Caplin & Drysdale

taxAlert

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As the result of a variety of factors — such as completion of the Internal Revenue Service's reorganization, renewed focus on tax compliance, and even the return of deficit spending by the Federal government — the IRS is reinvigorating its enforcement activities. At the same time, Treasury and the IRS are trying, through regulations and other pronouncements, to deal with a range of longstanding technical issues under the Internal Revenue Code. With so much going on, it's easy for an important development to escape the notice of busy tax practitioners.

Therefore, in this edition of TaxAlert, Caplin & Drysdale lawyers summarize a number of recent Government actions that may have significance for your own work on current tax issues. We hope you will find these short summaries useful. If you need additional information, please contact the attorneys mentioned at the bottom of each item.

Tax Shelters: Treasury Finalizes Tax Shelter Reporting Regulations

On February 27, 2003, Treasury and the IRS released final regulations requiring **registration, disclosure,** and **maintenance of investor lists** regarding tax shelters. The final regulations are the culmination of three years of effort to enhance the disclosure regimes applicable to abusive shelter transactions. The regulations are intentionally drafted very broadly, however, to encompass many kinds of transactions that may be perfectly legitimate, and all taxpayers and tax practitioners need to be familiar with them. Moreover, more changes and refinements, including new shelter legislation, may still be coming.

The new regulations were issued pursuant to three Internal Revenue Code provisions. The first set falls under IRC § 6111, which requires **registration** of certain kinds of tax shelters. Because sections 6111(c) and (d) narrowly define the kinds of covered transactions, these regulations apply to a limited range of activities, although Treasury officials have indicated that they intend to expand the scope of the registration rules to cover more transactions once legislation broadening the statute is enacted. In the meantime, taxpayers and practitioners should still be familiar with these rules, because the penalty for failure to register a transaction when required to do so can be substantial.

The **disclosure** regulations can potentially affect all kinds of taxpayers. Using its broad authority to prescribe the form of returns under IRC § 6011, Treasury and the IRS have enumerated six categories of transactions that must be separately disclosed by taxpayers when they file their returns. These include certain: (1) "listed" transactions; (2) "confidential" transactions; (3) "contractual protection" transactions; (4) section 165 loss transactions; (5) transactions involving large book-tax differences; and (6) transactions involving short asset holding periods. Because these categories are broadly drafted, there are numerous detailed exceptions, including two Revenue Procedures devoted entirely to "angels' lists" of transactions that may result in section 165 losses or large book-tax differences but that nevertheless need not be separately disclosed. The form of disclosure, the information to be submitted, and similar mechanical matters are also spelled out in detail in the regulations. While there is no specific penalty for failure to make a required disclosure, such a failure will prevent application of the "reasonable cause and good faith" exception to accuracy-related penalties.

Transactions that must be separately disclosed under IRC § 6011 are also generally subject to information-keeping requirements under IRC § 6112's **list maintenance** rules. The regulations impose these responsibilities on many tax practitioners who might not otherwise be considered tax shelter "promoters" but who may still be "material advisors" with respect to covered transactions. All that is needed to become a "material advisor" is to offer certain kinds of tax advice with respect to a covered transaction for a fee that exceeds a stated threshold. Consequently, all practitioners should familiarize themselves with these rules and set up internal systems to capture the required data. The penalties presently applicable for failing to maintain the required information are not significant in dollar terms, but failure may affect a practitioner's

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authorization to practice before the IRS.

Finally, the Treasury Department is seeking new **anti-tax-shelter legislation** on Capitol Hill, and it appears increasingly likely that such legislation will be enacted this year. The legislation would expand the definition of "registrable" transactions under section 6111, and would greatly enhance the penalties for failure to register, disclose, or maintain lists regarding covered transactions.

We will be closely following this legislation and related administrative developments in the tax shelter area. For more information, contact Christopher S. Rizek (202-862-8852 or csr@capdale.com), Seth Green (202-862-7849 or smg@capdale.com), or Richard Skillman (202-862-5034 or rws@capdale.com).

Corporate Taxation: New Consolidated Return Duplicated Loss Rules

On March 11, Treasury and the IRS issued proposed, temporary, and final regulations under IRC § 1502 aimed at preventing a consolidated group from obtaining **duplicated tax benefits** from a single economic loss. The regulations are substantially similar to proposed regulations issued last October which, in turn, were foreshadowed in Notice 2002-18. The regulations generally apply to stock transfers, dispositions, and events of worthlessness involving members of a consolidated group that take place on or after March 7, 2002, and no later than March 11, 2006. The regulations also provide an important transitional election applicable in certain circumstances.

The regulations address situations where stock of a member of the group that has net operating losses, built-in asset losses, or deferred deductions is sold or otherwise disposed of at a loss or becomes worthless. The regulations are intended to address **two types of transactions** in which duplicated tax benefits might otherwise be available. The first involves the group's absorption of the inside loss of the subsidiary in determining consolidated taxable income, with a group member subsequently recognizing a loss on a deconsolidating disposition of the stock of the subsidiary. The second type of transaction involves a group member's recognition of a loss on the non-deconsolidating disposition of subsidiary member stock that is duplicative of an inside unrecognized loss of the subsidiary, with the subsidiary remaining as a member of the group and the group subsequently recognizing the subsidiary's loss, or the subsidiary becoming a member of another group that subsequently recognizes the loss.

