NEW YORK STATE BAR ASSOCIATION TAX SECTION

POTENTIALLY ABUSIVE TAX SHELTER REGULATIONS

JUNE 6, 2003

Report No. 1033

This Report is in response to T.D. 9046, in which the Internal Revenue Service and Treasury Department promulgated final regulations regarding the disclosure of "reportable transactions," the listing of potentially abusive tax shelters and the registration of confidential corporate tax shelters (the "Regulations").[1] We commend the Service and Treasury for their continued efforts to combat tax shelters. We also note that the Regulations address a number of concerns raised by the Tax Section and others.[2] We continue to support the structure and approach of the Regulations.

However, in light of our understanding that the Service and Treasury would be willing to consider modifying the Regulations (whether directly or through the issuance of Revenue Procedures or other implementing guidance) to address certain continuing concerns, we think it important to bring to the attention of the Service and Treasury a number of significant aspects of the Regulations that continue to create unnecessary uncertainty or complexity or may lead to inappropriate results. As this report represents only our preliminary response to the Regulations, additional comments may follow.

The majority of our comments involve the "confidential transaction" category, because that category has the widest reach, has created significant confusion and has added a new layer of complexity to virtually every business transaction. We cannot overemphasize the level of uncertainty and disruption that the confidentiality provision has had on ordinary non-abusive transactions.

Additionally, we believe guidance is necessary regarding the scope of a "transaction" and what constitutes a "tax benefit." We also have a number of concerns regarding the "loss," "book-tax difference" and "listed transaction" categories. We think revisions should be made to the rule requiring a "reporting shareholder" of a foreign corporation to disclose the corporation's transactions and clarification should be provided regarding various aspects of the list maintenance regulations. Finally, we offer several suggestions relating to pending or future

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[2] *E.g.*, *NYSBA Members Urge Exemptions from Reportable Transactions*, 2003 TNT 2-12 (Jan. 3, 2003); *NYSBA Sends IRS Comments on Proposed Tax Shelter Regs*, 2003 TNT 11-31 (Jan. 16, 2003); *SIA Comments on Tax Shelter Regs*, 2003 TNT 11-29 (Jan. 16, 2003); *Association says Proposed Tax Shelter Regs Need Amending*, 2003 TNT 1-6, (Jan. 2, 2003); *Chicago Bar Tax Committee Submits Comments on Tax Shelter Regs*, 2003 TNT 45-63 (Mar. 7, 2003).

legislation imposing additional obligations with respect to "reportable transactions" and increasing the penalties for failure to comply with these regimes.

A. Confidential transactions.

We believe that the confidential transaction category is both unworkably overbroad and, in many cases, underinclusive, so that in practice it will cause the disclosure of many noncontroversial transaction structures but will not achieve its objective of causing the disclosure of tax-motivated transaction structures. The definition of a "confidential transaction" remains extremely broad in the Regulations, so that the category potentially encompasses virtually all commercial transactions. Because confidentiality is often required for any of numerous non-tax reasons, such as protection of proprietary business or valuation methods, intellectual property or similar information, limitation of non-tax-based liability exposure, minimization of Freedom of Information Act obligations, or minimization of media exposure or other disclosure of a transaction, as discussed more fully below, participants in many commonplace transactions are now forced to decide between accepting additional tax filing requirements and sacrificing the often crucial non-tax benefits of a confidentiality provision.[3]

Moreover, even where confidentiality is not required by the parties in a particular transaction, it may be difficult or impossible for taxpayers and their advisers to ensure that they can establish that the transaction was not in fact offered under conditions of confidentiality. Many taxpayers engage in large volumes of transactions annually, and will find it impossible to prove, if called upon to do so, that any particular transaction, however "innocuous," did not meet the criteria for treatment as a "confidential transaction."[4] The obvious prophylactic measure, satisfaction of the presumption requirements, is extremely burdensome in practice, and in many routine situations will be impractical or virtually impossible.

[3] It is our experience that many taxpayers cannot as a business matter tolerate the risk that the presumption language might permit others to disclose sensitive non-tax related information in the context of particular transactions. Absent the presumption language, or substantially similar language, taxpayers may not be willing to risk the substantial expected penalties associated with failure to list or disclose their transactions, particularly where confidentiality has unquestionably been requested, and thus may be expected to disclose many non-tax motivated structures. We are aware of several routine transactions, including employee severance agreements, cash sales of assets and sales of non-financial goods and services, that may be listed and disclosed solely due to these concerns.

[4] A transaction is disclosable as a confidential transaction if (i) a taxpayer is claiming any tax benefit from the transaction (which is broadly defined, and could encompass almost any U.S. tax consequences) and (ii) based on all the facts and circumstances, including prior conduct of the parties, the taxpayer's disclosure of the tax structure and tax treatment of the transaction has been limited in any way (whether or not by a legally binding agreement) by anyone who has made any statement of potential U.S. tax consequences to the taxpayer (or for whose benefit any such statement was made). It is not clear who bears the burden of establishing whether a taxpayer's disclosure of a transaction has been so limited, but most taxpayers obviously will not want to engage in this debate with the Service -- particularly where they execute a high volume of transactions -- even with respect to the most ordinary-course, non-tax-motivated transactions. Similarly, it is not clear who bears the burden of establishing that a "statement as to potential tax consequences" or "tax statement" was made or not made. Because such statements may be made in a context other than providing financial or tax advice, it may be difficult for companies to effectively monitor statements of employees and prohibit inadvertent statements from being made.

Nonetheless, as discussed further below, the inclusion of the "magic" authorization language in many *tax-motivated* transactions is noncontroversial, because the parties are not sharing sensitive non-tax-related information. Thus, these transactions will be executed with the benefit of the presumption against confidentiality and consequently no filing will be necessary due to the confidential transaction category.

