ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES (ACT)

TE/GE ABUSIVE TAX SHELTERS INVOLVING TAX-EXEMPT AND GOVERNMENT ENTITIES PROJECT GROUP

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The TE/GE Abusive Tax Shelters Involving Tax-Exempt and Government Entities Project Group respectfully submits the following report to the Advisory Committee on Tax Exempt and Government Entities (ACT) for transmittal to the Internal Revenue Service, Tax Exempt and Government Entities (TE/GE) Division.

EXECUTIVE SUMMARY

The Advisory Committee on Tax Exempt and Government Entities (ACT) created the TE/GE Abusive Tax Shelters Involving Tax-Exempt and Government Entities Project Group to study how the Tax Exempt and Government Entities (TE/GE) Division could better respond to abusive tax shelters and other abusive tax schemes. The goal of this project has been to identify various strategies that can be used by TE/GE and its component segments: Employee Plans (EP); Exempt Organizations (EO); and Government Entities (GE).

A. CATEGORIES OF TAX TRANSACTIONS

Tax transactions generally fall into three general categories, described below.

The first category consists of legitimate tax shelters that take advantage of the tax-savings advantages that Congress has written into the Code. For example, tax-exempt organizations, tax-qualified retirement plans, and tax-exempt bonds all involve such legitimate “tax shelters.” Monitoring and enforcing compliance with the rules necessary to obtain the advantages of such legitimate “tax shelters” is, of course, a core part of the TE/GE mission.

At the other end of the spectrum, there is another category of tax shelters and schemes consisting of abusive transactions that are aggressively sold by promoters in reckless disregard of Code provisions and that, under any reasonable interpretation, provide no basis for the tax advantages purportedly offered by those transactions. Such abusive tax transactions should (and do) lead to criminal prosecution and to civil enforcement mechanisms that focus on fraud.

In the middle is a broad category of tax transactions that may comply with the literal language of a specific tax provision yet yield tax results that may be unwarranted, unintended, or inconsistent with the underlying policy of the provision. Some of these disputed transactions should also be characterized as abusive tax transactions.

Of particular concern, are abusive tax transactions that are heavily “promoted” or that have the risk of becoming widely used. One important goal of the IRS’s initiatives against abusive tax transactions should be to chill the promotion or spread of such abusive tax transactions.

TE/GE uses a variety of statutory provisions, judicial doctrines, and regulatory guidance to identify and curb abusive tax transactions. For example, a number of the abusive tax transactions involving tax-exempts have been identified as ”listed transactions” that must be disclosed on taxpayer returns. Similarly, many Code section 6700 tax-promoter-penalty cases involve tax-exempt bonds. Still other abusive schemes involve overvaluation of contributions to tax-exempt organizations. On the whole, the Project Group believes that TE/GE is doing a good job in combating abusive tax shelters and other abusive tax schemes.

B. RECOMMENDATIONS

The Project Group makes the following recommendations that are elaborated on in Part IV of this report:

1. Focus on Promoters and Self-Promoting Transactions

With limited resources, the TE/GE Division simply cannot curb many abusive tax transactions audit-by-audit or taxpayer-by-taxpayer. The normal audit process catches many abuses, but, of course, this approach is very labor intensive. It is a kind of “retail” approach to catching abuses, and with limited resources, TE/GE should strive to curb abuses on a more “wholesale” basis. The more effective strategy is to try to stop the promoters who are marketing abusive tax transactions to multiple taxpayers. A second related “wholesale” approach is to focus on transactions that tend to “self-promote” and spread widely quickly. TE/GE should focus on these promoted and self-promoting transactions.

2. Open an Office of Abusive Tax Transactions

Another way to help TE/GE deal with abusive tax transactions would be to provide a single location to coordinate information received relating to abuses. Such an “Office of Abusive Tax Transactions” could also help to coordinate a more effective response by the TE/GE Division to identified abusive tax transactions.

This new office could: (1) provide a central “reporting house” for third parties and internal persons to report suspected promotion schemes and self-promoting transactions; (2) catalog and profile schemes and trends; (3) assist the TE/GE functions in the allocation of resources to abusive tax transactions; (4) increase employee knowledge and skills related to abusive tax transactions; and (5) enhance coordination within the IRS on issues related to abusive tax transactions. The office might initially be quite small, and essentially act as a clearinghouse to gather information and pass it along to the directors of the TE/GE segments.

The new office should also help develop a strategy for dealing with each identified abusive tax transaction. The new office would also be instrumental in coordinating with the other IRS operating divisions. That coordination role will be especially important because so many abusive tax transactions that involve tax-exempts show up, if at all, only on tax returns that are reviewed by the other operating divisions.

In short, the new office should help identify abusive tax transactions involving tax-exempt and government entities, help develop the strategies needed to deal with those abuses, and help implement those strategies.

3. Expand the Tools for Discovering Abusive Tax Transactions

The TE/GE Division learns about potentially abusive transactions from: routine audits, the determination letter process, other IRS operating divisions, legitimate practitioners who care about good tax policy, and even from newspaper and magazine stories. TE/GE should streamline its ability to get information about potentially abusive tax shelters and other schemes, perhaps by adding an "abuse line" to its phone bank and a "report-abuses-here" link on its World Wide Web page. In addition, the Project Group believes that TE/GE should be more proactive about uncovering abusive transactions. For example, TE/GE officials should encourage legitimate practitioners and industry representatives to "blow the whistle" on abusive tax transactions.

4. Provide Additional Priority to Guidance Projects for Disputed Tax Transactions that are Promoted or Self-promoted

TE/GE needs to act quickly to identify potentially abusive tax transactions and to develop strategies for dealing with them. If a disputed tax transaction is being promoted or self-promoted and becoming widespread, the sooner that TE/GE can step in and issue formal guidance, the better. Moreover, while the formal guidance process is pending, TE/GE should sometimes issue soft guidance (*e.g.*, Notices and Announcements) to curb the transactions.

5. Keep Identifying Listed Transactions

The Project Group was impressed with the efforts that the TE/GE Division has made to list potentially abusive transactions. The Project Group believes that the listing process has curbed a number of serious abuses. Moreover, the Project Group believes that having an ongoing listing process gives more credibility to honest practitioners who refuse to do suspect deals for clients. Listing puts the IRS on notice that taxpayers are claiming the benefits of a potentially abusive tax transaction and so gives the IRS an opportunity to challenge the transaction or request more information about it.

6. Bring More Criminal Cases

The Project Group believes that bringing more criminal investigations and prosecutions would have a significant deterrent effect on abusive tax transactions. In particular, the Project Group would like to see TE/GE, together with Criminal Investigation (CI) and the Department of Justice, make examples of some of the worst promoters of abusive tax transactions involving tax-exempt and government entities. In that regard, the Project Group recommends that TE/GE work with CI and the Department of Justice to develop a program to better educate TE/GE employees about criminal tax cases and about the "badges of fraud" that CI employees look for in developing cases for prosecution, and to better educate CI employees about abusive tax transactions that involve tax-exempt and government entities.

7. Modify TE/GE Forms to Steer Clients Away from Abusive Tax Transactions

IRS Forms can often steer taxpayers away from abusive tax transactions. For example, IRS Forms 1023 and 1024 help ensure that only qualifying entities can get exempt-organization status. The Project Group believes that TE/GE should solicit taxpayer and practitioner input about how it might change some of its other forms to improve compliance and generate more useful information.

I. INTRODUCTION

At the ACT working session on October 1-2, 2002, ACT determined that one of its projects would be to advise the Tax Exempt and Government Entities (TE/GE) Division about how to respond to abusive tax shelters and other abusive tax schemes involving tax-exempt and government entities. The Project Group's other working sessions were held on January 21-22, 2003, March 25-26, 2003, and May 20, 2003.

The following ACT members worked primarily on this project: Jonathan B. Forman (project leader), Brian L. Anderson, and Perry Israel. In addition, the following ACT members served as adjunct members on this project: Victoria B. Bjorklund, Karl E. Emerson, and David Mullon.

TE/GE and TE/GE Counsel officials and employees devoted countless hours to helping the Project Group understand how the Internal Revenue Service (IRS) deals with abusive tax shelters and other abusive tax schemes involving tax-exempt and government entities. These officials indicated that they were particularly interested in receiving advice about: (1) how to improve TE/GE's ability to find out about abusive tax shelters and other abusive tax schemes; (2) which anti-abuse tools the various segments of TE/GE should use to combat these abuses; (3) how IRS forms could be improved to help TE/GE identify these abuses; and (4) how TE/GE could encourage the other IRS Divisions to tap the expertise of TE/GE with respect to abusive tax transactions involving tax-exempt and government entities.

II. BACKGROUND

This part provides some general background about tax shelters and other abusive tax schemes and about how the IRS deals with these abuses.[1] The next part focuses more specifically on how TE/GE and its component parts have been dealing with tax shelters and abusive schemes.

There is no uniform standard as to what constitutes a tax shelter. Tax shelters generally fall into three general categories, described below.

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[1] *This part draws heavily from* JOINT COMMITTEE ON TAXATION, BACKGROUND AND PRESENT LAW RELATING TO TAX SHELTERS *(JCX-19-02, March 19, 2002); and* U.S. GENERAL ACCOUNTING OFFICE, INTERNAL REVENUE SERVICE: EFFORTS TO IDENTIFY AND COMBAT ABUSIVE TAX SCHEMES HAVE INCREASED, BUT CHALLENGES REMAIN, *(Report No. GAO-O2-733, 2002).*

The first category consists of legitimate tax shelters that take advantage of the tax-savings advantages that Congress has written into the Internal Revenue Code ("Code"). For example, tax-exempt organizations, tax-qualified retirement plans, and tax-exempt bonds all involve such legitimate "tax shelters." Monitoring and enforcing compliance with the rules necessary to obtain the advantages of such legitimate "tax shelters" is, of course, a core part of the TE/GE mission.

At the other end of the spectrum, there is another category of tax shelters consisting of transactions or products that are aggressively sold by promoters in reckless disregard of Code provisions and that, under any reasonable interpretation, provide no basis for the tax advantages purportedly offered by those transactions or products. Such tax shelters should (and do) lead to criminal prosecution and civil enforcement mechanisms that focus on fraud. For the remainder of this report, we will refer to these as "abusive tax transactions."