Prevention of duplicative losses is accomplished through a **basis redetermination** rule, a **loss suspension** rule, and a **basis reduction** rule. Under the **basis redetermination** rule, the regulations require the reallocation of the basis of subsidiary stock upon certain dispositions and deconsolidations if the basis of the stock exceeds its value. In general, this rule is intended to spread a loss from the stock of a subsidiary equally over all of the common shares of the subsidiary – preventing the concentration of basis on some common stock, and also preventing the group from claiming any loss from the disposition of the subsidiary's preferred stock.

If, after application of the basis redetermination rule, a consolidated group member recognizes a loss on the non-deconsolidating disposition of stock of a subsidiary, then under the **loss suspension** rule, the selling member's stock loss is suspended to the extent of the duplicated loss with respect to such stock. The suspended loss is then eliminated, dollar for dollar, as the subsidiary member's deductions and losses are taken into account in determining the group's consolidated taxable income. An exception (not contained in the October version of the regulations) is provided to prevent the disallowance of true economic losses.

The **basis reduction** rule is intended to prevent loss duplication through the absorption of losses generated by a subsidiary member after a loss on the stock of that member from either (i) the worthlessness of the subsidiary's stock, or (ii) the disposition of the subsidiary's stock where, immediately thereafter, the subsidiary is no longer a member of the group and does not have a separate return year. Under this rule, immediately before either event, the basis of the subsidiary's stock is reduced by the amount of any loss carryforwards attributable to the subsidiary. However, to avoid disallowance of a single economic loss, the regulations (unlike the October version) provide that the losses generated by, and attributable to, the subsidiary that are unabsorbed upon disposition or worthlessness shall be treated as expired but not as absorbed by the group — thereby having no effect on the basis of the subsidiary's stock for loss computation purposes.

A **transitional rule** allows a common parent to make an irrevocable election to reattribute to itself all or a portion of the losses attributable to the subsidiary member where the member's stock is disposed of or becomes worthless between March 7, 2002 and March 14, 2003. The effect of this election is that the reattributed losses are treated as absorbed by the group, thereby reducing (under the investment adjustment rules) the basis of the loss member's stock immediately prior to the determination of worthlessness or disposition while allowing the group to utilize the losses following this event. The election must be filed with the return for the taxable year in which the disposition or worthlessness event occurred.

The regulations should be reviewed carefully by all corporate taxpayers, especially those contemplating transactions with respect to the stock of a subsidiary with built-in losses. For more information, contact Daniel Rosenbaum (202-862-5032 or dbr@capdale.com) or Seth Green (202-862-7849 (smg@capdale.com).

Tax Accounting: Proposed Capitalization Regulations — Not All Good News.

In December, Treasury and the IRS **proposed regulations under IRC § 263(a)** that would comprehensively define the circumstances in which expenditures relating to the acquisition, creation, or enhancement of intangible assets must be capitalized. The regulations are intended to reduce both the compliance burdens in this area and the frequency of audit controversies that have arisen since the Supreme Court's 1992 INDOPCO decision.

In many respects, the proposed regulations are remarkably liberal; if adopted in their current form, the regulations would allow many taxpayers to expense items that had previously been the subject of actual or potential controversy. At the same time, the proposed regulations would draw a number of hard lines, which would require a significant number of service providers and other taxpayers to capitalize regularly recurring expenditures that have historically been expensed for both book and tax purposes.

Subject to several significant exceptions, the proposed regulations would require taxpayers to capitalize amounts paid to acquire, create, or enhance intangibles that are "separate and distinct assets" or that fall under certain defined categories of intangible assets. Costs incurred to "facilitate" the acquisition, creation, or enhancement of such intangible assets or to facilitate the restructuring, reorganization, or recapitalization of a business entity would also be subject to capitalization. **Except as required under these regulations, section 263(a) would not require capitalization of any other expenditures relating to acquired or created intangibles.**

One of the proposed exceptions is for **contracts**, excluding certain financial interests, that have a specified duration of 12 months or less. Amounts paid for such contracts, as well as related transaction costs, would not be subject to capitalization.

Perhaps the most significant exception to capitalization is for **employee compensation and overhead**. This exception, labeled as a "simplifying convention," would apply without limitation. Among other things, it would allow all employee compensation in connection with merger and acquisition transactions, including deal bonuses, to be currently deducted. However, while also allowing all "overhead" to be currently deducted, the proposed regulations do not define that term.

The last major exception, also designated as a simplifying convention, is a **$5,000 de minimis rule**, which would generally allow external costs (i.e., costs other than employee compensation and overhead) related to a transaction to be currently deducted if the aggregate external costs for the transaction do not exceed $5,000. If such external costs do exceed $5,000, all external costs related to the transaction, ostensibly down to the last taxi fare and overnight delivery charge, would need to be capitalized.