1. We think that many transactions that involve the sharing of sensitive non-tax-related information, but that involve little or no tax-motivated structuring, will in fact be "offered under conditions of confidentiality" within the meaning of the Regulations, because the participants will require confidentiality, a tax statement (often innocuous) will be made, and the parties will be unable for non-tax reasons to meet the requirements of the presumption. Ironically, however, we believe that taxpayers in many tax-motivated transactions will obtain the benefit of the presumption, because the "offerors" of such transactions (investment banks, accounting firms, etc.) do not typically share sensitive non-tax-related information and, based on our experience, will routinely authorize their counterparties or transferees to disclose the tax structure and treatment of such transactions. Thus, we believe that the confidential transaction category will in practice cause the disclosure of a vast number of uninteresting transaction structures, but will fail to generate the disclosure of the types of transaction structures that the Service and Treasury are interested in reviewing.

Indeed, the category is in this sense both so overbroad and so underinclusive as to provide the Service and Treasury with virtually none of the perceived benefits of the Regulations. Given this state of affairs, we think it is worth considering, once again, sharpening the substantive scope of the confidential transaction category.

In this regard, although other policy concerns can be articulated, we believe that the primary concern of the Service and Treasury should be limitations on a taxpayer's ability to disclose the tax treatment and structure of a transaction (i) to any independent tax adviser (as long as any such independent tax adviser's disclosure of the tax treatment and structure of the transaction is not limited in any way, other than the attorney-client privilege or the tax practitioner privilege under Section 7525) or (ii) to the Service or other government agencies. Thus, the category could be narrowed so that a transaction is not confidential if taxpayers may disclose the tax structure and treatment of the transaction to these groups of persons. Under this definition, an independent tax adviser could disclose the "core" of the tax structure and tax treatment of a transaction, but would presumably be limited by the attorney-client or tax practitioner privilege from disclosing information such as the identity of the parties, financial information, or other information not relevant to an understanding the tax structure or treatment. Because we would expect that this ordinarily would not be offensive to taxpayers who are concerned about preserving the confidentiality of sensitive non-tax-related information, this approach could eliminate the reporting obligations of a range of taxpayers who are preserving (limited) confidentiality for non-tax reasons.[5]

Another possibility, either in addition to the above or in lieu thereof, would be to provide a special rule for a category of persons objectively considered to be likely "promoters" of tax shelters, such as "financial institutions" within the meaning of Section 509(3)(A) of the Gramm-Leach-Bliley Act.[6] Such a rule could require disclosure under the Regulations where any limitation on disclosure of the tax structure and treatment is imposed by such persons if they are involved in the transaction in the ordinary course of business, perhaps with specified exceptions (for example, the rule might exempt involvement solely as a principal in an M&A transaction or as a non-lead member of a financing syndicate). This approach might be perceived to have the virtue of more narrowly targeting transaction types the Service and Treasury are concerned about, although we think any such rule would itself involve a great deal of complexity and uncertainty relating to what types of entities and activities should fall within its scope.

A third possibility (which in all events, we think should be adopted) would be to issue a Revenue Procedure identifying transaction types that are not subject to the confidentiality category. We believe that it is inherently difficult to try to carve out transaction types from a substantive rule, because the carveouts risk being underinclusive, overinclusive or both and are often themselves unclear in scope. Nonetheless, we think such an "angel list" would help to ameliorate the overwhelming burden of determining the application of the confidentiality category. This list might include noncontingent debt and common equity issuances (structurally unrelated to any other transaction),[7] employment contracts, severance agreements and other individual agreements concerning employee compensation and benefits. We also think consideration should be given to carving out the establishment of "traditional" hedge funds, merchant banking funds, private equity funds and similar vehicles.[8]

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[5] We note that this approach might limit the circumstances where a tax structure will be shown to competitors of the "offeror," and this may not be an ideal method of inducing (or accelerating) the public dissemination of such structures.

[6] Graham-Leach-Bliley Act of 1999, § 509(3)(A), 15 U.S.C. § 6809 (2003). The Graham-Leach-Bliley Act defined financial institutions as "any institution the business of which is engaging in financial activities as described in section 4(k) of the Bank Holding Company Act of 1956." *Id*. The Bank Holding Company Act of 1956, as amended, defines financial activities to include "providing financial, investment, or economic advisory services, including advising an investment company." 12 U.S.C. § 1843(k)(4) (2003).

[7] As evidence of the difficulty in crafting such an "angel list," we note that even noncontingent debt and common equity issuances could be part of a larger "transaction" that is a tax shelter, so that while the term "structurally unrelated" is far from clear, some such concept would seem to be necessary to preserve the integrity of the carveout.

[8] The initial offering of interests in such vehicles is typically made under conditions of confidentiality, for non-tax reasons. In most cases, while the vehicle is intended to engage in a variety of transactions, the offering documents do not identify specific transactions that the vehicle will engage in. Assuming the establishment of the vehicle is a "transaction" (independent of its subsequent activity), the establishment of the vehicle may be reportable by the investors as a confidential transaction. First, it is likely the vehicle's investors will claim tax benefits from
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Recommendation: We believe Treasury and the Service should promulgate an "angel list" of transaction categories that are not within the confidential transaction category, and should also consider further sharpening the substantive scope of the category.

2. To obtain the benefit of the presumption, taxpayers must be authorized to disclose the tax treatment and tax structure of a transaction, as well as all materials provided to the taxpayer relating to such tax treatment and tax structure. We understand that the "tax structure" of a transaction is intended to encompass only the structural aspects of the transaction relevant to an understanding of the tax treatment of the transaction. Accordingly, the parties' identities (other than their status for tax purposes) and other non-tax commercial or financial information should not be required to be the subject of an authorization to taxpayers. In order to ensure that taxpayers who are authorized to disclose the tax structure and tax treatment do not view themselves as authorized to disclose this non-tax-sensitive information, it is necessary so to inform them.

