatment of contingent fees for transactions that will entail a certain level of IRS scrutiny, such as private letter rulings, is unclear.

- Establish “best practices” for “tax advisors” providing tax advice;
- Modify the requirements for “practitioners” providing certain “tax shelter” opinions; and
- Provide compliance procedures for persons with responsibility for overseeing a firm’s tax practice.
- Failure to comply with the regulations is punishable by censure (public reprimand), suspension or disbarment of the practitioner from practice before the IRS.

#### **B. Scope of Circular 230**

- A threshold question is whether Circular 230’s regulation of opinion practice exceeds its authority. Pursuant to its authority to “regulate the practice of representatives of persons before the Department of the Treasury,”<sup>57</sup> Treasury issued regulations governing the practice of attorneys, CPAs, actuaries, enrolled agents and other persons practicing before the IRS in Treasury Department Circular No. 230 (“Circular 230”).<sup>58</sup>
- “Practice” before the IRS includes all matters connected with a presentation to the IRS relating to a taxpayer’s rights, privileges, or limitations under laws or regulations administered by the IRS.<sup>59</sup>

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(continued)

See “Treasury’s Solomon Lists Top 10 Comments Received in Conjunction with Circular 230,” Daily Tax Report No. 90, (May 11, 2004).

<sup>57</sup> 31 U.S.C. § 330(a)(1).

<sup>58</sup> Circular 230, 31 Fed. Reg. 10773 (proposed Dec. 29, 2003) (to be codified at 31 C.F.R. pt. 10) (hereinafter, “Cir. 230” or “Circular 230”).

<sup>59</sup> 31 C.F.R. § 10.2(d). This includes, but is not limited to, preparing and filing documents, communicating with the IRS, and representing clients at conferences, hearings and meetings.

- An attorney may practice before the IRS by filing with the IRS a written declaration that he or she is currently qualified as an attorney and is authorized to represent the party or parties on whose behalf he or she acts.<sup>60</sup> This person is a “practitioner” for purposes of the Circular 230 regulations.<sup>61</sup>
- Query: Is a tax attorney who has not filed a written declaration with the IRS a practitioner under Circular 230?<sup>62</sup> More generally, is it clear that the proposed Circular 230 regulations apply to an attorney or an accountant who will never appear before the IRS? If so, does opinion writing alone constitute practicing before the IRS?<sup>63</sup>
- Query: Can tax shelter promoters who are not attorneys or accountants also constitute practitioners, or are they exempt from the Circular 230 requirements?
- Proposed legislation would confirm the IRS’s authority to regulate written advice with respect to tax shelters and would allow the IRS to sanction practitioners through censure and the imposition of

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<sup>60</sup> 31 C.F.R. § 10.3(a).

<sup>61</sup> 31 C.F.R. § 10.2(e). The attorney may not currently be under suspension or disbarment from practice before the IRS.

<sup>62</sup> According to former IRS Chief Counsel B. John Williams Jr., “[i]f you’re not practicing before the agency then the agency is not licensing your practice . . . I don’t know any other agency where the federal government seeks to reach out and grab the practice of opinion giving.” Sheppard and Stratton, “News Analysis: Williams Advocates Tax Accrual Workpaper Policy Changes,” 101 Tax Notes 323 (Oct. 20, 2003). However, provisions confirming the IRS’s power to regulate opinions and impose monetary penalties have been proposed in legislation that has passed both the House and Senate. *See* Stratton, “Opinion Standards to be Finalized Soon, Treasury Official Says,” 2004 TNT 61-4 (Mar. 29, 2004).