One group of taxpayers that would be adversely affected are those who customarily enter into **large contracts to provide services** to customers or clients, such as investment managers and other service contractors. Under the structure of the proposed regulations, external costs incurred to seek new agreements, or to enhance existing contractual relationships, would be subject to capitalization if the total external costs exceeded $5,000. In many such cases, the recordkeeping burdens of this rule would be more significant than the actual tax consequences of capitalization.

Caplin & Drysdale is preparing written comments on behalf of interested clients addressing this and other problems posed by the proposed regulations. For more information, contact Richard Skillman (202-862-5034 or rws@capdale.com).

Transfer Pricing: IRS Cracking Down On Transfer Pricing Compliance

In January, the IRS announced an intensified effort to enforce compliance with the transfer pricing rules under IRC § 482. The IRS Large and Mid-Size Business Division issued a **Transfer Pricing Compliance Directive** requiring IRS auditors to take certain steps at the start of every audit. Specifically, the auditors must (1) request copies of any transfer pricing documentation prepared by the taxpayer pursuant to IRC § 6662(e), (2) apply the statutory 30-day time frame for providing that documentation, and (3) request relevant information regarding transfer pricing practices if the taxpayer has not maintained section 6662(e) documentation. (The regulations under section 6662(e) waive the onerous transfer pricing underpayment penalties if specified contemporaneous documentation has been maintained.)

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The collected documentation must be referred to an IRS international examiner or economist for risk assessment, with transfer pricing issues then included in the audit plan as appropriate. Finally, auditors are directed to **assert section 6662(e) penalties** "where warranted."

This enhanced audit investigation program makes it a particularly good time for corporate taxpayers to inventory and review their documentation for any significant cross-border intercompany transactions. With fortuitous timing, the Pacific Association of Tax Administrators (PATA) has just finalized a **Transfer Pricing Documentation Package** outlining principles for uniform transfer pricing documentation that will suffice for penalty protection with all of the member countries. Members of PATA include the tax authorities of the United States, Canada, Australia, and Japan. Advance Pricing Agreements (APAs) with the IRS (and foreign tax authorities), if not already in place, should also be considered to eliminate future controversies.

If we can be of assistance in assessing your transfer pricing documentation exposure or with substantive analysis, audits or APAs, please contact Patricia G. Lewis (202-862-5017 or pgl@capdale.com).

Exempt Organizations: Anti-terrorist Financing Guidelines May Impede Cross-border Grantmaking

Treasury and the IRS recently released **voluntary best practices guidelines** designed to help U.S.-based charities avoid terrorist financing. These guidelines may have the unintended consequence of slowing donor grants to legitimate non-governmental organizations operating beyond our borders. They will also add documentation costs and requirements that may be impossible for many foreign grantees to meet, let alone for U.S. charities to comply with and the IRS to administer.

The guidelines for "best practices" require foreign recipient organizations to have an "adequate governing structure." The initial question is whether the national law where these organizations were created is compatible with the guidelines. Additional data is also required. For example, the guidelines suggest that the granting charity should obtain from the foreign recipient the date and place of birth of officers and employees of the recipient organizations. The guidelines further suggest that the donor charity should run these names through "public data banks" and specified governmental lists for "links to terrorism or money laundering." These include lists maintained by the Treasury Department, the Justice Department, the United Nations, the European Union, and other "official lists."

The U.S. charity is additionally required to review financial operations of the foreign recipient organization, including seeking bank account information to determine whether the bank is a "shell" operating under an off-shore license, is licensed in a jurisdiction determined to be non-cooperative in the international fight against money laundering, or is designated by the Department of Treasury as a primary money-laundering concern or situs that lacks money-laundering control or oversight. Charities are even expected to conduct routine on-site audits of the foreign recipient organizations.

It is not clear whether there is any correlation between these new Treasury best practice guidelines and the existing rules governing distributions (the due diligence, control and discretion requirement for public charities, and the all reasonable efforts test for private foundations). If the IRS makes these new procedures mandatory for qualifying charitable distributions, onerous burdens and uneven compliance may result. Clarification of the use, scope, and application of these guidelines is urgently needed so that appropriate cross-border grantmaking can continue on an orderly basis.

Check with us for updates or to investigate the practical aspects of these guidelines. For more information contact Milt Cerny (202-862-5075 or mc@capdale.com).

Caplin & Drysdale helps clients plan and evaluate tax-related transactions. The firm's 35 tax lawyers have been designing and reviewing tax strategies for companies, organizations, and individuals throughout the United States and around the world since the firm was founded in Washington, D.C., by former IRS Commissioner Mortimer Caplin 38 years ago. Clients often call on us to provide our analysis and views on the tax consequences and reporting requirements for a transaction or series of transactions brought to them by an outside consultant. This gives the client a second, independent perspective. We may also play a role in designing or modifying the transaction to bolster the client's tax position. Finally, we are very active in the controversy area, representing clients and outside consultants in tax-shelter-related audits.

For more information on the issues discussed in this **taxAlert** or on Caplin & Drysdale, please contact Christopher S. Rizek (202-862-8852 or csr@capdale.com), Daniel B. Rosenbaum (202-862-5032 or dbr@capdale.com), or visit our website (www.caplindrysdale.com).