Moreover, "all materials of any kind . . . relating to such tax structure or tax treatment" is drastically overbroad, encompassing virtually every document provided to a taxpayer in a transaction including, for example, offering memoranda and partnership agreements. Such documents "relate" to the tax structure of a transaction but are not (at least in their entirety) necessary to an understanding thereof, and they often include highly sensitive non-tax-related information. Unless taxpayers are instructed that they must redact such sensitive information before disclosing these "materials" (and issuers are willing to take the risk that taxpayers will appropriately do so), literal satisfaction of the presumption as currently drafted is essentially unattainable in most ordinary commercial transactions.

Recommendation: We believe that it must be made clear that the explicit prohibition of a taxpayer's disclosure of identifying information relating to the parties or their affiliates and, to the extent not necessary to an understanding of the tax structure of a transaction, all sensitive information about the parties (including pricing terms and nonpublic business or financial

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the transaction (including amortization of start-up and management expenses, among others). Second, it is likely that the vehicle's sponsor will have made statements as to potential tax consequences to the investors, typically in the form of tax disclosure in the offering documents. Generally, we do not think it is appropriate that the investors in these vehicles should be required to disclose their investment in the vehicle (as distinct from their participation in subsequent transactions entered into by the vehicle).

We note that it seems, at least literally, that the investors in such a vehicle may also have been offered subsequent transactions entered into by the vehicle under conditions of confidentiality, due to the vehicle's assertion of confidentiality in the initial offering documents. This is because their disclosure of the tax structure and treatment of each such transaction has been limited by the vehicle itself, which may make statements to them, in one form or other, as to potential tax consequences of the transaction. Thus, investors in these vehicles may feel compelled to disclose transactions engaged in by their vehicles that generate any tax benefit.

information), does not jeopardize the presumption against confidentiality.[9] We also believe that it must be made explicit that in order for taxpayers to obtain the benefit of the nonconfidentiality presumption, the authorization may be explicitly limited to disclosure of those documents or portions of documents (redacted as appropriate) necessary to an understanding of the tax treatment or tax structure of the transaction.

3. There is a potential conflict between securities law limitations on offering unregistered securities and the authorization language required in order for investors to obtain the presumption against treatment of a transaction as offered under conditions of confidentiality. As one example, in a "Rule 144A" offering or a private placement of securities, the issuer's counsel may have difficulty rendering an opinion that the offering is made in compliance with the Securities Act of 1933[10] where the issuer in the offering document has authorized investors to disclose the tax treatment or tax structure of the transaction and all materials relating thereto (which as discussed above, absent specific limitation, would presumably include the entire offering document itself).

The principal concern is that an investor may believe that this authorization constitutes an authorization to disclose the issuer's identity and other non-tax related confidential information to third parties (including parties that are not qualified under the Act to purchase securities in a Rule 144A or other private offering), thus raising the question whether the issuer has inappropriately "solicited" purchases of its privately placed securities by unqualified persons without a registration statement. For this reason, it is market practice for issuers to assert confidentiality in private placement or other non-SEC-registered offering memoranda. It is not clear when a condition of confidentiality will be considered "reasonably necessary" to comply with securities laws.[11] Moreover, it is not clear whether it is appropriate, in authorizing disclosure of the tax treatment and tax structure of a transaction, to caveat that such disclosure is limited "to the extent reasonably necessary to comply with the securities laws," as the Regulations would seem to permit.[12]

[9] These sensitive items might include, but are not limited to, a party's proprietary commercial or financial information, intellectual property, trade secrets, customer lists, management, investment strategies, portfolio compositions, fees and pricing terms.

[10] The Act generally requires registration of securities offered to the public. Rule 144A exempts an offering from the registration requirements of the Act if, among other things, the offerees are limited to persons who are "qualified institutional buyers."

[11] We note that authorities interpreting the "ordinary and necessary" standard for determining whether a particular business expense may be deductible under Section 162 have found that an expense was "necessary" when it was "appropriate and helpful." *See, e.g., Welch v. Helvering*, 290 U.S. 111, 113 (1933).

[12] Certain government officials have publicly disapproved of various proposals that would modify or otherwise limit the authorization language to account for securities law limitations. We think a more formal response is warranted.

Recommendation: We believe, in addition to our recommendations in 2., that clarity is needed as to (i) what is "reasonably necessary" to comply with securities laws and (ii) precisely how taxpayers' disclosure of the tax treatment and structure of a transaction may be limited in order reasonably to comply with securities laws.

4. Because in certain circumstances underwriters will constitute "taxpayers" (*e.g.*, if they hold unsold allotments) who might claim "tax benefits," and because underwriters are involved in a very high volume of transactions, under the current Regulations, it may be advisable for other parties to the transaction and their advisers to provide the "magic" presumption language to the underwriters to preserve the position that the underwriters need not disclose their participation in the transaction. However, issuer's and underwriters' counsel in many transactions provide underwriters with fairly standard disclosure opinions relating to the transaction, which are typically made nondisclosable so that investors cannot obtain the opinion from the underwriters and assert a cause of action against the opinion's drafter. While counsel could give the authorization to underwriters subject to the condition that even if counsel's advice is disclosed, no person other than the addressee may rely on it (which we think is perfectly appropriate under the regulations), it is unclear whether this will suffice as a legal matter to cut off any potential cause of action by a third-party recipient of counsel's opinion.