In the middle is a broad category of tax shelters consisting of transactions that may comply with the literal language of a specific tax provision yet yield tax results that may be unwarranted, unintended, or inconsistent with the underlying policy of the provision. As to that middle category, there are a variety of statutory provisions, judicial doctrines, and administrative guidelines that attempt to limit or identify transactions in which a significant purpose is the avoidance or evasion of tax. There may be substantial dispute as to whether these types of transactions qualify for the purported tax benefits they yield. For the remainder of this report, we will refer to this middle category of transactions as "disputed tax transactions."

Of particular concern, especially for abusive tax transactions, but also for disputed tax transactions, are arrangements that are heavily "promoted" or that have the risk of becoming widely used. One particular goal of the IRS's initiatives against abusive tax transactions is to chill the promotion or spread of such transactions.

A. PRESENT-LAW PRINCIPLES APPLIED TO TAX SHELTERS

The Internal Revenue Code ("Code") provides specific rules regarding the determination of tax liability, and taxpayers generally may plan their transactions in reliance on these rules to determine the Federal tax consequences arising from those transactions. Notwithstanding the presence of specific rules for determining tax liability, a body of law has evolved in response to transactions that may comply with the literal language of a specific tax provision yet yield tax results that are unwarranted, unintended, or inconsistent with the underlying policy of the provision.

1. Selected Statutory Provisions Limiting Tax Benefits in Certain Transactions

Section 269. Section 269 provides that if a taxpayer engages in certain transactions for the principal purpose of evading or avoiding Federal income tax by securing the benefit of a deduction, credit, or other allowance that would not otherwise have been available, the Secretary of the Treasury (the "Secretary") has the authority to disallow the resulting benefits.

Section 446. Section 446(b) provides that if a taxpayer's method of accounting does not clearly reflect income, taxable income shall be computed under the method that, in the opinion of the Secretary, does clearly reflect income. The Secretary has broad discretion to determine whether a method of accounting clearly reflects income, and the Secretary may employ section 446 as a substantive means to modify the taxpayer's method of accounting in order to clearly reflect income.

Section 469. The rules of section 469, known as the passive loss rules, limit deductions and credits from passive trade or business activities.

Section 482. Section 482 provides that when two or more entities are controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate income, deductions, credits, or allowances between or among the entities in order to prevent the evasion of taxes or to reflect clearly the income of an entity.

Section 7701(l). Section 7701(l) provides the IRS with the authority to address tax shelter arrangements involving financing transactions. It provides: "[t]he Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent [the] avoidance of . . . tax . . . ." The subsection authorizes Treasury to prescribe regulations to deal generally with complicated, tax-motivated lending transactions that lack economic substance.

Section 7805. Section 7805 and many other sections of the Code give the IRS authority to issue rules and regulations to enforce the tax laws.

2. Judicial Doctrines

In addition to the statutory provisions, the courts have developed several doctrines over the years to deny certain tax-motivated transactions their intended tax benefits. The general doctrines used to deny such tax benefits are: (1) the sham-transaction doctrine, (2) the economic-substance doctrine, (3) the business-purpose doctrine, (4) the substance-over-form doctrine, and (5) the step transaction doctrine.

Sham-transaction doctrine. Sham transactions are those in which the economic activity that is purported to give rise to the desired tax benefits does not actually occur. The transactions have been referred to as "facades" or mere "fictions," and, in their most egregious form, one may question whether the transactions might be characterized as fraudulent. Courts have recognized two basic types of sham transactions:

> Shams in fact are transactions that never occur. In such shams, taxpayers claim deductions for transactions that have been created on paper but which never took place. Shams in substance are transactions that actually occurred but which lack the substance their form represents.[2]

[2] *United Parcel Service of America, Inc. v. Commissioner, 78 T.C.M. (CCH) 262 at n. 29 (1999), reversed 254 F.3d 1014 (11th Cir. 2001).*

Economic-substance doctrine. The courts generally will deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of tax considerations – notwithstanding that the purported activity did actually occur. The Tax Court has described the doctrine as follows:

> The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[3]

Business-purpose doctrine. Another doctrine that overlays and is often considered together with (if not part and parcel of) the sham-transaction and economic-substance doctrines is the business-purpose doctrine. In its common application, the courts use business purpose (in combination with economic substance) as part of a two-prong test for determining whether a transaction should be disregarded for tax purposes: (1) the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction; and (2) the transaction lacks economic substance. In essence, a transaction will only be respected for tax purposes if it has "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached."[4]

Substance-over-form doctrine. The concept of the substance-over-form doctrine is that the tax results of an arrangement are better determined based on the underlying substance rather than an evaluation of the mere formal steps by which the arrangement was undertaken. Under this doctrine, two transactions that achieve the same underlying result should not be taxed differently simply because they are achieved through different legal steps. The IRS generally has the ability to recharacterize a transaction according to its underlying substance. Taxpayers, however, are usually bound to abide by their chosen legal form.

Step-transaction doctrine. An extension of the substance-over-form doctrine is the step-transaction doctrine. The step-transaction doctrine "treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result."[5] The courts have generally developed three methods of testing whether to invoke the step transaction doctrine: (1) the end-result test, (2) the interdependence test, and (3) the binding-commitment test.

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[3] *ACM Partnership v. Commissioner, 73 T.C.M. (CCH) 2189, 2215 (1997), affirmed 157 F.3d 231 (3d Cir. 1998), certiorari denied 526 U.S. 1017 (1999).*

[4] *Frank Lyon Co. v. Commissioner, 435 U.S. 561 (1978).*

[5] *Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987).*

Of note, Congress is currently considering legislation that would codify many of the above judicial doctrines.[6]

3. Regulatory and Administrative Guidance with Respect to Tax Shelters

Over the years, the Treasury has promulgated a number of anti-abuse rules that specifically allow the Commissioner to recharacterize a transaction that might otherwise legitimately meet the applicable rules set forth in the regulations or other administrative guidance. In the Tax Exempt Bond area, for example, one regulation gives the Commissioner the ability to depart from the specific regulations relating to arbitrage as necessary to "clearly reflect the economic substance of the transaction."[7] Another regulation allows the Commissioner, by publication of a revenue ruling or revenue procedure, to specify contracts that, although they do not fall within the formal requirements of the qualified hedging rules, will nonetheless be treated as qualifying hedges.[8] Similarly, in the Employee Plans area, one of the nondiscrimination regulations advises that the regulations "must be interpreted in a reasonable manner consistent with the purpose of preventing discrimination in favor of [highly compensated employees]."[9] Like the sham-transaction, economic-substance, and substance-over-form judicial doctrines, these regulations are weapons that the IRS can use in its fight against abusive tax transactions.

More recently, the Treasury Department and the IRS have issued regulatory and administrative guidance that focuses specifically on abusive tax transactions. This guidance focuses primarily on requiring disclosure of transactions that may be considered potentially abusive, though it also includes notices that identify specific transactions in which the IRS will disallow the purported tax benefits. The IRS also has implemented certain organizational changes designed to improve the agency's collection, utilization, and dissemination of information regarding abusive tax transactions.

In particular, in the past few years, the IRS issued temporary and now final regulations relating to tax shelters.[10] The regulations establish certain disclosure

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[6] *See, for example, Joint Committee on Taxation, Description of the "CARE Act of 2003" (JCX-04-03, February 3, 2003), at 72 (clarifying the economic substance doctrine).*

[7] *Treasury Regulation § 1.148-10(e). Similarly, Treasury Regulation § 1.140-1(c)(5) provides that in order "to clearly reflect the economic substance of a transaction," the Commissioner may treat bonds as part of the same issue or as part of separate issues notwithstanding the regulatory rules relating to the definition of an "issue."*

[8] *Treasury Regulation § 1.148-4(h)(6).*

[9] *Treasury Regulation §1.401(a)(4)-1(c)(2).*

[10] *See, for example, Treasury Regulation § 1.6011-4 and related regulations recently finalized by T.D. 9046, 68 FEDERAL REGISTER 10,161 (2003). See generally Mark H. Leeds, Tax Shelter Disclosure, Registration, and Listing Rules for 2003 and Beyond, TAX NOTES, March 31, 2003, at 2025; Amy Hamilton, Treasury Issues Final Tax Shelter Disclosure Regs, TAX NOTES, March 3, 2003, at 1295; Steven M. Rosenthal & Jeanne K. Falstrom, Me, A Material Adviser? What Now?, TAX NOTES, March 17, 2003, at 1749. See also Erika W. Nijenhuos et al, The New Disclosure and Listing Regulations for Tax Shelters, TAX NOTES, November 18, 2002, at 943; Beckett G. Cantley, The Tax Shelter Disclosure Act: The Next*

obligations of taxpayers that participate in any "reportable transaction."[11] The regulations also describe the registration requirements of organizers who promote confidential corporate tax shelters under section 6111(d)(1),[12] as well as the requirement under section 6112 that organizers of potentially abusive tax shelters maintain a list identifying each person who was sold an interest in such shelter and certain other information about the shelter.[13] Additional administrative guidance included a description of the functions of the new Office of Tax Shelter Analysis,[14] as well as IRS Notices that have identified several transactions ("listed transactions") that must be disclosed by taxpayers and registered by promoters.[15]

a) Disclosure of reportable transactions by taxpayers

The regulations under section 6011 require certain taxpayers to disclose with their tax returns certain information for each "reportable transaction" in which the taxpayer participates. Reportable transactions fall into six categories: (1) listed transactions, (2) confidential transactions, (3) transactions with contractual protection, (4) loss transactions, (5) transactions with a significant book-tax difference, and (6) transactions involving a brief asset holding period.[16]

The regulations require disclosure of participation in reportable transactions by all direct and indirect participants.[17] Disclosure must be made on a Form 8886, "Reportable Transaction Disclosure Statement." While most disclosures will be made with respect to transactions involving income tax issues, starting in 2003, the regulations also authorize the IRS to require disclosure of listed transactions that involve Federal estate, gift, employment, pension, or exempt organization issues.

The regulations allow taxpayers to request a ruling as to whether a transaction must be disclosed.[18] A transaction will not be considered a reportable transaction, or will be excluded from any individual category of reportable transaction, if the Commissioner makes a determination, by published guidance, individual ruling, or otherwise, that the transaction is not subject to the disclosure requirements.