<sup>63</sup> Some practitioners do not think so. *See* Stratton, “Opinion Standards to be Finalized Soon, Treasury Official Says,” 2004 TNT 61-4 (Mar. 29, 2004).

monetary penalties. The proposed legislation would also permit the IRS to impose monetary penalties on a practitioner's employer, firm, or other entity that knew, or reasonably should have known, of the practitioner's conduct; the allowable penalty would be limited to the gross income derived (or to be derived) from the conduct giving rise to the penalty and could be imposed in addition to, or in lieu of, any suspension, disbarment, or censure of the practitioner.<sup>64</sup>

### C. Recommended Best Practices for Tax Advisors

- The proposed Circular 230 regulations provide that “tax advisors”<sup>65</sup> should adhere to the best practices set forth below, and that the tax advisors with oversight responsibility for a firm's tax practice should take reasonable steps to ensure that their firm's procedures for members and other employees are consistent with the following best practices:<sup>66</sup>
  - Communicate clearly with clients regarding the terms of an engagement (*e.g.*, determine the purpose for and use of the advice and have a clear understanding regarding the form and scope of the advice).<sup>67</sup>

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<sup>64</sup> See Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong. § 414 (2003).

<sup>65</sup> The proposed Circular 230 regulations do not define the term “tax advisor.”

<sup>66</sup> Cir. 230 § 10.33. Although the Treasury department has indicated that the best practices are purely recommendations and not enforceable standards, some practitioners are concerned that greater clarity regarding this point is needed. According to Julian Kim, Treasury Acting Deputy Tax Legislative Counsel, the government will ensure that Circular 230 works from a technical standpoint so that the best practices provisions are not subject to the disciplinary provisions. See Stratton, “Practitioners Concerned About Violating Circular 230 Rules,” 2004 TNT 91-6 (May 10, 2004).

<sup>67</sup> Cir. 230 § 10.33(a)(1).

- Establish the relevant facts and evaluate the reasonableness of assumptions or representations.<sup>68</sup>
- Relate the applicable law to the relevant facts and arrive at a conclusion supported by the law and the facts.<sup>69</sup>
- Advise clients regarding the importance of the conclusions reached (*e.g.*, whether taxpayer can avoid substantial understatement penalties if it relies on the advice).<sup>70</sup>
- Act fairly and with integrity in practice before the IRS.<sup>71</sup>

#### **D. Opinions Under the Proposed Circular 230 Regulations**

- The proposed Circular 230 regulations impose detailed requirements for “tax shelter opinions,” as defined by the regulations.
- A tax shelter is any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code.<sup>72</sup> This is the same definition that applies for purposes of the accuracy-related penalties.<sup>73</sup>
- Query: What types of transactions constitute tax shelters? For example, many practitioners believe the term is broad enough to encompass transactions such as like-kind exchanges, stock

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<sup>68</sup> Cir. 230 § 10.33(a)(2).

<sup>69</sup> Cir. 230 § 10.33(a)(3).

<sup>70</sup> Cir. 230 § 10.33(a)(5).

<sup>71</sup> Cir. 230 § 10.33(a)(6).

<sup>72</sup> Cir. 230 § 10.35(c)(2).

<sup>73</sup> I.R.C. § 6662.

purchases with section 338(h)(10) elections and acquisitions structured to qualify as tax-free reorganizations.<sup>74</sup> If so, it is important to note that the proposed Circular 230 regulations define a tax shelter much more broadly than the potentially abusive tax shelter rules.

- Query: What constitutes a “significant purpose”? For example, does structuring a transaction that would otherwise occur for good business reasons in a tax-efficient manner constitute a significant tax avoidance purpose?
- A tax shelter opinion generally includes any “written advice” by a “practitioner” concerning the federal tax aspects of any federal tax issue relating to a tax shelter item.<sup>75</sup>
  - Notably, a tax shelter opinion includes the federal tax aspects and risk factors portion of offering materials, and financial forecasts as well as projections prepared by or at the direction of a practitioner, if predicated on assumptions regarding federal tax aspects of the investment.<sup>76</sup>
  - Query: What should tax disclosure look like under the proposed Circular 230 regulations? Do the IRS and Treasury expect the tax disclosure and risk factors portion of offering materials to contain disclaimers and citations (and if so, have they reached agreement with the SEC regarding the application of these rules in light of the competing SEC plain English requirements)?