Recommendation: We think that underwriters, acting in their capacity as such, should be categorically excluded from the definition of a "taxpayer" (as opposed to potentially being required to maintain lists of participants).

5. The presumption against confidentiality now requires that each written authorization be delivered to the taxpayer within 30 days of the first tax statement made or provided by the authorizer. Thus, transactions as to which tax statements were made to a taxpayer before January 29, 2003 without the presumption language but that are entered into after February 28, 2003 cannot obtain the benefit of the presumption against confidentiality and thus may for this reason be subject to the Regulations. Similarly, interests in a partnership created prior to the effective date of the Regulations could become subject to the Regulations if transferred after February 28, 2003.

Recommendation: We think some form of transition relief is appropriate so that a transaction that began prior to February 28, 2003 can qualify for the presumption against confidentiality if all required authorization statements have been delivered to the taxpayer within a specified period after the date such relief is provided. We also think it is necessary to clarify how the Regulations, especially the presumption against confidentiality, should apply to transfers of interests created prior to February 28, 2003.

6. Many "ordinary" acquisition transactions, including joint ventures, are effected through the purchase of historic business assets from individuals acting through sole proprietorships, partnerships, limited liability companies or S corporations, or through the purchase of interests in partnerships, limited liability companies or S corporations. The exception provided for confidentiality asserted prior to the announcement of an acquisition

transaction in certain circumstances, however, does not encompass acquisitions of or from businesses other than C corporations, even if such acquisition would otherwise satisfy the requirements of the exception. Because the M&A exception is limited to acquisitions of an historic business with the intent to continue the business, we see no potential for abuse in expanding the exception to include acquisitions from other entities.[13]

Recommendation: We recommend expanding the scope of the "M&A exception" to include, where the other conditions are met, (i) acquisitions of historic business assets from any person and (ii) acquisitions of more than 50% of the stock, capital and profits or similar interests in any entity.

7. The M&A exception currently applies to a proposed taxable or tax-free acquisition of historic assets of a corporation that constitute an active trade or business that the acquiror intends to continue. The continuity of business enterprise requirement contained in the Treasury Regulations under Section 368 is satisfied if the acquiror either (i) continues the target corporation's business or (ii) uses a significant portion of the target's historic business assets in a business. We see no potential for abuse in expanding the exception to more precisely include ordinary transactions that qualify as tax-free reorganizations and meet the continuity of business enterprise requirement.

Recommendation: We recommend expanding the M&A exception to acquisitions of historic assets that will be "used in the active conduct of a trade or business by the acquiror or a member of the acquiror's qualified group (as defined in Treas. Reg. Section 1.368-1(d)(4))."

8. In many M&A transactions, a regulatory filing is required to be made by one or more of the parties. One example is a Hart Scott Rodino filing for antitrust purposes. We do not think this should constitute a "public announcement" of the transaction for purposes of the "M&A exception." We also do not think a "public announcement" should include "leaks" and other announcements or publicization of a potential transaction by other than the potential parties thereto.

Recommendation: We think it is appropriate to clarify that the term "public announcement" as used in the M&A exception does not include a regulatory filing or a third-party publication of a potential transaction.

9. In many M&A transactions, taxpayers will provide each other with disclosure authorization intended to satisfy the M&A exception and then the transaction will be terminated prior to closing. Because the termination may occur after the earliest of the three dates specified

[13] We note in this regard that the "M&A exception" currently carves out acquisitions of non-publicly traded "investment companies" within the meaning of Section 351(e). This carveout could be expanded to include non-publicly traded partnerships that would be treated as investment companies under Section 721(b), which we believe would further limit any potential for abuse.

in the authorization (*i.e.*, after the authorization to disclose the tax structure and treatment of the transaction has become effective under the language of the M&A exception), taxpayers will want the ability to prevent each other from potentially disclosing sensitive non-tax-related information after a deal has "busted." Similar issues may arise in the context of "bids," where a seller offers a transaction structure to multiple buyers; if the seller authorizes each bidder to disclose the tax structure and treatment after the earliest to occur of the three dates (as it will often do in the early stages of the bidding, to ensure that the M&A exception is available once the winning bidder is selected), the losing bidders may feel authorized to disclose sensitive information after the winning bidder's deal is announced, for example. Because M&A participants are typically highly sensitive to the possibility that non-tax-related information may be revealed through a transaction process, we think it is important that these risks be avoided without jeopardizing the availability of the M&A exception.

Recommendation: We think that it should be made explicit that the M&A exception will not be vitiated by a provision that states that a party's authorization to disclose expires once it is determined that that party will not complete the transaction.

10. In many cases, related parties engaging in a transaction, or one party to a transaction and its own employees or agents, will agree on conditions of confidentiality for non-tax reasons, and we question whether it is intended (or appropriate) that such transactions be considered as "offered under conditions of confidentiality."[14]

Recommendation: It should be made explicit that related persons (whether at a 50% or an 80% level) are deemed not to "offer" transactions to each other, and that confidentiality agreements between a participant in a transaction and its own employees or agents are not conditions of confidentiality, in each case within the meaning of the confidential transaction category.

11. The presumption against confidentiality applies only if every person who makes a statement as to potential tax consequences provides written authorization to the taxpayer, even if that person did not impose a confidentiality limitation. Thus, for example, in the context of a securities offering, it appears necessary for persons other than the issuer who make a tax statement (such as lawyers who draft the tax disclosure for the offering memorandum) to provide offerees with their written authorization to disclose the tax structure and treatment. Such authorization may be difficult or impossible to provide in a public context (such as a Rule 144A

[14] As one specific example, in a typical spin-off transaction, distributing and controlled will often agree to confidentiality for non-tax reasons, such as employee morale. It is not clear, as a technical matter, whether the spin-off may benefit from the "M&A exception," because neither distributing nor controlled is "acquiring" any stock, as the M&A exception literally requires. Other examples include internal confidentiality arrangements, whereby a participant in a transaction will require its employees and agents involved in the transaction (rather than other participants) not to disclose the transaction, either to other employees or agents or to third parties. Again, this is often done for reasons relating to employee morale or other non-tax considerations.

offering or other exempt offering) because of the number of investors and the remote connection between the authorizer and the investor.

