III.C.3. Return Line Items

Introduction

Tax shelters take various forms and involve multi-step transactions that may include: loans, assets, sales, transfers/ exchanges, stock transactions, leases, rental income or expenses, service contracts, professional fees, insurance, gains/losses, annuities, investments, charitable contributions, depreciation deductions, financial instruments (options, swaps, debt instruments, etc.), foreign tax credits, employee benefit plans, assumption of liabilities, and the creation of Controlled Foreign Corporations (CFCs), trusts, partnerships, 1120s, or subsidiary corporations.

Therefore, there are no set line items on the return that will alert the agent to the presence of a tax shelter. However, the standard audit techniques found in the EQMS Audit Guide and the IRM Technical Guide both serve as good reference sources.

Examination Quality Management System Audit Guide

Examination Quality Management System has developed an Audit Guide to help in examinations. The web link is:

http://cqms.ncal.wr.irs.gov/EQMSWelcome/reviewer.htm

Audit Scope

One of the eight standards found in the Audit Guide is Audit Scope, Standard 2. This section of the Audit Guide discusses various areas that an auditor should look at during the course of an audit. When looking for tax shelters, these same areas are important. A key element in the search for tax shelters is to look for the large, unusual, or questionable (LUQ) items (i.e. income, deduction, credit, and other transactions) on the return and those that become evident during the examination. Balance sheet and Schedule M items on the return should be considered. Be aware that amounts on the tax return or the general ledger may be netted. Therefore, accounts with irregular activity should be identified for in-depth analysis.

Unusual and Material Amounts

Also, consideration should be given to accounts with unusual titles or unusual amounts. Items can be material in absolute dollar value, relative dollar value, material when viewed on a multiple year comparison, and/or material to the specific industry involved. Judgment and experience should also be used in determining issues of materiality.

Continued on next page

IRM Cites

IRM CITES FOR STANDARD 2

2. A1. Were LUQ income/deduction/balance/credit items considered?

4.2.2.3	In-Depth Pre-Contact Analysis
4.2.2.3.1	LUQ's Defined
4.2.3.6.1.1	Sch M-l Audit Technique
4.2.3.8	Balance Sheet Analysis

The web link for this IRM section is:

(http://publish.no.irs.gov/pubsys/irm/indp04.html)

LUQ's

(Large, Unusual, Questionable Items)

The IRM defines LUQ's in the Examination Of Returns Handbook, under Examination Techniques at 4.2.2.3.1. This section states:
"

(1) The definition of a large, unusual, or questionable item (LUQ) will depend on the examiner's perception of the return as a whole and the separate items that comprise the return. Some factors to be considered when identifying LUQs are:

a. Comparative size of the item
b. Absolute size of the item
c. Inherent character of the item — although the amount of an item may be insignificant, the nature of the item may be significant
d. Evidence of intent to mislead — this may include missing, misleading or incomplete schedules, or incorrectly showing an item on the return.
e. Beneficial effect of the manner in which an item is reported — expenses claimed on a business schedule rather than claimed as an itemized deduction.
f. Relationship to other items — incomplete transactions identified on the tax return.
g. Whipsaw Issues — whenever there is a transaction between two parties and characteristics of the transaction will benefit one party and harm the other.

Continued on next page

Review Return to Identify LUQ's

Regardless of the type or class of return being examined, examiners should first review the return in its entirety. This review should include not only the line items and credits claimed, but also such things as the balance sheet, elections, schedules, or any other documents attached to the return.

After the return has been reviewed and a LUQ has been found, the agent should analyze the transaction to determine if it is similar to any of the known listed transactions (See Section I.D.2.), or whether it possesses any tax shelter characteristics discussed in Temp. Treas. Reg. §1.6011-4T.

Temp. Treas. Reg. §1.6011-4T

The following is a partial extract from Temp. Treas. Reg. §1.6011-4T. There are certain exceptions not set forth below.