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<sup>74</sup> For commentary on the prior proposed modifications to Circular 230, *see* NYSBA Tax Sec., “Report on Proposed Modifications to Circular No. 230,” 2001 TNT 149-41 (July 15, 2001).

<sup>75</sup> Cir. 230 § 10.35(c)(4). Note that the written advice does not have to address a “material federal tax issue.”

<sup>76</sup> Cir. 230 § 10.35(c)(4)(iii).

- Query: How would the new Circular 230 requirements apply to a financial forecast?
- Query: Does written advice include informal emails regarding potential transactions and/or pure legal questions, *e.g.*, “what are the requirements for a tax-free spin-off”?<sup>77</sup> If emails regarding pure legal issues the IRS has a reasonable basis to challenge are tax shelter opinions, do the IRS and Treasury believe it is reasonable to assume that emails can and will satisfy all the requirements in the proposed regulations; or is it the government’s desire to discourage brief emails in lieu of telephone calls?<sup>78</sup> A reasonable compromise might be to require a non-reliance caveat at the beginning of such emails in lieu of compliance with the more burdensome tax shelter opinion rules.
- A tax shelter opinion does not include written advice provided to a client during the course of an engagement if the practitioner is expected to subsequently provide a tax shelter opinion on the issue.<sup>79</sup>
- The proposed regulations address the requirements for three types of tax shelter opinions: “more likely

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<sup>77</sup> The Association of the Bar of the City of New York believes that the proposed Circular 230 rules would apply to, “letters, memoranda and emails written by a practitioner addressing a wide range of matters not connected with transactions traditionally viewed as tax shelters.” *See* The Association of the Bar of the City of New York, “Notice of Proposed Rulemaking Circular 230: Tax Shelter Opinions” (March 31, 2004).

<sup>78</sup> A brief email that summarizes only conclusions that the IRS has no reasonable basis to challenge should not constitute a tax shelter opinion and so should be exempt from the Circular 230 rules, as discussed in the text below.

<sup>79</sup> Cir. 230 § 10.35(c)(4)(ii). In contrast, prior proposed regulations did not contain this specific exclusion. *See* Notice of Proposed Rulemaking, 66 Fed. Reg. 3276 (Jan. 12, 2001).

than not” tax shelter opinions; “marketed” tax shelter opinions; and “limited scope” opinions.

- A “more likely than not” tax shelter opinion is a tax shelter opinion that concludes at a confidence level of at least more likely than not that one or more material federal tax issues would be resolved in the taxpayer’s favor.<sup>80</sup>
- A “material federal tax issue” is any federal tax issue for which the IRS has a reasonable basis for a successful challenge and the resolution of which could have a significant impact (good or bad and under any reasonably foreseeable circumstance) on the federal tax treatment of a taxpayer’s tax shelter items.<sup>81</sup>

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<sup>80</sup> Cir. 230 § 10.35(c)(5). In contrast, prior proposed regulations did not define a “more likely than not tax shelter opinion” with reference to “material federal tax issues.” *See* Notice of Proposed Rulemaking, 66 Fed. Reg. 3276 (Jan. 12, 2001). Note that a taxpayer may generally avoid a substantial understatement penalty with respect to a tax shelter if, among other things, it has reasonably relied on an opinion stating that the tax treatment is more likely than not the correct tax treatment. Treas. Reg. § 1.6664-4(f)(2). A corporate taxpayer generally must also establish that it reasonably relied in good faith on tax advice that is (i) based on all pertinent facts and circumstances and the law as it relates to those facts and circumstances, (ii) not based on unreasonable factual or legal assumptions, and does not unreasonably rely on the representations, statements, findings or agreements of the taxpayer or any other person, and (iii) provided by an advisor who is knowledgeable in the relevant aspects of federal tax law (or the taxpayer did not know, and should not have known, that the advisor lacked knowledge in the relevant aspects of tax law). Treas. Reg. § 1.6664-4(b)(1); (c)(1).