Recommendation: The Regulations should be amended to provide that, in order to obtain the presumption against confidentiality, written authorization must be received only from persons who have limited the taxpayer's disclosure of the transaction or on whose behalf such disclosure was limited. Failing that, we believe it should be clarified whether and to what extent persons other than the issuer in a securities offering must actually provide written authorization to investors.

12. Because the definition of a "transaction" includes a "plan" or "arrangement," parties who enter into an agreement involving a structured dispute resolution appear literally to have entered into a "transaction." The parties to such agreements commonly require confidentiality as a condition of settlement to avoid the possibility that the settlement agreement could be used as evidence against one of them in subsequent litigation. As this need for confidentiality is unrelated to tax and there is little opportunity for tax abuse in structuring dispute resolutions, we do not believe such agreements should be subject to the Regulations.

Recommendation: We recommend adding a new exception to the confidential transaction category for agreements entered into for the purpose of dispute resolution.

13. We see no reason why a transaction should be a "confidential transaction" merely because a taxpayer's disclosure of the transaction was limited by a person who made statements as to potential tax consequences (as opposed to potential tax *benefits*). More generally, we note that the concept of "statements as to potential tax consequences" in the disclosure rules is significantly (and unnecessarily) broader than the concept of a "tax statement," which is required to trigger the listing requirements for material advisers, and which requires that a statement concern a tax benefit.

Recommendation: We think that a transaction should be a confidential transaction only if a taxpayer's disclosure of the transaction is limited by or for the benefit of any person who makes a statement as to potential tax benefits that may result from the transaction.

Attached hereto is a proposed revision of the confidential transaction section of the disclosure regulations, reflecting the recommendations discussed in this section.

B. Meaning of "Transaction."

Because the definition of a "transaction" includes, among other things, a series of steps carried out as part of a plan, it continues to be unclear when a transaction "results in" losses or book-tax differences. For example, it would be most helpful to clarify that the creation of an investment or trading partnership and the various transactions entered into by that partnership do not generally constitute a single "transaction" for purposes of aggregating the partners' book-tax differences and losses.

Recommendation: We recommend clarification, perhaps by example, that a "transaction" encompasses only items that (without regard to contingencies relating to the magnitude of the item) are reasonably identifiable at the inception of the transaction.[15]

C. Tax benefits.

It is not clear whether a "tax benefit" can be disregarded if it arises solely in connection with a simultaneous or prior ordinary income inclusion by the taxpayer in the same amount. As an obvious example, a taxpayer may be required to include in income original issue discount on a debt instrument and to make a corresponding basis adjustment. Because the basis adjustment, which is a potential tax benefit, occurs contemporaneously with an equivalent ordinary income inclusion, we do not believe that the basis adjustment should be viewed as a "tax benefit" for purposes of the Regulations.

Recommendation: We recommend clarification that a "tax benefit" is disregarded if it arises solely in connection with a simultaneous or prior ordinary income inclusion by the same taxpayer in the same amount. At a minimum, we think it should be clarified that tax benefits do not, without more, include "qualifying basis" as defined in Revenue Procedure 2003-24 (as modified to reflect our suggestion in part D.1., below).

D. Loss Transactions.

1. Under Revenue Procedure 2003-24, "qualifying basis" does not include basis determined in part by reference to prior noncash income inclusions. For example, this means that a holder of a note issued with original issue discount or acquired with market discount will not have a "qualifying basis" in the note and will be required to disclose any resulting loss that exceeds the relevant threshold.

Recommendation: We recommend expanding the definition of "qualifying basis" in Revenue Procedure 2003-24 to include, in addition to "cash" basis, basis determined by a taxpayer's prior noncash income inclusions with respect to the relevant asset (such as original issue discount, market discount, amortizable bond premium, imputed interest income under Treasury Regulations Section 1.446-3(g)(4) and deemed dividend inclusions under Section 305).

2. Under Revenue Procedure 2003-24, holders of interests in "passthrough entities" within the meaning of Section 1260 must take into account losses from the sale or exchange of

[15] We would propose making clear, perhaps by example, that a transaction involving specific offsetting positions involves reasonably identifiable losses, even if the precise terms of the positions are not described to investors or it is not known which of the offsetting positions will generate the loss. We think, however, that it should also be made clear that establishing a vehicle to engage in unspecified offsetting positions, such as the creation of a hedge fund that contemplates engaging in various straddles and other long-short trades over time, is not a single "transaction" all of the losses from which must be aggregated for purposes of the loss-transaction rules.

such interests. It is not clear whether grantor trusts are specifically encompassed within the Section 1260 definition of a "passthrough entity."[16] We see no reason why grantor trust interests should be excluded categorically from the definition of qualifying basis.

Recommendation: We think it should be clarified that an interest in a grantor trust is not an interest in a "passthrough entity" for purposes of Section 4.02 of Revenue Procedure 2003-24.

3. It is not clear whether losses described in Revenue Procedure 2003-24 should be considered in determining whether the transaction is "reportable" under some other category. This is because Section 4.01 of Revenue Procedure 2003-24 provides that losses described in the Revenue Procedure are not to be considered for purposes of determining whether a transaction is a "reportable transaction," while Sections 4.02 and .03 explicitly limit the application of those sections to the loss transaction category. Additionally, the stated purpose of the Revenue Procedure is limited to the loss transaction category.