Listed transactions. First, according to the regulations, a "listed transaction" is a transaction that the IRS has identified as having a tax avoidance purpose and that the

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Battle in the Tax Shelter War, 22 VIRGINIA TAX REVIEW 105 (2002); Ronald A. Pearlman, Demystifying Disclosure: First Steps, 55 TAX LAW REVIEW 289 (2002).

[11] *Treasury Regulation § 1.6011-4(b).*

[12] *Treasury Regulation § 301.6111-2.*

[13] *Treasury Regulation § 1.6112-1.*

[14] *See, for example, Announcement 2000-12; 2000-12 INTERNAL REVENUE BULLETIN 1.*

[15] *See, for example, Notice 2001-51, 2001-34 INTERNAL REVENUE BULLETIN 190 (providing a comprehensive list of "listed transactions" as of August 20, 2001). In addition, certain "material advisors" must keep lists and other information with respect to these transactions. Treasury Regulation § 301.6112-1(c)(2) provides a broad definition of who is a "material advisor."*

[16] *Treasury Regulation § 1.6011-4(b).*

[17] *Treasury Regulation § 1.6011-4(c)(3).*

[18] *Treasury Regulation § 1.6011-4(f).*

tax benefits are subject to disallowance under existing law. When the IRS determines a transaction has a tax-avoidance purpose, a notice is issued informing taxpayers of the details of such transaction.[19] The list is supplemented from time to time, when other such tax-avoidance transactions are identified.[20] Listing is used by the IRS to chill particular types of transactions as well as to collect additional information that may be useful in curtailing the spread of the identified transactions.

Confidential transactions. Second, a "confidential transaction" is a transaction that is offered under conditions of confidentiality, unless one of the exceptions in the regulations applies. Of note, one exception in the regulations provides a presumption if the promoter specifically authorizes the taxpayer to freely disclose the structure and tax aspects of the transaction.

Transactions with contractual protection. Third, a "transaction with contractual protection" is a transaction for which the taxpayer has the right to a full or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained.

Loss transactions. Fourth, a "loss transaction" is any transaction resulting in, or that is reasonably expected to result in, a loss under section 165 of at least:

$10 million in any single taxable year or $20 million in any combination of taxable years for corporations;

$10 million in any single taxable year or $20 million in any combination of taxable years for partnerships that have only corporations as partners; or $2 million in any single taxable year or $4 million in any combination of taxable years for all other partnerships;

$2 million in any single taxable year or $4 million in any combination of taxable years for individuals, S corporations, or trusts; and

$50,000 in any single taxable year for individuals or trusts, if the loss arises with respect to a section 988 foreign currency transactions.

Transactions with a significant book-tax difference. Fifth, a "transaction with a significant book-tax difference" is a transaction where the treatment for Federal income tax purposes of any item or items from the transaction differs, or is reasonably expected to differ, by more than $10 million on a gross basis from the treatment of the item or items for book purposes in any taxable year. Book income is determined by applying U.S. generally accepted accounting principles (GAAP) for worldwide income. A recent Revenue Procedure identifies a number of book-tax differences that will not be taken

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[19] *See, for example, Notice 2002-21, 2002-14 INTERNAL REVENUE BULLETIN 730, for a recent example of a transaction that has been identified as a listed transaction for purposes of the taxpayer disclosure, promoter registration, and list maintenance requirements.*

[20] *See, for example, Notice 2001-51, 2001-34 INTERNAL REVENUE BULLETIN 190 (providing a comprehensive list of "listed transactions" as of August 20, 2001).*

into account in determining whether a transaction has a significant book-tax difference.[21] This category of reportable transactions only applies to reporting companies under the Securities and Exchange Act of 1934 (15 U.S.C. § 78a) and certain related business entities.[22]

Transactions involving a brief asset holding period. Sixth, a "transaction involving a brief asset holding period" is a transaction resulting in, or that is reasonably expected to result in, a tax credit exceeding $250,000 (including a foreign tax credit) if the underlying asset giving rise to the credit is held by the taxpayer for less than 45 days.

b) Registration and list maintenance requirements of tax shelter promoter

Registration of tax shelters (sec. 6111). Section 6111 requires an organizer of a tax shelter to register the tax shelter with the Secretary not later than the day on which the shelter is first offered for sale. The definition of tax shelter is not quite as broad as the definition under section 6011.[23]

Tax shelter promoter investor lists (sec. 6112). Section 6112 requires promoters to maintain (for a period of seven years) a list identifying each person who was sold an interest in any tax shelter with respect to which registration was required under section 6111.[24] Promoters are required to provide the lists and other required information to the IRS within 20 days of an IRS request; no administrative summons is required.[25] The term promoter is broadly defined and includes "material advisors" to the transaction.[26]

B. PENALTIES AND SANCTIONS APPLICABLE TO TAX SHELTERS

1. Penalties

a) Taxpayer penalties relating to tax shelters

Accuracy-related penalty (sec. 6662). The accuracy-related penalty, which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift-tax valuation understatement. If the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most

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[21] *Revenue Procedure 2003-25, 2003-11 INTERNAL REVENUE BULLETIN 1. Of note, section 4.08 of this ruling exempts book-tax differences relating to "Compensation….including pensions."*

[22] *See Treasury Regulation § 1.6011-4(b)(6)(ii)(A)(1).*

[23] *Section 6111(d) relating to confidential tax shelters is limited to certain corporate tax shelters.*

[24] *The concept of "owners and sellers" (who must keep lists) is very broad and includes not only tax advisors that make "tax statements" with respect to reportable transactions (and receive the requisite minimum fee) but also non-tax advisors who talk about tax consequences and receive a fee. Treasury Regulation § 301.6112-1(c)(2).*

[25] *Treasury Regulation § 301.6112-1(g).*

[26] *Treasury Regulation § 301.6112-1(c)(2).*

corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[27] Under section 6664 of the Code, the accuracy-related penalty does not apply to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and the taxpayer acted in good faith with respect to such portion. There are special rules which apply to tax shelter items.

Fraud penalty (sec. 6663). The accuracy-related penalty under section 6662 discussed above does not apply to any underpayment of tax that is attributable to fraud. Rather, a penalty under section 6663 equal to 75 percent of the understatement may be imposed. The IRS must establish by clear and convincing evidence that an understatement of tax exists and that an understatement is attributable to fraud. The courts have defined "fraud" to mean an intentional wrongdoing on the part of a taxpayer motivated by a specific purpose to evade a tax known or believed to be owing.

b) Non-taxpayer penalties

Understatement of taxpayer's liability by income-tax preparer (sec. 6694). Section 6694 imposes a penalty on an income-tax preparer for any understatement of tax liability on a tax return due to a position for which there was not a realistic possibility of success of being sustained on its merits, but only if: (1) the return preparer knew (or reasonably should have known) of the position; and (2) the position was not adequately disclosed on the return or was frivolous. The penalty is $250 with respect to each return, unless the preparer establishes that there was reasonable cause for the understatement and the preparer acted in good faith. The penalty amount is increased to $1,000 if any part of the understatement is due to the preparer's willful conduct, or reckless or intentional disregard of the rules and regulations.

Penalties with respect to the preparation of income-tax returns for others (sec. 6695). Section 6695 imposes a penalty on any income-tax return preparer who, in connection with the preparation of an income-tax return, fails to: (1) furnish the taxpayer with a completed copy of the tax return; (2) sign the tax return (if required to do so by regulations); (3) furnish the proper identification number with respect to the tax return; (4) retain a copy of the completed return or a list (with names and taxpayer identification numbers) of the taxpayers for whom a return was prepared; or (5) comply with certain due-diligence requirements in determining a taxpayer's eligibility for the earned income credit. Section 6695 also prohibits an income tax preparer from endorsing or otherwise negotiating a refund check that is issued to the taxpayer. In most cases, the penalty is $50 for each failure, with a maximum penalty of $25,000 per category. The failure to comply with the due-diligence requirements in determining eligibility for the earned income credit carries a $100 penalty for each failure.

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[27] *Of note, the IRS recently issued proposed regulations that limit the defenses available to taxpayers facing the penalty for failing to disclose reportable transactions or for failing to disclose their position that a regulation is invalid. See Internal Revenue Service, Notice of Proposed Rulemaking, 67 FEDERAL REGISTER 79,894 (2002).*

Promoting abusive tax shelters (sec. 6700). Section 6700 imposes a penalty on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement. A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A "gross valuation overstatement" means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

The amount of the penalty equals $1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity). In calculating the amount of the penalty, the organizing of an entity, plan or arrangement and the sale of each interest in an entity, plan, or arrangement constitute separate activities. A penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

Aiding and abetting understatement of tax liability (sec. 6701). Section 6701 imposes a penalty on any person who (1) aids, assists, procures, or advises with respect to the preparation or presentation of any portion of a return, affidavit, claim, or other document, (2) knows (or has reason to believe) that the document will be used in connection with any material matter arising under the internal revenue laws, and (3) knows that the document would result in an understatement of another person's tax liability.

Failure to register tax shelters (sec. 6707). Under section 6707, the penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or $500. However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees. Section 6707 also imposes (1) a $100 penalty on the promoter for each failure to furnish the investor with the required tax shelter identification number, and (2) a $250 penalty on the investor for each failure to include the tax shelter identification number on a return.

Failure to maintain lists of investors in potentially abusive tax shelters (sec. 6708). Under section 6708, the penalty for failing to maintain the list required under section 6112 is $50 for each name omitted from the list (with a maximum penalty of $100,000 per year).

2. Injunctive Actions

Action to enjoin income-tax return preparers (sec. 7407). Under section 7407, the Secretary may bring a civil action in district court to enjoin a tax return preparer from further engaging in conduct (1) described in section 6694 (the understatement of tax liability by a return preparer penalty, discussed above) or section 6695 (other assessable penalties with respect to the preparation of income tax returns, also discussed above), (2) misrepresenting his eligibility to practice or his experience or education, (3) guaranteeing the payment of any tax refund or allowance of any tax credit, or (4) engaging in any other fraudulent or deceptive conduct which substantially interferes with the proper administration of the Internal Revenue laws. For repeat offenses, the court may enjoin the person from acting as an income-tax preparer.