(b) Definition of reportable transaction –

(1) In general. A reportable transaction is a transaction that is described in either paragraph (b)(2) or (3) of this section and that meets the projected tax effect test in paragraph (b)(4) of this section. The term transaction includes all of the factual elements necessary to support the tax benefits that are expected to be claimed with respect to any entity, plan, or arrangement, and includes any series of related steps carried out as part of a prearranged plan and any series of substantially similar transactions entered into in the same taxable year.

(2) Listed transactions. A transaction is described in this paragraph (b)(2) if the transaction is the same as or substantially similar to one of the types of transactions that the Internal Revenue Service (IRS) has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction for purposes of section 6011.

Continued on next page

Temp. Treas. Reg. §1.6011-4T

(Continued)

(3) Other reportable transactions -- (i) In general. Except as provided in paragraph (b)(3)(ii) of this section, a transaction is described in this paragraph (b)(3) if it is entered into after February 28, 2000, and has at least two of the following characteristics:

(A) The taxpayer has participated in the transaction under conditions of confidentiality (as defined in Treas. Reg. § 301.6111-2T(c)).

(B) The taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained, including, but not limited to, recission rights, the right to a full or partial refund of fees paid to any person, fees that are contingent on the taxpayer's realization of tax benefits from the transaction, insurance protection with respect to the tax treatment of the transaction, or a tax indemnity or similar agreement (other than a customary indemnity provided by a principal to the transaction that did not participate in the promotion of the transaction to the taxpayer).

(C) The taxpayer's participation in the transaction was promoted, solicited, or recommended by one or more persons who have received or are expected to receive fees or other consideration with an aggregate value in excess of $100,000, and such person or persons' entitlement to such fees or other consideration was contingent on the taxpayer's participation in the transaction.

(D) The expected treatment of the transaction for Federal income tax purposes in any taxable year differs or is expected to differ by more than $5 million from the treatment of the transaction for purposes of determining book income as taken into account on the schedule M-1 (or comparable schedule) on the taxpayer's Federal corporate income tax return for the same period.

(E) The transaction involves the participation of a person that the taxpayer knows or has reason to know is in a Federal income tax position that differs from that of the taxpayer (such as a tax exempt entity or a foreign person), and the taxpayer knows or has reason to know that such difference in tax position has permitted the transaction to be structured on terms that are intended to provide the taxpayer with more favorable Federal income tax treatment than it could have obtained without the participation of such person (or another person in a similar tax position).

Continued on next page

Temp. Treas. Reg. §1.6011-4T

(Continued)

(F) The expected characterization of any significant aspect of the transaction for Federal income tax purposes differs from the expected characterization of such aspect of the transaction for purposes of taxation of any party to the transaction in another country.

(4) Projected tax effect -- (i) In general. A transaction described in paragraph (b)(2) of this section meets the projected tax effect test if, at the time the taxpayer enters into the transaction or at any time thereafter, the taxpayer reasonably estimates that the transaction will reduce the taxpayer's Federal income tax liability by more than $1 million in any single taxable year or by a total of more than $2 million for any combination of taxable years in which the transaction is expected to have the effect of reducing the taxpayer's Federal income tax liability. A transaction described in paragraph (b)(3) of this section meets the projected tax effect test if, at the time the taxpayer enters into the transaction or at any time thereafter, the taxpayer reasonably estimates that the transaction will reduce the taxpayer's Federal income tax liability by more than $5 million in any single taxable year or by a total of more than $10 million for any combination of taxable years in which the transaction is expected to have the effect of reducing the taxpayer's Federal income tax liability. For purposes of this paragraph (b)(4), a transaction will be treated as reducing a taxpayer's Federal income tax liability for a taxable year if, and to the extent that, disallowance of the tax treatment claimed or expected to be claimed would result in an increase in the taxpayer's Federal income tax liability for that year. These dollar thresholds may be adjusted pursuant to forms prescribed for reporting under this section and the instructions to such forms.