Recommendation: We recommend clarifying that the losses described in the Revenue Procedure are to be disregarded only for purposes of the loss transaction category.

E. Book-tax differences.

1. In most acquisition transactions, the acquiror uses "purchase accounting" to account for the target's assets for book purposes, which requires the acquiror to value the acquired assets at their then-fair market value. If the transaction is a simple stock purchase, there will be no such adjustment to the tax basis of the target's assets.[17] In such a situation, assuming that the acquiror and the target are consolidated for both book and tax purposes, then under the Regulations, such an acquisition could result in significant book-tax differences due solely to the requirement to use purchase accounting.[18] We do not believe that book-tax differences resulting from purchase accounting are of a type that should cause a transaction to be a potentially abusive tax shelter.

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[16] The tax treatment of grantor trusts under the Code is not consistent; in many cases they are effectively disregarded, although there are also many exceptions to this general rule. In the absence of regulations under Section 1260, in light of the literal language of the Section, it seems quite possible that a grantor trust interest would be treated as described in that Section. Whether this is the appropriate result is beyond the scope of this report.

[17] We do not believe that book-tax basis differences constitute book-tax differences, because they do not in themselves involve any current income, gain, loss, or expense (but only the potential for such items), and we believe that this should be made explicit in Revenue Procedure 2003-25.

[18] An obvious example would involve the acquisition of 100% of the stock of a corporation whose assets have depreciated in value. The "book-down" required by purchase accounting would not be commensurate with any step-down in tax basis of those assets (assuming a Section 338 election is not made), and thus subsequent items of tax depreciation or loss may exceed the corresponding items of book depreciation or loss. As we note in Part B, above, it is not clear whether these potential differences are part of the "transaction" in which the acquiror acquires the target (and we do not believe that they should be), but in any event we do not believe that these items should be treated as book-tax differences for purposes of the Regulations.

Recommendation: Expand the types of book-tax differences enumerated in Revenue Procedure 2003-25 to include book-tax differences arising from the use of purchase accounting for book purposes.

2. The Regulations contain an exception for a parent corporation's participation in a book-tax difference transaction caused by the consolidation of a subsidiary for book purposes but not for tax purposes. This exception includes consolidation "in part," although it is not clear what this means.[19] While we assume this encompasses any inclusion of a subsidiary's book items by its parent, such as differences caused by "equity method" treatment for subsidiaries in which the taxpayer owns 20-50% of the interests, we believe it should be clarified that this is the intended result.

Recommendation: Clarify that for purposes of the book-tax difference category consolidation "in part" refers to any inclusion of a subsidiary's items for book purposes, including inclusions required by the equity method of accounting.

3. The Regulations provide a rule for allocating book items of a partnership to its partner, but it is unclear why this should be the case. Like the case of contractual protection and confidentiality, we see no reason why a partner should be treated as having a book-tax difference simply because its non-consolidated partnership does, unless the partner itself has a sufficiently large book-tax difference from the transaction.

Moreover, we note that the application of this rule is quite unclear. For example, if a partnership marks its positions to market for book purposes but its partners do not, it is not clear whether the marked-to-market items should be allocated to a partner in accordance with the partnership's accounting method or whether adjustments are to be made such that the allocated items are consistent with the partner's accounting method.

Recommendation: We recommend that a partner be treated as having a book-tax difference as a result of a transaction entered into by its partnership only if the partner's book items and tax items differ by the threshold amount. Failing that, we recommend clarifying, perhaps by example, how the partnership allocation rule for book-tax differences should be applied.

[19] Treasury Regulations Section 1.6011-4(c)(3)(ii), example 4(ii), provides that the book-tax differences of a 60%-owned subsidiary are not "attributed" to the parent, even if the subsidiary's book items are included in the parent's accounts, because the parent's book-tax difference arises solely because the subsidiary is not part of the parent's consolidated group for tax purposes (notwithstanding the possibility that the book-tax difference might have resulted even if parent and subsidiary had been consolidated for tax purposes, as it evidently would have under the facts of example 4). The operative provision, however, provides that in order to obtain the benefit of this exception, the subsidiary also must be consolidated with the parent, in whole or in part, for book purposes. *See* Treas. Reg. Section 1.6011-4(c)(3)(i)(E). No explanation is given in the example as to why or how the subsidiary is considered to be "consolidated" with the parent for book purposes.

4. Although there is a special rule in the Regulations allocating partnership book items to the partners (which, as described in Part E.3, above, we think should be modified), there is currently no rule attributing similar book-items of a trust to its owners or grantors.[20] Thus, if a taxpayer that is a reporting company or a large enough business entity does not consolidate a trust in which it is an owner or grantor for book purposes, it is possible that it will be required to disclose many transactions entered into by the trust. It is not clear whether the disparate treatment for trusts as opposed to partnerships was intended or why it is appropriate.

Recommendation: We recommend that the Regulations provide for the same treatment for trusts as for partnership under the book-tax difference rules.

5. Neither the Regulations nor the Revenue Procedure carves out book-tax differences attributable solely to a taxpayer's pre-existing status as a tax-exempt organization under Section 501(a). Because such taxpayers will routinely have book-tax differences in excess of the threshold, and because the scope of a "business entity" is unspecified and potentially quite broad,[21] we think it possible that many large tax-exempt organizations will be required to disclose many of their transactions. We believe this is inappropriate, and assume it was unintended.

Recommendation: Add a carveout in Revenue Procedure 2003-25 for book-tax differences attributable solely to the taxpayer's pre-existing status as a tax-exempt organization under Section 501(a).