Action to enjoin promoters of abusive tax shelters (sec. 7408). Under section 7408, the Secretary may bring a civil action in district court to enjoin a person from further engaging in conduct subject to penalty under section 6700 (the penalty for promoting abusive tax shelters, discussed above) or section 6701 (the penalties for aiding and abetting the understatement of tax liability, also discussed above). Consequently, statements incidental to the operation of an abusive tax shelter, in addition to statements made in the organization or sale of an abusive tax shelter, are subject to injunction. These actions may be brought in the United States District Court for the district in which the promoter resides, has his principal place of business, or has engaged in the conduct subject to the penalty. If a citizen or resident of the United States does not reside in or have a principal place of business in any U.S. judicial district, such citizen or resident is treated as a resident of the District of Columbia.

C. GENERAL IRS INITIATIVES

The IRS has undertaken a variety of general initiatives to curb abusive tax transactions.

1. The Office of Tax Shelter Analysis

In February of 2000, the IRS established the Office of Tax Shelter Analysis (OTSA), located in the Large and Mid-Size Business (LMSB) Division, to serve as a focal point for many tax shelter compliance initiatives, including the gathering of information relating to tax shelters affecting taxpayers other than those served by the LMSB.

The responsibilities of the OTSA include: (1) reviewing all disclosures by promoters and taxpayers under the tax shelter disclosure regulations; (2) identifying taxpayers that have participated in such transactions, to assist in evaluating the tax treatment of cutting edge tax-structured transactions to identify improper tax shelters; and (3) providing a better assessment of the overall extent of tax-shelter activity by taxpayers. The OTSA also helps review many of the tax-shelter transactions that come to the attention of the IRS in other ways, including transactions examined by field personnel and those that are disclosed to the IRS by taxpayers, practitioners, and other

members of the public. In addition, the OTSA is responsible for planning, coordinating and providing assistance to LMSB field personnel on tax shelter issues.

2. The Office of Flow-Through Entities and Abusive Tax Schemes

Also, in January of 2000, the IRS established the Office of Flow-Through Entities and Abusive Tax Schemes, located in the Small Business and Self-Employed (SB/SE) Division. This office was created to organize the IRS's efforts in addressing abusive tax schemes, particularly trusts, and to identify their promoters and sellers. The office's goals are: (1) to catalog and profile schemes and trends; (2) direct compliance resources to examine schemes and promoters and participants for criminal prosecution; (3) increase employee knowledge and skills related to abusive tax scheme issues; and (4) enhance coordination within the IRS on issues related to abusive tax schemes.[28]

Flow-through entities include domestic trusts and offshore trusts and partnerships. These are flow-through entities because their income "flows through" to their partners or other beneficiaries subject to taxation.

According to the General Accounting Office, the IRS characterizes an "abusive tax scheme" as any plan or arrangement created and used to obtain tax benefits not allowable by law.[29] As such, schemes can be based on improper use of domestic and foreign trusts, inflated business expenses and deductions, falsely claimed tax credits and refunds, and various anti-tax arguments. According to the IRS, abusive tax schemes fall into four categories: frivolous returns, frivolous refunds, abusive domestic trusts, and offshore schemes.

For example, the Frivolous Return Program, located in the SB/SE Division, identifies the tax returns of individuals who assert unfounded legal or constitutional arguments and refuse to pay their taxes or to file a proper tax return. The program also identifies returns claiming frivolous refunds, such as those involving slavery reparations.

The IRS estimates the potential revenue loss from abusive tax schemes to be in the tens of billions of dollars annually. For example, in February 2002, the IRS estimated that about 740,000 taxpayers used abusive tax schemes in tax-year 2000. The IRS detected approximately $5 billion in improper tax avoidance or tax credit and refund claims, and it estimated that another $20 billion to $40 billion in taxes had not been identified and addressed related to offshore schemes.

3. Other Compliance and Enforcement Efforts

The IRS has taken a number of other steps to enhance compliance and enforcement activities – its audit and other civil enforcement activities – that focus on abusive tax transactions. The Wage and Investment (W&I) Division, the SB/SE

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[28] *See, for example, Small Bus/Self-Employed, Abusive Schemes Counter-Marketing Tools, available at http://www.irs.gov/businesses/small/article/0,,id=106788,00.html.*

[29] *U.S. GENERAL ACCOUNTING OFFICE, INTERNAL REVENUE SERVICE: EFFORTS TO IDENTIFY AND COMBAT ABUSIVE TAX SCHEMES HAVE INCREASED, BUT CHALLENGES REMAIN, above note 1, at 1.*

Division, and the LMSB Divisions process taxpayers' tax returns, and all have responsibility for identifying tax returns that may involve abusive tax transactions.

Also, the National Fraud Program, which operates at IRS campuses and field offices, coordinates efforts and provides oversight to IRS's compliance efforts to identify potential tax fraud.

4. Criminal Investigation (CI)

Criminal Investigation (CI) is the investigative arm of the IRS and is comprised of approximately 2,900 special agents. Criminal Investigation is responsible for the enforcement of tax, money laundering, and Bank Secrecy Act laws. Pertinent here, CI investigates and pursues promoters and sellers of abusive schemes and the individuals using such schemes. CI's role is the enforcement of the tax laws for individuals who willfully fail to comply with their obligation to file and pay taxes and who ignore IRS's collection and compliance efforts. The most flagrant cases are recommended for criminal prosecution.

CI also administers the Questionable Refund Program that focuses on stopping the payment of various false tax refunds and, if warranted, prosecuting the taxpayers involved. Furthermore, CI develops education and publicity activities warning taxpayers about abusive tax schemes.

CI's enforcement strategy as it relates to fraudulent tax schemes is to focus primarily on the promoters of these schemes and on taxpayers who willfully use these schemes to evade taxes. For example, during a tax scheme investigation, CI generally attempts to gain access to a fraudulent promoter's list of clients to whom the promoter sold the scheme. In addition to pursuing the promoter, CI can then use the list of clients to determine who may have used the abusive scheme.

CI carries out IRS's criminal law enforcement responsibilities under three principal statutes.[30] Under the Internal Revenue Code, the IRS has the authority to investigate alleged criminal tax violations, such as tax evasion and filing a false tax return. Under title 18 U.S. Code, IRS has the authority to investigate a broad range of fraudulent activities, such as false claims against the government and money laundering. Under title 31 U.S. Code, IRS is responsible for enforcing certain recordkeeping and reporting requirements of large currency transactions, such as cash bank deposits of more than $10,000. In fulfilling these responsibilities, CI coordinates as necessary with the IRS Chief Counsel, the U.S. Department of Justice, and the U.S. Attorneys.

5. Publications

Another initiative for discouraging abusive tax transactions involves IRS publication of the abuse and notice that the IRS is investigating. For example, the web

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[30] *U.S. General Accounting Office, Tax Administration: IRS' Audit and Criminal Enforcement Rates for Individual Taxpayers Across the Country (Report No. GAO/GGD-99-19, 1998).*

page for Criminal Investigation identifies such tax fraud schemes as: the Slavery Reparation Scam and the Abusive Trust Schemes.[31] Similarly, in IRS News Release IR-2003-18, the IRS warns taxpayers about the "Dirty Dozen" tax scams.[32]

D. STANDARDS OF TAX PRACTICE AND PROFESSIONAL CONDUCT REGARDING TAX SHELTERS AND OTHER TAX SCHEMES

1. Circular 230 – Treasury Regulations that Govern Practice Before the IRS

An individual who is a member in good standing of the bar of the highest court of a State may represent a person before the IRS. Similarly, an individual who is duly qualified to practice as a CPA in a State may represent a person before the IRS. Individuals not qualifying under either the attorney or the CPA rules may represent a person before the IRS if they qualify either by passing an examination or by nature of their previous employment with the IRS. The Treasury Department is authorized to regulate the practice of representatives before the Treasury Department (which includes the IRS), and (after notice and opportunity for a proceeding) to suspend or disbar any representative from practice before the Treasury Department for a violation of such rules and regulations. In accordance with this grant of authority, the Treasury Department has issued regulations that govern the practice of attorneys, certified public accountants, enrolled agents, and other persons representing clients (hereafter "practitioners") before the IRS. These regulations are commonly referred to as Circular 230.[33]

Circular 230 contains rules governing the standards for certain tax shelter opinions, as well as rules governing the standards for advising a taxpayer to take a position on its return. Historically, the IRS Office of Director of Practice was responsible for the enforcement of Circular 230.

On January 8, 2003, however, the IRS created a new Office of Professional Responsibility, taking the place of the Office of the Director of Practice.[34] A major emphasis of the new Office of Professional Responsibility will be to investigate allegations of misconduct and negligence against agents, attorneys, accountants and other professionals representing taxpayers before the IRS. The new office will have more than twice the staff that was available under the previous organization, and with those additional resources, the IRS has announced that the Office of Professional Responsibility "will thoroughly concentrate on enforcing the standards of practice for those who represent taxpayers before the IRS as detailed in Circular 230."

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[31] *See http://www.irs.gov/irs/content/0,,id=106057,00.html.*

[32] *See IRS News Release IR 2003-18 (February 19, 2003), available at http://www.irs.gov/newsroom/article/0,,id=107493,00.html.*

[33] Circular 230, Regulations Governing Practice Before the IRS*, 31 CODE OF FEDERAL REGULATIONS Part 10 (2002).*

[34] *IRS News Release IR 2003-3 (January 8, 2003), available at http://www.irs.gov/newsroom/index.html.*

In addition, the Treasury Department recently proposed modifying and expanding the Circular 230 rules that relate to tax shelter opinions.[35]

2. American Bar Association Guidelines

The American Bar Association ("ABA") has promulgated a series of rules and guidelines concerning the standards of practice for lawyers. The ABA rules, in and of themselves, do not have legal effect. However, most States have adopted rules of professional conduct based on rules promulgated by the ABA (which rules of conduct do have the force and effect of law). The two primary sets of rules that have been promulgated by the ABA are the Model Code of Professional Responsibility ("Model Code") and Model Rules of Professional Conduct ("Model Rules"). The ABA, through its Standing Committee on Ethics and Professional Responsibility, issues formal and informal opinions that interpret the Model Code and Model Rules. Of particular relevance to tax practitioners are: (1) ABA Formal Opinion 346, regarding a lawyer's duties and responsibilities in rendering tax shelter opinions, and (2) ABA Formal Opinion 85-352, regarding a lawyer's duty in advising a client on a position that can be taken on a tax return.