Continued on next page

Temp. Treas. Reg. §1.6011-4T

(Continued)

(ii) Estimation of projected tax effect. A taxpayer's estimate of the effect of a transaction on its Federal income tax liability shall take into account all projected Federal income tax consequences of the transaction, including all deductions, exclusions from gross income, non-recognition of gain, tax credits, adjustments (or the absence of adjustments) to the basis of property, and any other tax consequences that may reduce the taxpayer's Federal income tax liability by affecting the timing, character, or source of any item of income, gain, deduction, loss, or credit. The estimate shall not take into account the potential Federal income tax effect of any other transaction or transactions that the taxpayer might have entered into if the taxpayer had not entered into the transaction in question. Gross income may not be taken into account if the elements of the transaction that result in the creation of the gross income are not necessary to achieve the intended tax results of the transaction, whether or not these elements are an integral part of the transaction. For example, gross income may not be taken into account to the extent that it would have been reasonably possible for the taxpayer to have participated in the transaction in a manner that would have been expected to produce less gross income without a commensurate effect on the other tax consequences of the transaction. In addition, gain on property that the taxpayer acquired independent of its participation in the transaction may not be taken into account.

Treasury White Paper on Corporate Tax Shelters

The following seven characteristics of corporate tax shelters were identified in the Treasury White Paper:

- **Lack of economic substance**
- **Inconsistent financial accounting and tax treatments**
- **Tax-indifferent parties**
- **Marketing activity**
- **Confidentiality**
- **Contingent or refundable fees and rescission or insurance arrangements**
- **High transaction costs**

Review Section 1B2 for an in-depth discussion of the characteristics of corporate tax shelters.

III.C.3. Specific Tax Return Lines

Introduction

While there are no set line items on the tax return that will necessarily alert the agent to the presence of a tax shelter, some of the line items that may indicate the presence of tax shelter transactions are discussed in this section.

Items to Look at

Some items on a tax return that may indicate a potential tax shelter are:

1. Large loans
2. Acquisition or sale of assets
3. Stock transactions
4. Large leases
5. Rental income or expenses
6. Service contracts
7. Large professional fees
8. New insurance plans/ subsidiaries
9. Large gains/ losses
10. Annuities
11. Large investments
12. Large charitable contributions
13. Large depreciation deductions
14. Large amortization deductions
15. Financial instruments (options, swaps, debt instruments, etc)
16. Large foreign tax credits
17. New employee benefit plans
18. Assumption of liabilities
19. Creation of CFCs, trusts, partnerships, 1120s, or subsidiary corporations
20. Large Schedule M-1s

Netting

These items may be <u>netted</u>. This is particularly true on Sch. D. Agents, therefore, should request tax return work papers, tax compilation schedules, sub-ledgers/journals, and the original schedules that support the sub-ledgers/journals (where expense/income is first recorded). Often, due to accounting practices that may allow some items for book but not for tax, an item may be netted before it reaches the general ledger.

Continued on next page

Look at Whole Transaction

When the items listed above are found on a tax return, they may represent only a part of the transaction. In order to determine if there is a tax shelter, the arrangement needs to be looked at in the context of the whole transaction with all involved parties.

Economic and Business Sense

The key question to be answered is: When the transaction is looked at as a whole, **does** it **make economic and business sense when it is isolated from the tax benefits it generates?**

Sample Return Lines

Some of the lines on the tax return that may indicate tax shelter transactions are shown below:

Form 1040

Form 1040 –

- Line 13 Capital gain or (loss)
  — Schedule D
- Line 14 Other gains or (losses)
  — Form 4797
- Line 17 Rental real estate, royalties, partnerships, S corporations, trusts, etc.
  — Schedule E
- Line 21 Other income
- Line 36 Itemized deductions
  — Schedule A
- Line 43 Foreign tax credit
  — Form 1116