<sup>81</sup> Cir. 230 § 10.35(c)(7). In contrast, prior proposed regulations defined the phrase “material Federal tax issue” as “any Federal tax issue the resolution of which could have a significant impact (whether beneficial or adverse) on a taxpayer under any reasonably foreseeable circumstance,” which would not carve out issues the IRS lacks a reasonable basis to challenge. *See* Notice of Proposed Rulemaking, 66 Fed. Reg. 3276 (Jan. 12, 2001).

- Commentators have equated a reasonable basis for success with a 10-25% chance of success.<sup>82</sup> Although regulations do not attach any percentage to a reasonable basis for success standard, the accuracy-related penalty regulations define reasonable basis as, “a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper,” which is “not satisfied by a return position that is merely arguable or that is merely a colorable claim.”<sup>83</sup> Further, a return position reasonably based on one or more “substantial authorities” (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), generally satisfies the reasonable basis standard.<sup>84</sup>

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<sup>82</sup> See Banoff and Coustan, “Final Regulations on Return Preparer Penalties,” 70 *Taxes* 137, 176 (1992) (reasonable basis is generally a 10-20% likelihood of success); Wolfman, Holden, and Schenk, *Ethical Problems in Federal Tax Practice*, p. 42 (Little, Brown 3d ed. 1995) (reasonable basis is generally a 20-25% likelihood of success); Raby, “Reasonable Basis vs. Other Opinion Standards,” 73 *Tax Notes* 1209, (Dec. 9, 1996) (reasonable basis is generally a 15-20% likelihood of success).

<sup>83</sup> Treas. Reg. § 1.6662-3(b)(3). *See also* Treas. Reg. § 301.6111-2(b)(4) (reasonable basis standard is not satisfied by an IRS position that would be merely arguable or that would constitute merely a colorable claim).

<sup>84</sup> Treas. Reg. § 1.6662-3(b)(3).

Substantial authorities include applicable provisions of the Code and other statutory provisions; proposed, temporary and final regulations; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers; General Explanations of tax legislation prepared by the Joint Committee on Taxation (the “Blue Book”); PLRs and technical advice memoranda issued after

- Government representatives have confirmed that since “will” opinions that the IRS has no reasonable basis to challenge do not address a “material federal tax issue,” they should not constitute “more likely than not” tax shelter opinions. As a result, such “will” opinions need not be reasoned, although this result is not completely clear in the regulations.
- It appears that a different result may obtain if the opinion is marketed, although government representatives have stated that marketed “will” opinions that the IRS has no reasonable basis to challenge were also meant to be excluded from the scope of the regulations even if, within the same document, counsel delivers opinions that are governed by the regulations.
- A “marketed” tax shelter opinion is a tax shelter opinion that a practitioner knows or has reason to know will be used or referred to by a person other than the practitioner (or another attorney

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October 31, 1976; actions on decisions and GCMs issued after March 12, 1981 (as well as certain pre-1955 published GCMs); IRS information and press releases; and published notices, announcements and other administrative pronouncements.

An authority does not continue to be an authority to the extent it is overruled or modified, implicitly or explicitly, by a body with the power to overrule or modify the earlier authority. For example, a district court opinion on an issue is not an authority if overruled or reversed by the United States Court of Appeals for such district. However, a Tax Court opinion is not considered to be overruled or modified by a court of appeals to which a taxpayer does not have a right of appeal, unless the Tax Court adopts the holding of the court of appeals. Similarly, a private letter ruling is not authority if revoked or if inconsistent with a subsequent proposed regulation, revenue ruling or other published administrative pronouncement. Treas. Reg. § 1.6662-4(d)(3)(iii).

in the same firm) in promoting, marketing or recommending the tax shelter.<sup>85</sup>

- Query: Does disclosure for a public offering or a private placement, or the filing of an opinion with the SEC constitute a marketed tax shelter opinion? If so, note that the scope of such disclosure or opinion may not be limited, which will produce exhaustive disclosure and lengthy opinions. The authors have recommended that the government consider an angel list of transactions that will not be considered marketed tax shelter opinions, including disclosure in public transactions filed with the SEC.<sup>86</sup>
- A limited scope opinion is an opinion the taxpayer and the practitioner agree to limit to one or more federal tax issues. Notably, the scope of a marketed tax shelter opinion may not be limited.<sup>87</sup>