3. American Institute of Certified Public Accountants Guidance

The American Institute of Certified Public Accountants ("AICPA") has not issued standards of practice specifically related to tax shelter arrangements. However, AICPA Statements on Responsibilities in Tax Practice (1991 Revision) represent general guidance for AICPA members, but do not constitute enforceable standards. Rather, the statements are considered only educational and advisory in nature.

4. State Licensing Authorities

Each State, by virtue of the State courts (for lawyers), or through a licensing board (for CPAs), regulates and disciplines practitioners who are authorized or licensed to practice in the State. Many State regulatory bodies maintain rules that mirror the standards of national organizations, such as the ABA and the AICPA. Tax practitioners that fail to abide by their respective State requirements may be subject to disciplinary actions, such as disbarment, suspension, reprimand, or denial of license to practice within such State.

III. HOW THE IRS HAS DEALT WITH TAX SHELTERS AND OTHER ABUSIVE TAX SCHEMES INVOLVING THE TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

A. THE TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

The Tax Exempt and Government Entities Division (TE/GE) was established in late 1999 as part of the Internal Revenue Service's modernization effort.[36] The division

[35] *See, for example,* Advanced Notice of Proposed Rulemaking*, 67 FEDERAL REGISTER 77,725 (2002).*

is designed to serve the needs of three very distinct customer segments: Employee Plans (EP), Exempt Organizations (EO), and Government Entities (GE).[37] The customers range from small local community organizations and municipalities to major universities, huge pension funds, state governments, Indian tribal governments, and complex tax-exempt bond issuers.

These organizations represent a large economic sector with unique needs and are governed by complex, highly specialized provisions of the tax law. For example, in the employee-plans, exempt-organizations, and tax-exempt-bond areas, these provisions are not designed to generate revenue, but rather to ensure that the entities fulfill the policy goals that their tax exemptions were designed to achieve. Although generally paying no income tax, the tax-exempt sector does pay more than $220 billion in employment taxes and income tax withholding and controls approximately $6.7 trillion in assets.

TE/GE was created to address four basic key customer needs: education and communication, rulings and agreements, examination, and customer account services. Education and communication efforts focus on helping customers understand their tax responsibilities with outreach programs and activities tailored to their specific needs. Rulings and Agreements efforts provide a strong emphasis on up-front compliance programs, such as the determination, voluntary compliance, and private letter ruling programs. Examination initiatives identify and address non-compliance, through customized activities within each customer segment, and Customer Account Services provide taxpayers with efficient tax filings as well as accurate and timely responses to questions and requests for information.

The Commissioner of TE/GE is responsible for the uniform interpretation and application of the Federal tax laws on matters pertaining to the Division's customer base. In addition, the Commissioner provides advice and assistance throughout the Service, to the Department of the Treasury, other government agencies, including state governments and Congressional committees, and maintains particularly close liaison with the Department of Labor and the Pension Benefit Guaranty Corporation.

TE/GE headquarters is located in Washington, D.C. The EP and EO determination letter programs are managed in Cincinnati, Ohio, and the EP and EO audit functions are managed through six area offices. GE is centrally managed out of the headquarters office.

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[36] *This section follows: Tax Exempt & Government Entities Operating Division, At-a-Glance, available at http://www.irs.gov (click on About IRS, IRS History and Structure, and TAX EXEMPT AND GOVERNMENT ENTITIES).*

[37] *The mission of TE/GE is:*

> *To provide TE/GE customers top quality service by helping them understand and comply with applicable tax laws and to protect the public interest by applying the tax law with integrity and fairness to all.*

B. SOME EXAMPLES OF HOW THE IRS ADDRESSES ABUSIVE TAX TRANSACTIONS THAT INVOLVE TE/GE

1. General Efforts to Achieve Compliance

Regulations are the most powerful guidance that the IRS can issue as these typically have "the full force and effect of law." The IRS also identifies abusive tax transactions through revenue rulings and revenue procedures. Finally, the IRS has used so-called "soft guidance" to inform and direct practitioners. Examples of TE/GE-related guidance to curb abusive tax transactions include: [38]

a) Qualified appraisal rules for charitable contributions

Since only section 501(c)(3) organizations are eligible for section 170 tax-deductible contributions, they are the number one target for abuses targeted by the Exempt Organization segment of TE/GE. Historically, one of the most common abuses has involved overvaluation of charitable contributions to section 501(c)(3) organizations. Most of those abuses have been curtailed by extensive recordkeeping, valuation, and appraisal requirements.[39] IRS forms, instructions, and publications have also been particularly effective in curbing these abuses.[40]

In that regard, the IRS recently issued Revenue Ruling 2002-67 to deter taxpayers from claiming excessive charitable deductions for giving used cars to charities.[41] This ruling tells taxpayers how to determine the proper amount to deduct. The ruling advises that the donor may use a used car pricing guide to determine the car's fair market value as long as the comparison is for the same make, model, and year, is sold in the same geographical area, and in the same condition as the donated car. If not (*i.e.*, if the car doesn't run), the donor must use some other reasonable method.

b) Anti-abuse provisions in the regulations

The Treasury has promulgated a number of regulations that are intended to curb abuses.[42] For example in the tax-exempt bond area, one particularly broad provision gives the Commissioner the authority to "take any action to reflect the substance of the transaction" if an issuer enters into a transaction "with a principal purpose of transferring to governmental persons . . . significant benefits of tax-exempt financing in a manner that is inconsistent with the purposes of section 141."[43]

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[38] *See also the regulations described in the first paragraph of Part II.A.3 above.*

[39] *See, for example, Treasury Regulation § 1.170A-13.*

[40] *See, for example, Charitable Contributions, IRS Publication No. 526 (2000) and Determining the Value of Donated Property, IRS Publication No. 561; see also U.S. GENERAL ACCOUNTING OFFICE, VEHICLE DONATIONS: TAXPAYER CONSIDERATIONS WHEN DONATING VEHICLES TO CHARITIES (Report No. GAO-03-608T, 2003).*

[41] *2002-47 INTERNAL REVENUE BULLETIN 873.*

[42] *A complete discussion of the use of these anti-abuse rules is beyond the scope of this report.*

[43] *Treasury Regulation § 1.141-14.*

Similarly, in the pension plan area, a number of Treasury regulations are designed to prevent retirement plans from discriminating significantly in favor of highly compensated employees. For example, with respect to the timing of retirement-plan amendments, when a pension-plan sponsor winds up its business, it might consider first terminating its nonhighly compensated employees, and then, while the plan covers only highly compensated employees, amending the plan (before it is terminated) to provide significantly increased benefits for those highly compensated employees. Treasury regulations, however, provide a clear warning to plan sponsors by stating that the determination of whether the timing of a plan amendment (or series of amendments) is discriminatory shall be determined based on all the facts and circumstances.[44] The regulations contain several examples of plan amendments that have an improper discriminatory effect (including the one just described).

Another Treasury regulation provides that all the pension-plan nondiscrimination regulations under section 401(a)(4) "must be interpreted in a reasonable manner consistent with the purpose of preventing discrimination in favor of [highly compensated employees]."[45]

c) Yield-burning tax-exempt bonds

In the tax-exempt bond area, one abuse, known as yield-burning, involves issuing tax-exempt bonds that remarket Treasury bonds and other Treasury securities. The IRS has issued several rulings that address this abuse.[46]

d) Soft Guidance

A variety of other forms of guidance have also been used to curb abusive tax transactions. In that regard, notice that the IRS is "concerned" about a transaction is often enough for the many relatively compliant communities of taxpayers serviced by the TE/GE Division. For example, TE/GE officials advised the Project Group that merely announcing that IRS Employee Plans and the Department of Labor's Employee Benefits Security Administration were going to be investigating non-filers led to an increase in the number of plans coming into the Department of Labor's delinquent-filer program.[47]

In short, TE/GE can speak softly and still have significant powers of persuasion. For TE/GE soft guidance can be particularly effective because of the nature of the regulated entities. Charities, pensions, and governmental entities generally strive to comply with the prescribed laws. Similarly, in order to market a tax-exempt bond, the issuer must be able to provide an unqualified tax opinion. Consequently, the IRS is

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[44] *Treasury Regulation § 1.401(a)(4)-5.*

[45] *Treasury Regulation § 1.401(a)(4)-1(c)(2).*

[46] *See, for example, Revenue Ruling 94-42, 1994-2 CUMULATIVE BULLETIN 15 (curbing zero coupon bonds that remarket Treasury bonds); Revenue Procedure 96-41, 1996-2 CUMULATIVE BULLETIN 301 (curbing yield-burning).*

[47] *See, for example, http://www.dol.gov/ebsa/newsroom/0302fact_sheet.html.*

often able to stop a perceived abuse merely by issuing a notice indicating that the IRS is looking at a certain type of transaction.

Even just talking about a perceived abuse can help curb it. For example, the IRS recently let practitioners know that it is looking at certain section 412(i) plans.[48] While there are many legitimate uses of section 412(i), the IRS has recently become aware of certain schemes that use section 412(i) as a vehicle for abuse. These abusive schemes purportedly enable small businesses to generate large tax-deductible contributions to plans and tax-free retirement distributions and death benefits. The IRS addressed a similar issue in Notice 89-25,[49] and the IRS is expected to issue formal guidance with respect to these abusive section 412(i) plans soon.

TE/GE's many voluntary compliance programs are also soft guidance mechanisms for encouraging compliance and discouraging abusive tax transactions.[50]

2. Listed Transactions

Tax shelters that are determined to be abusive are often identified as "listed transactions."[51] Listed transactions require disclosure by participating taxpayers.[52] TE/GE has been instrumental in identifying and listing a number of potentially abusive tax transactions. Listing a potentially abusive transaction takes it out of the audit lottery, as practitioners and taxpayers are required to disclose these transactions, and those disclosures give the IRS enough information to decide if the transaction merits further investigation.