6. Revenue Procedure 2003-25, section 2.20, provides that a book-tax difference is disregarded if it results solely from (i) marking to market for book and not tax, (ii) marking to market for tax and not book, or (iii) marking to market for book and tax but using different methodologies. We think this exception is unduly narrow, because a taxpayer who marks to market all of its positions for tax purposes, or who marks to market all items associated with any particular transaction for tax purposes, can not be considered to be achieving a tax benefit of any kind from the transaction. Thus, we see no reason why such a taxpayer should be required to prove that it would not have had a book-tax difference but for such marking to market.

[20] This is also true, technically, for S corporation shareholders, although it is unlikely that an S corporation shareholder (which can only be an individual, trust or estate) will be a reporting company or a sufficiently large business entity to be required to disclose book-tax difference transactions.

[21] *Compare* Treas. Reg. Sec. 301.7701-3(c)(1)(v)(A) (classifying an entity determined to be or claiming to be exempt from taxation under 501(a) as a business entity) *with* Treas. Reg. Sec. 301.7701-2(a) (for a specified purpose, "a business entity is any entity recognized for federal income tax purposes (including an entity with a single owner that is disregarded as an entity separate from its owner . . .) that is not properly classified as a trust under sec. 301-7701-4 or otherwise subject to special treatment under the Internal Revenue Code.").

Recommendation: Section 2.20 of Revenue Procedure 2003-25 should be expanded to exclude any book-tax differences resulting from a transaction if the taxpayer is marking to market all items relating to the transaction for tax purposes, without regard to how the taxpayer accounts for the transaction for book purposes or whether the difference arises "solely" from any differential in methods of accounting.

F. Listed Transactions.

Under a technical reading of the Regulations, it is unclear that a taxpayer ever "participates" in a transaction substantially similar to a Listed Transaction. A transaction "substantially similar" to a Listed Transaction is broadly defined to include a transaction that "is expected to obtain the same or similar types of tax consequences and that is factually similar or based on the same or similar tax strategy." However, in order to be "participating" in a Listed Transaction, a taxpayer's tax return must reflect "tax consequences or a tax strategy described in the published guidance that lists the transaction . . . ." Because a transaction substantially similar to a Listed Transaction may not involve tax consequences or a tax strategy described in published guidance (but only similar consequences or a similar strategy), taxpayers could inappropriately take the position that they are not "participating" in a transaction substantially similar to a Listed Transaction.

Recommendation: Clarify, perhaps by example, how a taxpayer "participates" in a transaction substantially similar to a Listed Transaction.

G. Reporting Shareholders.

Except in the case of book-tax difference transactions, "reporting shareholders" of foreign corporations must disclose the corporation's transactions if the corporation would be required to disclose were it domestic. A reporting shareholder, for example, must disclose a transaction entered into by the corporation solely because the corporation is asked for confidentiality or has been given contractual protection against loss of tax benefits. This rule is significantly broader than the rules regarding a partner's participation in transactions of a partnership, which require for example that the partner have been asked for confidentiality or given contractual protection.[22] Moreover, it may be difficult or impossible for the shareholder to comply with this rule, because the shareholder may not know that a transaction entered into by the corporation is a reportable transaction.

[22] We note that it is difficult as a policy matter to reconcile the treatment of domestic partnerships, foreign partnerships and foreign corporations under the Regulations. If the concern underlying the differential treatment of foreign corporations is that they do not file U.S. tax returns and so will not disclose otherwise disclosable transactions in their own returns, the same concern would seem to apply to foreign partnerships.

We note also, as a more general related point, that we believe an economic disincentive to disclosure of the tax structure and treatment of a transaction should be considered a "limitation" and clarification on the point may be warranted.

Recommendation: We think a U.S. shareholder of a foreign corporation should be treated as a participant in a reportable transaction only to the extent it would be so treated if the corporation were a partnership and the U.S. shareholder were a partner in such partnership.

H. List Maintenance Regulations.

1. It is possible to interpret the Regulations so that information reports and statements required by law constitute "tax statements." For example, a partnership is required to deliver a Schedule K-1 to each partner annually, often attaching additional documents to explain various items on the Schedule. Because information reports like Schedules K-1 often contain statements as to the potential tax consequences of transactions, if the partners have agreed to maintain confidentiality as to the partnership and its transactions, this could result in a partner's obligation to disclose those transactions. Moreover, if an information report such as a Schedule K-1 or IRS Form 1099-B describes losses, for example, the distributor of such a report may be treated as having made a "tax statement" and could therefore be required to maintain a list of its recipient(s). Because such reports are required by law, they should not be treated as "statements" for purposes of the Regulations.

Recommendation: Clarify that information reports or other statements required by any taxing authority, and any supporting documentation provided in connection therewith, will not constitute either "statement[s] . . . as to the potential tax consequences that may result from" a transaction for purposes of Treasury Regulations Section 1.6011-4(b)(3) or "tax statements" for purposes of Treasury Regulations Section 301.6112-1(c)(2)(iii).

2. Section 301.6112-1(e)(2)(i) provides that persons described in Treasury Regulations Section 301.6112-1(c)(2)(i)(A) through (D) must be included on a list; however an example indicates that persons described in Section 301.6112-1(c)(2)(i)(E) must also be included.[23] It is not clear why persons described in clause (E) were not explicitly identified as persons who must be included on a list.

[23] The example involves a corporation, M, that describes the potential loss from a transaction type to another corporation, N, which pays M for the information. M knows that N will sell the information to O and P, and that O and P will participate in that type of transaction. O and P pay N for the transaction, and N makes tax statements to O and P. Both M and N know that O and P will be required to disclose the transaction under Treasury Regulations Section 1.6011-4(b)(5). The example concludes that M's "information" provided to N is a potentially abusive tax shelter and also that M knew that N would transfer the information to O and P who would have to disclose the transaction. Accordingly, M must maintain a list of N and, because M knows about their "subsequent participation," O and P as well.