### E. Requirements for Tax Shelter Opinions

- The opinion must identify and consider all relevant facts.<sup>88</sup>

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<sup>85</sup> Cir. 230 § 10.35(c)(6). In contrast, prior proposed regulations defined “marketed” tax shelter opinions as “a tax shelter opinion that does not conclude that the Federal tax treatment of a tax shelter item or items is more likely than not the proper treatment . . .” Under the new proposed amendments to Circular 230, a “marketed” opinion is broader in scope because it includes a “more likely than not tax shelter opinion” as well. *See* Notice of Proposed Rulemaking, 66 Fed. Reg. 3276 (Jan. 12, 2001).

<sup>86</sup> The Association of the Bar of the City of New York has made a similar request. *See* The Association of the Bar of the City of New York, “Notice of Proposed Rulemaking Circular 230: Tax Shelter Opinions,” (March 31, 2004).

<sup>87</sup> Cir. 230 § 10.35(a)(3)(ii). In contrast, prior proposed regulations did not specifically address “limited scope” opinions. *See* Notice of Proposed Rulemaking, 66 Fed. Reg. 3276 (Jan. 12, 2001).

<sup>88</sup> Cir. 230 § 10.35(a)(1)(i).

- However, a practitioner is not expected to identify or ascertain facts peculiar to a taxpayer to whom the transaction may be marketed.<sup>89</sup> Accordingly, practitioners apparently may deliver marketing opinions based on (necessarily) hypothetical facts as long as the opinion includes appropriate disclosure(s).
- Query: Could this requirement be satisfied for a non-marketed opinion if, notwithstanding extensive diligence efforts, a practitioner does not uncover a relevant fact? Presumably the practitioner can only be required to consider those relevant facts it identifies during its due diligence, although this result is not completely consistent with the regulatory language.
- The opinion may not be based on unreasonable factual or legal assumptions, representations, statements or findings the practitioner knows or should know are incorrect or incomplete.<sup>90</sup>
  - For example, the opinion may not assume a business purpose, a conclusion on a material valuation issue, or a potential profit apart from tax benefits.<sup>91</sup>
  - The opinion may not rely on a taxpayer's factual representation of a business purpose that does not specifically describe the business purpose, or that the practitioner knows or should know is

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<sup>89</sup> Cir. 230 § 10.35(a)(1). In contrast, prior proposed regulations did not specifically contain this qualification. *See* Notice of Proposed Rulemaking, 66 Fed. Reg. 3276 (Jan. 12, 2001).

<sup>90</sup> Cir. 230 § 10.35(a)(1)(ii).

<sup>91</sup> Cir. 230 § 10.35(a)(1)(ii). In its comments to the Department of Treasury on Circular 230 the American Bar Association recommended that Circular 230 expressly require practitioners to make reasonable inquiry into a taxpayer's specific facts supporting the presence of a sufficient business purpose on pretax profit before delivering a favorable tax shelter opinion. *See* American Bar Association letter to the Department of Treasury, "Circular 230," (March 30, 2004).

incorrect or incomplete.<sup>92</sup> What sort of due diligence is contemplated with respect to business purposes?