The process of getting a specific transaction listed is evolving, and currently involves a team approach. All of the operating divisions share tips. Any operating division can suggest a potential abuse for listing. Once a potential abuse is identified, a collaborative process involving all interested operating divisions takes place. For each identified transaction, the team develops a strategy for dealing with the abuse, which may include a recommendation that the transaction be listed. Listing a transaction is treated as the equivalent of published guidance and ultimately requires the approval of the Commissioner, the Chief Counsel, and the Assistant Secretary of the Treasury for Tax Policy. At present the list is maintained by the Office of Tax Shelter Analysis (OTSA) in the Large and Mid-Size Business (LM/SB) Division.

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[48] *See, for example, Tom Gilroy, Treasury, IRS Promise Guidance on Abusive Insurance-funded Benefit Plans, 30 BNA PENSION AND BENEFITS REPORTER 246 (No. 5; February 4, 2003); 412(i) Plan: A "Dream" or "Nightmare" for the Small Business Owner?, MILBERG CONSULTING, LLC NEWS AND INSIGHTS (March 28, 2003) available at http://www.milbergconsulting.com/articles.asp?id=39.*

[49] *1989-1 CUMULATIVE BULLETIN 662.*

[50] *For example, the IRS recently started an initiative aimed at bringing taxpayers who used "offshore" credit cards and other devices to hide their income back into compliance with tax law. See Revenue Procedure 2003-11, 2003-4 INTERNAL REVENUE BULLETIN 311.*

[51] *See, for example, Notice 2001-51, 2001-34 INTERNAL REVENUE BULLETIN 190; see also http://www.irs.gov/businesses/corporations/index.html (click on Abusive Tax Shelters).*

[52] *Treasury Regulation § 1.6011-4.*

As far as TE/GE customers are concerned, it is not always easy to tell whether they "participate" in a listed transaction and so must disclose the transaction. According to the regulations, a "taxpayer has participated in a listed transaction if the taxpayer's tax return reflects tax consequences or a tax strategy described in published guidance that lists the transaction" or "if the taxpayer knows or has reason to know that the taxpayer's tax benefits are derived directly or indirectly from tax consequences or a tax strategy described in published guidance that lists a transaction."[53] Of note, the definition of tax benefit specifically includes, *inter alia*, "exclusions from gross income" and "status as an entity exempt from Federal income taxation."[54]

Examples of TE/GE-related listed transactions include:

a) Section 401(k) Accelerators

The underlying transaction here occurs when employers take premature deductions for certain 401(k) plan contributions. TE/GE efforts have resulted in identifying this abusive transaction in two separate listings.[55]

More specifically, this listed transaction involves contributions to a 401(k) plan made during the section 404(a)(6) grace period. The abuse occurs when an employer takes a deduction for the taxable year for employer contributions that are attributable to compensation earned by plan participants after the end of that taxable year. The proper tax treatment is for the employer to take the deduction in the following year – the year in which the underlying compensation is earned by the plan participants.

This type of abuse was found on audit and, at about the same time, disclosed to the IRS by third-party contacts. The IRS studied the matter, identified it as an abuse, and noted the abuse in Revenue Ruling 90-105.[56] The matter was successfully litigated by the IRS,[57] and it was later identified as the first listed transaction in Revenue Ruling 2001-15.[58] Revenue Ruling 2002-46 indicates that "substantially similar" transactions

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[53] *Treasury Regulation § 1.6011-4(c)(3).*

[54] *Treasury Regulation §§ 1.6011-4(c)(6), 301.6112-1(d)(6).*

[55] *Revenue Ruling 2002-46, 2002-29 INTERNAL REVENUE BULLETIN 1; Revenue Ruling 90–105, 1990–2 CUMULATIVE BULLETIN 69*

[56] *1990-2 CUMULATIVE BULLETIN 69.*

[57] *See, for example, Lucky Stores, Inc. v. Commissioner, 153 F.3d 964 (9th Cir. 1998), certiorari denied, 526 U.S. 1111 (1999) (indicating, in the context of a defined benefit plan, that the plain meaning of § 404(a)(6) precludes deduction in the preceding taxable year of grace period contributions that are required under collective bargaining agreements for work performed after the end of that preceding taxable year).*

[58] *2000–1 CUMULATIVE BULLETIN 826; see also Notice 2001–51, 2001–34 INTERNAL REVENUE BULLETIN 190 (Listed transaction number (1): "(transactions in which taxpayers claim deductions for contributions to a qualified cash or deferred arrangement or matching contributions to a defined contribution plan where the contributions are attributable to compensation earned by plan participants after the end of the taxable year (identified as "listed transactions" on February 28, 2000))." See also Vons Companies, Inc. v. United States, No. 00-234T, (United States Court of Federal Claims, filed March 28, 2003).*

are also abuses.[59] To date, the largest number of disclosures received by the Office of Tax Shelter Analysis have been associated with this type of 401(k) deferral abuse.

b) Abuses Associated with S Corporation ESOPs

The underlying abuse here has to do with certain transactions involving S Corporation Employee Stock Ownership Plans (ESOPs). The ESOPs in question were trying to take advantage of a transition rule under section 656(d)(2) of the Economic Growth and Tax Relief Reconciliation Act of 2001(EGTRRA) that permitted certain ESOPS to use a delayed effective date for the nonallocation rules of Code section 409(p).[60] The IRS has since ruled that these S Corporation ESOPs are not eligible for the transition rule, and thus these S Corporation ESOPs are subject to the nonallocation rules of section 409(p) of the Code.[61]

TE/GE discovered this potentially abusive transaction after it received some 300 determination letter requests from a few practitioners. The letters asked TE/GE to issue determination letters with respect to certain ESOPs for S corporations that were not actually conducting business. Instead, it appeared that the promoters were creating inventories of shell S corporations and related ESOPs for sale in the future as tax shelters.

Alert TE/GE employees discovered these potentially abusive tax shelters, and TE/GE ceased issuing determination letters to those promoters. Subsequently, TE/GE got the IRS to identify the S Corporation ESOP abuse as a listed transaction.[62]

Of note, the applicable ruling listing the transaction avoids the issue of whether the ESOP must disclose the transaction on its Form 5500 information return. Instead, the ruling specifically says that the transaction is listed only with respect to "disqualified persons" (*i.e.*, the individual participants in the ESOP).[63]

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[59] *2002-29 INTERNAL REVENUE BULLETIN 118; see also Notice 2002-48, 2002-29 INTERNAL REVENUE BULLETIN 130.*

[60] *Section 656 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) amended § 409 of the Code to add a new subsection (p) regarding the allocation of employer securities consisting of stock in an S corporation. However, EGTRRA § 656(d)(2) provides that § 409(p) of the Code applies to plan years ending after March 14, 2001 (the date the provision was introduced in committee), in the case of any ESOP established after March 14, 2001, or in the case of an ESOP established on or before March 14, 2001, if employer securities held by the ESOP consist of stock in a corporation with respect to which an election to be an S corporation under § 1362(a) of the Code is not in effect on such date. Here, the promoter created straw S corporations and related ESOPs prior to March 14, 2001, for sale to taxpayers after March 14, 2001.*

[61] *Revenue Ruling 2003-6, 2003-1 INTERNAL REVENUE BULLETIN 6.*

[62] *Id.*

[63] *This is unusual in the listing announcements, perhaps even unprecedented. It is worth wondering whether the ESOP would have had to disclose on its Form 5500 if the ruling had not be limited to "disqualified persons."*

c) Certain Trusts Purporting to be Multiple Employer Welfare Funds Exempt from the Limits of Sections 419 and 419A

Another listed transaction involves section 419A(f)(6). In this transaction, certain trust arrangements purport to qualify as multiple employer welfare benefit funds in order to be able to deduct what would otherwise be nondeductible life insurance premiums. Initially, SB/SE, with technical support from TE/GE, found this type of abuse on audit. At about the same time, TE/GE learned of this abuse from third-party contacts. The IRS subsequently noted the abuse in Revenue Ruling 95-34[64] and successfully litigated some of the more egregious violations.[65] The transaction was later identified as a listed transaction in Revenue Ruling 2001-15[66] and in proposed regulations.[67] TE/GE is involved in this listing primarily because of its actuarial expertise.

d) Off-shore Reinsurance Companies

Another listed transaction generally involves certain income-shifting transactions involving producer-owned reinsurance companies that are subject to little or no U.S. income tax.[68] The transaction involves a taxpayer (typically a service provider, automobile dealer, lender, or retailer) that offers its customers an insurance contract in connection with the products being sold. The insurance covers repair or replacement costs if the product breaks down, is lost, stolen, or damaged. The taxpayer acts as an insurance agent for an unrelated insurance company (Company X). The taxpayer gets a sales commission from Company X equal to a percentage of the premiums paid by taxpayer's customers. The taxpayer forms a wholly owned corporation (Corporation Y), typically in a foreign country, to reinsure the policies sold by the taxpayer. Promoters refer to these companies as producer-owned reinsurance companies (PORCs). The IRS guidance listing this transaction tells taxpayers that these transactions often do not generate the tax benefits claimed and informs taxpayers, their representatives, and promoters of these transactions about the applicable reporting and record-keeping requirements, and about the penalties that may result from these transactions. TE/GE is directly and substantially involved in this listing because one of the issues involves Exempt Organization qualification under section 501(c)(15).

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[64] *1995-1 CUMULATIVE BULLETIN 309.*

[65] *See Booth v. Commissioner, 108 T.C. 524 (1997); Neonatology Associates, P.A. v. Commissioner, 115 T.C. 43 (2000), affirmed 299 F.3d 221 (3d Cir. 2002).*

[66] *2000–1 CUMULATIVE BULLETIN 826. See also Notice 2001-51, 2001-34 INTERNAL REVENUE BULLETIN 190 (Listed transaction number (2): "(certain trust arrangements purported to qualify as multiple employer welfare benefit funds exempt from the limits of §§ 419 and 419A of the Internal Revenue Code (identified as "listed transactions" on February 28, 2000))."*

[67] *Proposed Treasury Regulation § 1.419A(f)(6)-1, 67 FEDERAL REGISTER 45,933 (2002).*

[68] *Revenue Ruling 2002-70, 2002-44 INTERNAL REVENUE BULLETIN 765.*

e) Certain Trust Arrangements Seeking to Qualify for the Exception for Collectively Bargained Welfare Benefit Funds under Section 419A(f)(5)

Another listed transaction generally involves certain businesses seeking to deduct extraordinarily large contributions made to a welfare benefit fund under certain new collective bargaining agreements.[69] In general, contributions to a welfare benefit fund are deductible when paid, but only if they qualify as ordinary and necessary business expenses of the taxpayer and only to the extent allowable under Code sections 419 and 419A. Those sections impose strict limits on the deduction for contributions in excess of current costs, but an exception to some of those limits is provided under section 419A(f)(5) for contributions to a welfare benefit fund required by a collective bargaining agreement. In the typical listed transaction, the business had no prior involvement with a union or with the collective bargaining process until a tax-shelter promoter helped the business create a welfare benefit fund that purportedly qualifies for the exception for collectively bargained funds. The IRS guidance listing this transaction tells taxpayers that these transactions are not allowable for federal income tax purposes and informs taxpayers, their representatives, and promoters of these transactions about the applicable reporting and record-keeping requirements, and about the penalties that may result from these transactions.

