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In the wake of the Enron debacle, Congress, Treasury, and the IRS are intensifying the focus on corporate tax shelters. In this environment, tax directors, as well as corporate management and board members, need to be aware of the tax risks their companies may face if they participate in aggressive, partially tax-motivated transactions.

The two pieces below are designed to alert readers to recent procedural developments in the tax shelter area and suggest possible actions to control risk in this rapidly changing area. In the coming months, we will be closely monitoring the Government's progress in its campaign against abusive corporate tax shelters. For more information, contact Chris Rizek (202-862-8852 or csr@capdale.com) or Dan Rosenbaum (202-862-5032 or dbr@capdale.com).

Evaluating and Managing Tax Shelter Risks

In recent years, Treasury and the IRS have taken a series of heavily publicized actions against so-called "corporate tax shelter" transactions. Because of the difficulty of defining precisely the difference between legitimate tax planning and illegitimate avoidance or evasion, Treasury has identified certain characteristics that may indicate a tax shelter. In its 1999 "White Paper" study, Treasury stated that a potential tax shelter transaction may include some of the following features:

- *Lack of economic substance in the transaction.*
- *Inconsistent treatment for financial and tax accounting purposes.*
- *The presence or involvement of "tax-indifferent" parties.*
- *Extreme complexity.*
- *Unnecessary steps or novel investments.*
- *Promotion or marketing.*
- *Confidentiality that benefits the shelter promoter.*
- *High transaction costs.*
- *Risk reduction arrangements.*

Of course none of these "badges of shame" is dispositive, and perfectly legitimate transactions may share several of these characteristics. But some of these features have been incorporated into the regulations that require registration and/or maintenance of investor list information by the promoter or organizer of a tax shelter under IRC §§ 6111 and 6112. Additionally, these characteristics are reflected in the Treasury regulation (§ 1.6011-4T(b)) defining a category of "reportable transactions" that a taxpayer must separately disclose and describe on its return.

The IRS is using these registration and disclosure statements to target particular corporate transactions for intense examination, and it has promulgated standard, and extremely thorough, requests for documents and other information for IRS agents to use. Both Treasury and the IRS have indicated they intend to continue their campaign against abusive corporate tax shelters.

What you should do. To evaluate the risks your company may face from enhanced Governmental scrutiny of tax shelters, there is certain information that can be collected from the company's tax files. And there are certain actions that can be taken to minimize the risk of an adverse determination by the IRS, with its attendant costs in dollars and publicity.

- *Identify "listed" transactions.* You should review the IRS's current list of abusive transactions and determine whether your company is involved in any. You can be fairly confident that there will be an extended IRS examination of such transactions, and potentially some additional tax due.
- *Identify "registered" transactions.* Has the company participated in any tax shelter transactions that had to be registered by the promoter or organizer? If so, the company and the transaction are already on the IRS's radar screen, and an IRS examination and additional tax bill are very likely.
- *Review separate disclosures of transactions.* Like the shelter registrations, the separate disclosures that corporate taxpayers must submit are intended to alert the IRS to a potentially questionable transaction. The current disclosure rules are broad, and may cover transactions that are neither "listed" nor "registered."
- *Identify other potential shelter transactions.* While these can be hard to identify, the list of characteristics above provide a good approximation of the kinds of transactions the IRS is likely to question if it finds out about them.

If your company has engaged in one or more corporate tax shelter transactions, it may face significant liability for additional taxes and penalties. So there are some further questions that you should focus on in order to evaluate your risk:

- *What's the current state of the law?* The law on particular transactions continues to evolve. As of this writing, the Government has won most of its attacks on corporate-owned life insurance transactions, recently lost some significant cases involving foreign tax credit stripping, and has not yet litigated several of the known shelters. Also, not infrequently the IRS issues announcements targeting and "closing down" specific tax-motivated transactions. So the law

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may be changing with respect to existing transactions, and having up-to-date information may help head off problematic new ones.

- *What's the likelihood of an examination?* As noted, registered and separately disclosed transactions are almost certain to be identified by the IRS, whether or not your company is under regular IRS examination. But others may escape scrutiny. Knowing the status and stage of your company's tax audit situation is critical to assessing the extent of your risk from tax shelter situations.
- *Who looked at this transaction?* Because shelter transactions tend to be on the cutting edge, most companies insist on thorough opinions from law or accounting firms before they enter such transactions. Who gave the opinion here? Was it the same firm that marketed or promoted the transaction?
- *Should we take another look?* If there is any doubt about the strength of the opinion, or the merits of the company's position on the transaction, it may very well be worthwhile to obtain a second look by an independent law or accounting firm retained just for that purpose.
- *Do our risk assessment procedures need improvement?* If the company's potential tax shelter liability is of sufficient concern, consider process improvements to minimize the risks associated with current and possible future shelters. Ascertain why these transactions are occurring and whether the potential benefits justify the risks. Independent outside advisors can be helpful in evaluating management procedures for tax risks.

In short, a self-audit for tax shelter risks is prudent and potentially beneficial in today's climate.

Recent Developments In Treasury's Campaign Against Tax Shelters

The government's campaign against corporate tax shelters is now moving rapidly on three fronts: (1) legislation; (2) regulations and formal guidance; and (3) administrative actions.

In March, senior Treasury officials announced a package of eleven **legislative proposals**, two of which are targeted at specific loopholes, but the rest of which are generically applicable to a broad range of potentially abusive transactions. The proposals include five provisions to impose new penalties or enhance existing penalties, ranging from some that seem draconian (increasing the penalty for failure to produce investor lists to $10,000 per day, per failure) to others that appear largely irrelevant to the corporate tax shelter problem (such as increasing to $5,000 the "frivolous return" penalty). Other provisions would broaden the scope of the existing tax shelter registration, list maintenance, and disclosure rules. As of this writing, drafts of the legislation have not yet been introduced, but in view of Congressional interest they bear careful watching.

Treasury and the IRS also announced sweeping revisions of the existing tax shelter registration, list maintenance, and disclosure **regulations**, another round of revisions to Circular 230, and **additional guidance** targeted at specific abusive transactions. Again, the scope of these ideas varies dramatically. Some proposals attempt to coerce taxpayers into making disclosures by imposing "strict liability" penalties (eliminating "reasonable cause" or other excuses) for failure to disclose a reportable transaction or failure to disclose a position that disregards an applicable regulation. Others proposals tighten loopholes in existing rules, such as the requirement that non-corporate taxpayers disclose certain transactions separately. One announcement is intended to "shut down" a specific variety of abusive "basis shifting" transactions. Still other proposals reflect lofty goals that may prove unattainable, such as establishing a consistent, bullet-proof definition of a tax shelter for all purposes (to replace, in part, the 2-of-5 factor test in Treas. Reg. § 1.6011-4T(b)). As yet, most of these proposals have not been implemented, but since Congressional approval is not required, taxpayers should monitor these developments even more closely than legislative events.

Finally, Treasury and the IRS will take additional **administrative action** in the campaign against shelters. The steps announced, such as providing a consistent form for disclosures and establishing better examination procedures for identifying abusive transactions, build on the so-called "amnesty" disclosure program and other activities of the IRS Office of Tax Shelter Analysis. These actions may seem relatively trivial to some taxpayers, but there is an old military adage that "amateurs talk strategy, professionals talk logistics." Such administrative nitty-gritty is an unglamorous but necessary precondition for both uniform tax administration in general and the war on shelters in particular. These actions will give the IRS additional firepower in its battle against corporate tax shelters, and suggest more cautious compliance by taxpayers.