- Query: What limitations, if any, are intended with respect to practitioners' reliance on valuations? Are third-party valuations required to satisfy specific guidelines (and if so, which ones), or can a practitioner reasonably rely on a valuation that appears reasonable on its face?
- The opinion must relate the law (including potentially applicable judicial doctrines) to the relevant facts.<sup>93</sup>
  - The opinion may not assume the favorable resolution of any material federal tax issue (unless the scope of a non-marketed opinion is limited or the practitioner properly relies on another legal opinion) or otherwise be based on unreasonable legal assumptions, representations or conclusions.<sup>94</sup>
  - Note that the requirement that an opinion apply the relevant facts to every potentially applicable judicial doctrine seems to spell the end of most short-form opinions, and in fact, seems likely to produce very long (and expensive) opinions.
    - Query: Does the cost outweigh the benefit of requiring analysis of all "potentially applicable" legal doctrines, rather than all "relevant" legal doctrines, for example? Presumably all facts and circumstances based doctrines, *e.g.*, step transaction and substance over form, must be analyzed under this rule, although tax shelter opinions should not reasonably be required to analyze

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<sup>92</sup> Cir. 230 § 10.35(a)(1)(iii).

<sup>93</sup> Cir. 230 § 10.35(a)(2)(i).

<sup>94</sup> Cir. 230 § 10.35(a)(2)(ii).

doctrines the IRS has unsuccessfully (albeit repeatedly) invoked.

- Query: How is the scope of potentially relevant legal doctrines determined in the case of a limited scope opinion?  
Presumably doctrines relevant to a single issue being opined on must be addressed, but could step transaction and substance over form doctrines be potentially applicable with respect to an opinion on a single issue, or transaction?
- Query: What level of knowledge of potentially applicable judicial doctrines will be assumed?
- The opinion may not include internally inconsistent legal analyses or conclusions.<sup>95</sup>
  - The opinion must consider all material federal tax issues (except in the case of a non-marketed limited scope opinion containing the requisite disclosure),<sup>96</sup> provide a conclusion as to the likelihood of success on the merits with respect to each material federal tax issue, and describe the reasons for each conclusion (including the facts and analysis supporting each conclusion).<sup>97</sup>
  - The opinion may not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled.<sup>98</sup>
- The opinion must provide an overall conclusion as to the likelihood that the federal tax treatment of the

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<sup>95</sup> Cir. 230 § 10.35(a)(2)(iii).

<sup>96</sup> Cir. 230 § 10.35(a)(3)(i), (ii).

<sup>97</sup> Cir. 230 § 10.35(a)(3)(iii).

<sup>98</sup> Cir. 230 § 10.35(a)(3)(iv).

tax shelter items is proper together with the reasons for that conclusion.<sup>99</sup>

- A practitioner who is unable to reach a conclusion with respect to one or more material federal tax issues (or an overall conclusion) must state and describe the reasons for the inability to reach a conclusion, and provide disclosure, as described below.<sup>100</sup>
- Query: Does the reference in the regulations describing the reasons for “the conclusions” include issues that are not material federal tax issues, which would therefore be subject to the reasoned conclusion rule?
- Presumably, the same assumption limitations applicable to opinions on specific material federal tax issues would also apply to overall opinions, although this result should be clarified. Final regulations should also clarify that any overall conclusion regarding a limited scope non-marketed opinion would, in fact, be limited to the issues the opinion addresses.

#### **F. Required Disclosures for Tax Shelter Opinions**

- A practitioner must disclose at the beginning of all tax shelter opinions:<sup>101</sup>
  - The existence of any compensation, referral, referral fee, or fee-sharing arrangement between the practitioner or the practitioner’s firm and any promoter, other than the client for whom the opinion was prepared.<sup>102</sup>

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<sup>99</sup> Cir. 230 § 10.35(a)(4).

<sup>100</sup> Cir. 230 § 10.35(a)(3)(iii), (4).

<sup>101</sup> Cir. 230 § 10.35(d).

<sup>102</sup> Cir. 230 § 10.35(d)(1)(i), (ii).

- A practitioner must disclose at the beginning of a marketed tax shelter opinion that:<sup>103</sup>
  - The opinion may not be sufficient to avoid substantial understatement penalties.<sup>104</sup>
  - The taxpayer should seek advice based on its individual circumstances from its own tax advisor.<sup>105</sup>
- A practitioner must disclose at the beginning of an opinion that fails to reach at least a more likely than not conclusion with respect to a material federal tax issue addressed in the opinion that:<sup>106</sup>
  - The opinion does not reach a conclusion of at least more likely than not with respect to a material federal tax issue addressed in the opinion,<sup>107</sup> and
  - The opinion was not written, cannot be used by the recipient, to avoid substantial understatement penalties with respect to those issues.<sup>108</sup>
- A practitioner must disclose at the beginning of a limited scope opinion that:<sup>109</sup>
  - The opinion is limited as agreed by the taxpayer and the practitioner;<sup>110</sup>

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<sup>103</sup> Cir. 230 § 10.35(d)(2).