3. Civil and Criminal Investigations of Promoters

TE/GE officials often learn about abusive tax transactions that are being promoted through routine audits and from information shared by legitimate practitioners concerned about those abuses. At that point, TE/GE officials have a number of tools. TE/GE can initiate a civil investigation under section 6700 (promoter penalties) or section 6701 (aiding and abetting penalties), make a referral to the IRS Office of Professional Responsibility, or refer the matter to Criminal Investigation (CI).

The Tax Exempt Bonds unit generally initiates its own section 6700 investigations. Other TE/GE units typically initiate their section 6700 investigations in conjuction with the SB/SE or LMSB Divisions and with the Chief Counsel's Procedure and Administrative Office. Once a section 6700 investigation begins, the IRS may seek to enjoin the abusive transaction, and it may issue summonses to the promoters and other related parties to gather more information.

With respect to criminal investigations, TE/GE and TE/GE Counsel often consider criminal penalties – for example, for tax evasion, wire fraud, embezzlement, or perjury. In that regard, for example, Tax Exempt Bonds (TEB) officials advised the Project Group that TEB has made a number of referrals to Criminal Investigation (CI). All in all, however, relatively few promoters end up being investigated by CI and even fewer are prosecuted.

TEB often uses its investigative powers to curb abusive transactions, including: yield-burning, abuses involving zero coupon bonds, the improper use of private activity

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[69] *Notice 2003-24, 2003-18 INTERNAL REVENUE BULLETIN 1.*

bonds, and false valuations. These section 6700 proceedings typically involve some material misrepresentation or a false statement by the promoter or issuer of the tax-exempt bonds. TEB uses section 6700 to take the money out of the deals by forcing the promoters to disgorge any fees or profits they might otherwise have made. The issuer or investment banker agrees to pay a penalty, and the bonds remain tax-exempt.

For example, consider the yield-burning cases. Yield-burning has to do with the tax-exempt remarketing of Treasury bonds and securities. According to TEB officials, something like 4,000 to 5,000 bond issues involved such improper markups of Treasury securities. IRS efforts to curb this abuse grew out of a 1991 study of the problem by the IRS Chief Counsel. Then, a 1993 report of the U.S. General Accounting Office urged the IRS to develop a section 6700 program to curb yield-burning.[70] In the typical section 6700 case, the IRS pursued the bond issuers, bond counsel, and the conduit buyers of the abusive bonds. The IRS has entered into a number of settlement agreements, including one that resulted in a $15 million penalty.

Similarly, the zero coupon bond abuse involves an arbitrage, with the promoter taking a large, up-front fee. In the private-activity bond area, the typical abuse is that the bonds are used for something they should not be used for.

In addition to conducting section 6700 investigations of abusive transactions, TEB often issues Revenue Rulings and other guidance to curb abusive deals.[71]

4. Use of the Determination Letter Process

Sometimes, the determination letter process can alert TE/GE to potentially abusive tax transactions relating to Employee Plans (EP) and Exempt Organizations (EO). For example, TE/GE recently learned about the S Corporation ESOP abuse when EP received hundreds of applications for ESOP determination letters from just a few applicants.[72] EP initially refused to issue determination letters for those ESOPS. Soon thereafter, the S Corporation ESOP abuse was identified as a listed transaction.[73]

5. IRS Forms Can Also Promote Compliance

IRS forms can also be used to push taxpayers towards compliance and away from abusive tax transactions. For example, in the charitable area, the determination letter process is meant to be the first barrier to sham charities and other abuses of exempt-organization status. IRS Forms 1023 and 1024 help ensure that only qualifying entities can get through the process and secure an exemption.

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[70] *See, for example, Edward I. Foster,* Tax-Exempt Bond Examination and Appeals Process*, 29 EXEMPT ORGANIZATION TAX REVIEW 269 (2001).*

[71] *See, for example, Revenue Ruling 94-42, 1994-2 CUMULATIVE BULLETIN 15 (curbing zero coupon bonds that remarket of Treasuries); Revenue Procedure 96-41, 1996-2 CUMULATIVE BULLETIN 301 (curbing yield-burning).*

[72] *See Part III.B.2.b above.*

[73] *Revenue Ruling 2003-6, 2003-1 INTERNAL REVENUE BULLETIN 6. If the transaction involves an abuse of the deduction or funding provisions, or plan qualification operational defects, the determination letter program may not be an effective tool.*

The IRS Form 8038 series of information returns can help serve a similar function in the tax-exempt bond area.

6. The TE/GE Abusive Tax Shelter Committee

In order to better address the problems associated with tax shelters and other abusive transactions, TE/GE recently formed an Abusive Tax Shelter Committee. The committee includes representatives from Employee Plans, Exempt Organizations, Government Entities, and advisory input from the TE/GE Counsel. The committee collects information that TE/GE has about abusive tax transactions, and the committee is beginning to coordinate all of TE/GE's anti-abuse activities.

In addition, key officials from TE/GE and TE/GE Counsel participate in a new Service-wide committee designed to deal with abusive tax transactions.

7. Other Activities

TE/GE is also in the process of developing a comprehensive strategy to address the growth of abusive tax transactions. In particular, TE/GE has recently made it a priority to develop education and examination strategies to identify and counter abusive tax schemes. All segments of TE/GE are working to train their employees to recognize and address abusive tax transactions.

TE/GE segments are also developing their own strategies. For example, Employee Plans is collaborating with the Department of Labor to share information about abusive tax transactions. Exempt Organizations has already developed a new compliance unit and is developing a new fraud unit, too. Government Entities is developing a broad-based strategy to educate Indian tribal customers on the nature of abusive tax transactions and working with other IRS operating divisions to identify those transactions.

C. SPECIAL PROBLEMS FOR THE TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

The Tax Exempt and Government Entities Division clients can be involved in abusive tax transactions in a variety of ways. Sometimes a promoter uses a tax-exempt entity as the core of the abuse. For example, an exempt organization might give fraudulent appraisals in exchange for used car donations. Similarly, a promoter might use a purportedly exempt trust as an asset-management or estate-planning tool.

Sometimes the tax-exempt entity acts as an intermediate accommodation partner in a much larger scheme. For example, in so-called "lease-stripping", a limited partnership sells the rights to lease payments to investors but tries to allocate the "taxable" income to an exempt organization.[74] Abusive schemes involving charitable remainder trusts also implicate exempt organizations, either directly or indirectly.

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[74] *See, for example, Notice 2001-51, 2001-34* INTERNAL REVENUE BULLETIN *190 (Listed transaction number (3) "(certain multiple-party transactions intended to allow one party to realize rental or other*

Still other times, TE/GE clients are the victims of a scam, not the abusers. Indian tribes, for example, are often approached by promoters who want to take advantage of their unique tax status. For example, promoters of tax avoidance schemes have begun to approach Indian tribes about joint ventures structured to bring limited income to an exempt Indian tribe and substantial tax savings to a third party.

As more fully explained in this subpart, TE/GE has some special problems with learning about these various kinds of abuses, and with shutting them down.

1. TE/GE Has Difficulty Learning About Abusive Tax Transactions

One of the biggest problems for TE/GE is simply finding out about abusive tax transactions. TE/GE often learns about abusive tax transactions in the course of routine audits. Also, TE/GE sometimes learns about potentially abusive tax transactions through the determination letter process. In both instances, topic specialization by TE/GE employees has helped improve TE/GE's ability to see and flag many key problems.

TE/GE also often learns about abusive tax transactions from other IRS operating divisions. For example, sometimes the TE/GE finds out about abuses because its expertise is sought after by the other operating divisions. For example, TE/GE sometimes learns about abuses because IRS officials in the other operating divisions seek out TE/GE's actuarial expertise.[75]

Of particular importance, TE/GE often learns about abusive tax transactions from legitimate practitioners and industry groups that take the time to share their tips with TE/GE officials in Washington and around the country at various professional meetings. TE/GE also sometimes learns about abusive tax transactions from newspaper and magazine stories and from disgruntled employees of promoters.

2. TE/GE Needs to Coordinate with the Other IRS Operating Divisions

More than almost any other operating division of the IRS, the TE/GE Division needs to coordinate its efforts with other parts of the IRS. Many abusive tax transactions involving tax-exempt and government entities show up on individual and business tax returns that are reviewed by other operating divisions.

3. TE/GE Has Limited Resources

Given limited resources, TE/GE may have to concentrate on transactions that are being promoted. TE/GE simply does not have time to audit all its clients. With limited resources such a "retail" approach to catching abusive transactions could never work. Instead, TE/GE will probably need to focus on the more "wholesale" approach of stopping abusive tax transactions that are being promoted to multiple taxpayers.

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income from property or service contracts and to allow another party to report deductions related to that income (often referred to as "lease strips") (identified as "listed transactions" on February 28, 2000))."

[75] *See Part III.B.2.c above.*

Even then, TE/GE will need to ask questions that will enable it to focus its resources effectively. TE/GE will need to ask questions like:

> How bad is the transaction? Is it real bad? Is it being promoted? Or is it just one advisor and one client making a mistake? If it is being promoted, who is the promoter? Is it a big four accounting firm, a mid-level accounting firm, or an independent promoter? Who are the investors? Are they unsophisticated individuals or large corporations?

Answering these kinds of questions will help TE/GE decide how to best allocate its resources.