Continued on next page

Form 1065

Form 1065 –

- Line 4 Ordinary income (loss) from other partnerships, estates, and trusts
- Line 6 Net gain (loss)
  — Form 4797
- Line 7 Other income (loss) *(attach schedule)*
- Line 12 Bad debts
- Line 15 Interest
- Line 16a Depreciation
  — Form 4562
- Line 19 Employee benefit programs
- Line 20 Other deductions *(attach schedule)*
- Schedule B- Lines 6, 8, 10, & 11.
- Schedule K- Lines 4, 5, 7, 8, 10, 11, 14, 16, 17, 19, 22, 23, & 24
- Schedule L - Lines 2, 8, 12, 13, 15, 19, 20 & 21
- Schedule M-1
- Schedule M-2
- Schedule K-1 (Form1065)

Form 1120S

Form 1120S –

- Line 4, Net gain (loss)
  — Form 4797,
- Line 5, Other income (loss) (attach schedule)
- Line 10, Bad debts
- Line 13,Interest
- Line 14, Depreciation
  — Form 4562
- Line 18, Employee benefit programs
- Line 19, Other deductions (attach schedule)
- Schedule B, Lines 5 & 6
- Schedule K, Lines 1,4, 5, 6, 7, 9, 10, 11, 13, 14, 15, 16, 17, 18, 19, 20, 21
- Schedule L, Lines 2, 6, 7, 9, 10, 12, 13, 14, 16, 17, 18, 19, 20, 21, 22, 23
- Schedule M-1
- Schedule M-2
- Schedule K-1 (Form 1120S)

Continued on next page

Form 1120

Form 1120 –

- Line 4, Dividends
  — Schedule C
- Line 5, Interest
- Line 6, Gross rents
- Line 7, Gross royalties
- Line 8, Capital gain (losses)
  — Schedule D[1]
- Line 9, Net gain or (loss)
  — Form 4797[2]
- Line 10, Other income (attach schedule)
- Line 15, Bad debts
- Line 16, Rents
- Line 18, Interest
- Line 19, Charitable contributions
- Line 20, Depreciation
  — Form 4562
- Line 24, Pension, profit-sharing, etc., plans
- Line 25, Employee benefit programs
- Line 26, Other deductions (attach schedule)
- Schedule C
- Schedule J
- Schedule K,
- Schedule L, Lines 2, 6, 7, 9, 10, 12, 13, 14, 16, 17, 18, 19, 20, 21,22, 23
- Statements attached regarding - IRC §§ 351 and 368, as well as Reg. § 1.1502-20
- Disclosure statements under Temp. Treas. Reg. §1.6011-4T
- Disclosure statements under IRC § 6662
- Schedule M-1 and supporting statements
- Schedule M-2

Continued on next page

[1] In many Coordinated Industry taxpayers' tax returns, a statement –is attached such as "Details available upon request." It is essential to compare the annual report to the return. If the annual report (or other source of information) indicates a large gain from the disposition of an asset, a gain is not reported and no large M-1 adjustment is shown on the return, a large loss may have been netted.

[2] Same as above

Misc. Forms

Misc. Forms

- Form 1116, Foreign Tax Credit
- Form 2555, Foreign Earned Income
- Form 4562, Depreciation and Amortization
- Form 4797, Sales of Business Property
- Form 4952, Investment Interest Expense Deduction
- Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations
- Form 6252, Installment Sale Income
- Form 6781, Gains and Losses from Section 1256 Contracts and Straddles
- Form 8271, Investor Reporting of Tax Shelter Registration Number
- Form 8283, Noncash Charitable Contributions
- Form 8582, Passive Activity Loss Limitations
- Form 8824, Like Kind Exchanges

Technical Advisors should be contacted for help in developing tax shelter issues. A listing of the Technical Advisors can be found in lesson III.C.3. Also, Area Counsel should be brought in early.