Technically, M is a "material adviser" because it gave "tax statements" to N, who is described in Treasury Regulations Section 301.6112-1(c)(2)(i)(E). However, under Treasury Regulations Section 301.6112-1(e)(2)(i), material advisers are required to maintain lists only of people described in Treasury Regulations Section 301.6112-1(c)(2)(i)(A) through (D). Thus, technically, notwithstanding the example, N is not required to be on M's list.

Recommendation: Issue a technical correction encompassing within the scope of persons required to be included on a list those described in clause 301.6112-1(c)(2)(i)(E).

I. Pending and Future Legislation.

We believe it is essential that any legislation relating to "reportable transactions" be conformed to the scope of the Regulations.[24] In addition, legislation that significantly redefines a "reportable transaction" or a "material advisor" may create unnecessary confusion and uncertainty. Accordingly, we strongly encourage Treasury to coordinate with Congress so that any enacted future legislation will be consistent with the existing legal framework.

[24] *See, e.g.*, Energy Tax Incentives Act of 2003, S. 1149, 108th Cong. (2003); Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2003, H.R. 1555, 108th Cong. (2003); Charity Aid Recovery and Empowerment Act, S. 476, 108th Cong. (2003).

ATTACHMENT

There follows a proposed amendment to Treasury regulations Section 1.6011-4(b)(3), reflecting various of our recommendations described in this report:

(i) In general. A confidential transaction is a transaction that is offered to a taxpayer under conditions of confidentiality. A transaction is considered offered under conditions of confidentiality only if the taxpayer knows or has reason to know that its use or disclosure of the tax treatment or tax structure of the transaction to (A) any independent tax adviser or advisers (as long as any such independent tax adviser's disclosure of the tax treatment and structure of the transaction is not limited in any way, other than by the attorney-client privilege or the tax practitioner privilege under Section 7525) or (B) any taxing authority, is limited in any manner by an express or implied understanding or agreement with or for the benefit of any person (other than a person related to the taxpayer within the meaning of Section 267(b) or 707(b) or an employee, representative or other agent of the taxpayer) who makes or provides a statement, oral or written, to the taxpayer (or for whose benefit a statement is made or provided to the taxpayer) as to the potential tax benefits that may result from the transaction, whether or not such agreement is legally binding. . . .

(ii) . . . .

(B) Mergers and acquisitions. In the case of a proposed taxable or tax-free acquisition of historic assets of a business (other than from an investment company, as defined in section 351(e), or a partnership that is described in Section 721(b), that is not publicly traded) that are used in the active conduct of a trade or business by the acquirer or a member of its qualified group (as defined in Treas. Reg. Section 1.368-1(d)(4)), or a proposed taxable or tax-free acquisition of more than 50 percent of the stock, capital and profits or similar interests in any entity (other than an investment company, as defined in section 351(e), or a partnership described in Section 721(b), that is not publicly traded) that owns historic assets that are used in the active conduct of a trade or business by the acquirer or a member of its qualified group (as defined in Treas. Reg. Section 1.368-1(d)(4)), the transaction is not considered a confidential transaction under this paragraph (b)(3) if the taxpayer is permitted to disclose the tax treatment and tax structure of the transaction no later than the earlier of the date of the public announcement by the parties (other than to any governmental agency) of discussions relating to the transaction, the date of the public announcement by the parties of the transaction (other than to any governmental agency), or the date of the execution of an agreement (with or without conditions) to enter into the transaction. However, this exception is not available where the taxpayer's ability to consult any tax advisor (including a tax advisor independent from all other entities involved in the transaction) regarding the tax treatment or tax structure of the transaction is limited in any way. The exception provided by this subparagraph (b)(3)(ii)(B) shall not be affected by any limitation on the taxpayer's ability to disclose the tax structure or tax treatment of a transaction following the termination of discussions regarding the transaction with the taxpayer.

(iii) Presumption. Unless the facts and circumstances indicate otherwise, a transaction is not considered offered to a taxpayer under conditions of confidentiality if every person who has limited in any way the taxpayer's disclosure of the tax treatment or tax structure of the transaction provides express written authorization to the taxpayer in substantially the following form: "Effective from the commencement of discussions, the taxpayer (and each employee, representative, or other agent of the taxpayer) may disclose the tax treatment and tax structure of the transaction and, only to the extent necessary to an understanding of the tax treatment or tax structure of the transaction, all materials of any kind (including opinions or other tax analyses) that are provided to the taxpayer, to any of the following persons, without limitation of any kind: (i) any independent tax adviser or advisers (as long as such independent tax adviser's disclosure of the tax treatment and structure of the transaction is not limited in any way, other than by the attorney-client privilege or the tax practitioner privilege under Section 7525) or (ii) any taxing authority." Except as provided in paragraph (b)(3)(ii) of this section, this presumption is available only in cases in which each written authorization is given no later than 30 days from the day the person providing the written authorization first limits the taxpayer's ability to disclose the tax treatment or tax structure of the transaction. A transaction that is claimed to be exclusive or proprietary to any party other than the taxpayer will not be considered a confidential transaction under this paragraph (b)(3) if written authorization to disclose is provided to the taxpayer in accordance with this paragraph (b)(3)(iii) and the transaction is not otherwise confidential. The presumption provided by this paragraph (b)(3)(iii) shall not be affected by any limitation on the taxpayer's ability to disclose the identities of any party to the transaction or (unless and except to the extent necessary to an understanding of the tax treatment and tax structure of the transaction) any other information or materials regarding or describing any party to the transaction, its assets, business or financial information, or any pricing terms or fees associated with the transaction.