4. Section 6103 Limits Disclosure

In trying to deter abusive tax transactions, it can be important to penalize bad promoters and make examples of them. In that regard, however, Code section 6103 prevents disclosure of most taxpayer information. Matters of public record, such as criminal convictions and civil summonses, however, can be publicized, but TE/GE is involved in relatively few such cases. Without mentioning the particular taxpayers involved, however, TE/GE can disclose the types of transactions that it is investigating and the kinds of tools it is using to curb the underlying abusive tax transactions.

IV. RECOMMENDATIONS

The Project Group offers the following recommendations:

A. FOCUS ON PROMOTERS AND SELF-PROMOTING TRANSACTIONS

With limited resources, the TE/GE Division simply cannot curb many abuses audit-by-audit or taxpayer-by-taxpayer. The normal audit process catches many abuses, but, of course, this approach is very labor intensive. It is a kind of “retail” approach to catching abuses, and with limited resources, TE/GE should strive to curb abuses on a more “wholesale” basis. As noted by many of the IRS officials that the Project Group spoke with, the more effective strategy is to try to stop the promoters who are marketing abusive tax transactions to multiple taxpayers. A second related “wholesale” approach is to focus on transactions that tend to “self-promote” and spread widely quickly (such as employee classification schemes). TE/GE should focus on these promoted and self-promoting transactions.

B. OPEN AN OFFICE OF ABUSIVE TAX TRANSACTIONS

Another way to help TE/GE deal with abusive tax transactions would be to provide a single location to coordinate information received relating to abuses. Such an “Office of Abusive Tax Transactions” could also help to coordinate a more effective response by the TE/GE Division to identified abusive tax transactions.

In the course of this project, the TE/GE Division created an abusive tax shelter committee to coordinate the TE/GE response to tax shelters and other tax schemes.

The Project Group congratulates TE/GE on this effort and urges TE/GE to set up an Office of Abusive Tax Transactions.

This new office could: (1) provide a central "reporting house" for third parties and internal persons to report suspected promotion schemes and "self-promoting" transactions; (2) catalog and profile schemes and trends; (3) assist the TE/GE functions in the allocation of resources to abusive tax transactions; (4) increase employee knowledge and skills related to abusive tax transactions; and (5) enhance coordination within the IRS on issues related to abusive tax transactions. The office might initially be quite small, and essentially act as a clearinghouse to gather information and pass it along to the directors of the TE/GE segments.

The new office should also help develop a strategy for dealing with each identified abusive tax transaction. In that regard, however, much of the responsibility for developing the strategy should remain in the various TE/GE segments. That is where most of the substantive expertise is, and that is where the employees who must find and curb the abuses reside.

The new office would also be instrumental in coordinating with other IRS operating divisions. That coordination role will be especially important because so many abusive tax transactions that involve tax-exempt and government entities show up, if at all, only on tax returns that are reviewed by other operating divisions. For example, many tax abuses involve unwarranted charitable contributions, either because the taxpayer gets value back[76] or because the donated property is overly or improperly valued.[77] Code section 170 is not directly within TE/GE's purview, except to alert and educate charities and cooperate with W&I Division agents. Similarly, abuses involving business taxpayers will typically show up on tax returns handled by SB/SE or LMSB. TE/GE needs to establish itself as a resource to be pulled in on abusive tax transaction issues involving tax-exempt and government entities.

Coordination is also important when it comes to shutting down promoters. For example, in order to list a transaction, TE/GE often needs to coordinate with other operating divisions. Similarly, criminal cases must be coordinated with Criminal Investigation and with the Department of Justice and the U.S. Attorneys.

In short, this new office should help identify abusive tax transactions involving tax-exempt and government entities, help develop the strategies needed to deal with those abuses, and help implement those strategies.

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[76] *For example, the IRS recently attacked certain life-insurance purchases through National Heritage Foundation's donor-advised funds. See, for example, Gary L. Weiner v. Commissioner, T.C. Memo. 2002-153 (2002).*

[77] *Requiring "qualified appraisals" has helped compliance in this area. See Part III.B.1.a above.*

C. EXPAND THE TOOLS FOR DISCOVERING ABUSIVE TAX TRANSACTIONS

The TE/GE Division learns about potentially abusive transactions from: routine audits, the determination letter process, other IRS operating divisions, legitimate practitioners who care about good tax policy, and even from newspaper and magazine stories. TE/GE should streamline its ability to get information about abusive tax transactions, perhaps by adding an "abuse line" to its phone bank and a "report-abuses-here" link on its World Wide Web page.

In addition, the Project Group believes that TE/GE should also be more proactive about uncovering abusive tax transactions. TE/GE officials should encourage legitimate practitioners and industry representatives to "blow the whistle" on abusive tax transactions. When TE/GE officials are speaking and attending meetings of professional groups and industry association, they should ask for leads and ideas about promoted transactions and self-promoting schemes.

D. PROVIDE ADDITIONAL PRIORITY TO GUIDANCE PROJECTS FOR DISPUTED TAX TRANSACTIONS THAT ARE PROMOTED OR THAT ARE SELF-PROMOTED

TE/GE needs to act quickly to identify potentially abusive tax transactions and to develop strategies for dealing with them. If a disputed tax transaction is being promoted or self-promoted and becoming widespread, the sooner that TE/GE can step in and issue guidance, the sooner it will be able to curb the abusive tax transactions and validate the legitimate ones. Guidance is always greatly appreciated by practitioners and their tax-exempt clients. In that regard, the Project Group notes that that the IRS, the Office of Chief Counsel, and the Office of the Assistant Secretary of Treasury for Tax Policy are working well at providing as much guidance as possible to TE/GE clients and their advisors.

While the formal guidance process is pending, TE/GE also needs to consider whether it should issue soft guidance to curb the disputed transaction. Some transactions may call for public remarks by TE/GE officials or even a warning notice indicating that TE/GE is looking at a particular type of transaction. Of course, such soft guidance needs to be used carefully so as not to curb legitimate transactions. In general, soft guidance is most appropriate where the rules are clear or at least generally agreed upon, but the IRS has not yet issued formal guidance curbing the particular transaction in question.

E. KEEP IDENTIFYING LISTED TRANSACTIONS

The Project Group was very impressed with the efforts that TE/GE has made to list potentially abusive tax transactions. The Project Group believes that the listing process has curbed a number of serious abuses. Moreover, the Project Group believes that having an ongoing listing process gives more credibility to honest practitioners who refuse to do suspect deals for clients.

To be sure, the listing process can present some problems for the IRS and for the TE/GE Division. The biggest problem is deciding just where to draw the line. If the listed transaction is defined too broadly, many nonabusive taxpayers will be required to report on their legitimate transactions, and the IRS will be overwhelmed with disclosures that it might not have the time to follow up on. The Office of Tax Shelter Analysis has committed itself to give at least some degree of scrutiny to each listed transaction that is reported.

On the other hand, if the listed transaction is defined too narrowly, taxpayers will try to game the system – even when the IRS indicates that "substantially similar" transactions are to be included. Abusive taxpayers will do something slightly different from the published listing and argue that it is not "substantially similar" to the listed transaction. For example, in the case of the 401(k) deferral abuse,[78] the IRS has already felt it necessary to expand upon its initial determination by subsequently issuing Revenue Ruling 2002-46 outlining a "substantially similar" transaction that is reportable,[79] and Notice 2002-48 outlining a somewhat similar transaction that is not reportable.[80]

Moreover, listing is not the best approach for all abusive tax transactions. For example, listing would probably not be very useful in the tax-exempt bond area – any concern raised about a bond issue would make the bonds unmarketable. Consequently, listing a tax-exempt bond transaction would not just shut down the abusive tax transactions, it would shut down all similar transactions, even those that were legitimate.

Nevertheless, the Project Group believes that the listing process is working well in helping to curb many identified abuses. The listing process does not automatically shut down abusive tax transactions. For example, listing has not stopped taxpayers from claiming accelerated deductions with respect to 401(k) plan contributions or the questionable deductions of life insurance premiums under section 419A(f)(6).[81] But listing does put the IRS on notice that taxpayers are claiming the benefits of a potentially abusive tax transaction and so gives the IRS an opportunity to challenge the transaction or request additional information about it.

F. BRING MORE CRIMINAL CASES

The Project Group also believes that bringing more criminal investigations and prosecutions would have a significant deterrent effect on abusive tax transactions. In particular, the Project Group would like to see TE/GE, together with Criminal Investigation (CI) and the Department of Justice, make examples of some of the worst promoters of abusive tax transactions involving tax-exempt and government entities.

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[78] *See Part III.B.2.a above.*

[79] *2002-29 INTERNAL REVENUE BULLETIN 118.*

[80] *Notice 2002-48, 2002-29 INTERNAL REVENUE BULLETIN 130, described the same basic 401(k) transaction with one twist: the money was actually contributed to the plan in the prior taxable year. In that instance, the IRS indicated that it would not challenge the employer's deduction for the prior year.*

[81] *See Part III.B.2.a and c, respectively, above.*

TE/GE officials acknowledged that the TE/GE employees receive relatively little training about how to help develop criminal tax cases. In that regard, the Project Group recommends that TE/GE work with CI and the Department of Justice to develop a program to better educate TE/GE employees about criminal tax cases and about the "badges of fraud" that CI employees look for in developing cases for prosecution, and to better educate CI employees about abusive tax transactions that involve tax-exempt and government entities.

G. MODIFY TE/GE FORMS TO STEER CLIENTS AWAY FROM ABUSIVE TAX TRANSACTIONS

IRS Forms can often steer taxpayers away from abusive tax transactions. For example, IRS Forms 1023 and 1024 help ensure that only qualifying entities can get exempt-organization status. IRS Forms might also be designed in a way that could help the IRS discover more potentially abusive tax transactions. TE/GE should think about whether it should modify some of its other tax forms to help promote greater compliance and get the information that TE/GE needs to discover abusive tax transactions more quickly.

For example, Tax Exempt Bonds might want to modify its series of Form 8038 information returns so that the forms elicit more relevant information about new bond issues, and Employee Plans might want to think about ways that it could improve Form 5300 to elicit more relevant information from plan sponsors seeking determination letters.

The Project Group recognizes that changing forms can be burdensome for taxpayers. Nevertheless, TE/GE would do well to solicit taxpayer and practitioner input about how it might change some of its forms to improve compliance and generate more useful information.