<sup>104</sup> Cir. 230 § 10.35(d)(2)(i).

<sup>105</sup> Cir. 230 § 10.35(d)(2)(ii).

<sup>106</sup> Cir. 230 § 10.35(d)(4).

<sup>107</sup> Cir. 230 § 10.35(d)(4)(i).

<sup>108</sup> Cir. 230 § 10.35(d)(4)(ii).

<sup>109</sup> Cir. 230 § 10.35(d)(3).

<sup>110</sup> Cir. 230 § 10.35(d)(3)(i).

- Additional issues may exist that could affect the federal tax treatment of the tax shelter, and the opinion does not consider or reach a conclusion with respect to such additional issues;<sup>111</sup> and
- The opinion was not written, and cannot be used, for the purpose of avoiding substantial understatement penalties with respect to material federal tax issues outside the scope of the opinion.<sup>112</sup>

### G. Compliance Procedures

- The proposed Circular 230 regulations require a practitioner with principal authority and oversight responsibility for a firm's federal tax practice to take reasonable steps to ensure adequate firm procedures for all members, associates, and employees (*e.g.*, counsel) to comply with the tax shelter opinion regulations.<sup>113</sup> Such practitioners will be disciplined for failure, due to willfulness, recklessness, or gross incompetence, to:<sup>114</sup>
- Take reasonable steps to ensure the firm has adequate procedures to comply with the tax shelter opinion regulations, in the event a member, associate or employee of the firm engages in a pattern or practice of failing to comply with the Circular 230 regulations,<sup>115</sup> or

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<sup>111</sup> Cir. 230 § 10.35(d)(3)(ii).

<sup>112</sup> Cir. 230 § 10.35(d)(3)(iii).

<sup>113</sup> Cir. 230 § 10.36(a). Because of the unduly broad nature of the Circular 230 rules and the disproportionality between the high cost of compliance and the amount of tax often at issue, the Association of the Bar of the City of New York is concerned that there is a high likelihood that practitioners will not comply with the rules. *See* The Association of the Bar of the City of New York, "Notice of Proposed Rulemaking Circular 230: Tax Shelter Opinions," (March 31, 2004).

<sup>114</sup> Cir. 230 § 10.36(b)(1).

<sup>115</sup> Cir. 230 § 10.36(b)(1).

- Take prompt action to correct noncompliance of a member, associate or firm employee whom the practitioner knows or has reason to know has engaged in a practice that does not comply with the Circular 230 regulations.<sup>116</sup>
- Query: Would the head of a tax department, the head of a firm's opinion committee, and/or a firm's managing partner constitute a practitioner with oversight responsibility for the firm's tax practice?
- Query: How certain can practitioners be that their procedures comply with these rules if noncompliance occurs? If final regulations impose liability for actions of other attorneys, hopefully they will also contain a safe harbor, or at least examples of accepted procedures.

#### **H. Effective Date**

- The proposed Circular 230 regulations would generally be effective on the date that final regulations are published in the Federal Register, which is expected to occur during 2004.<sup>117</sup>
- Query: More specifically, how soon will the regulations be finalized?
- Note that because final regulations would be immediately effective when published, transactions such as debt and equity offerings and mergers and acquisitions in process on the date final regulations are published will likely be delayed due to the need to include all applicable disclosures and ensure compliance with other requirements contained in final regulations.

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<sup>116</sup> Cir. 230 § 10.36(b)(2).

<sup>117</sup> Cir. 230 §§ 10.35(f), 10.36(c), 10.37(b).