

Tax Shelter ALERT

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New regs apply excise tax to exempt organizations involved in tax shelters

The IRS has issued temporary and proposed regs (NPRM REG-142039-06, NPRM REG-139268-06, T.D. 9334, T.D. 9335) to clamp down on exempt organizations that profit from and assist in the completion of tax shelter transactions. The relevant provisions under Code Sec. 4965 and 6033 impose excise taxes and disclosure requirements on charities, federal government possessions, state and local governments, Indian tribal governments, IRAs and employee benefit plans, as well as on an entity manager that approves the entity’s participation.

Temporary regs under Code Sec. 6033(a)(2) provide rules regarding the form, manner and timing of disclosure obligations, while proposed regs under Code Sec. 4965 relate to the entity-level and manager-level excise taxes for tax-exempt entities involved in prohibited tax shelters. Final and temporary regs under Code Sec. 6071 detail the filing requirements for non-plan entities.

Prohibitions and penalties

As enacted by the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), Code Sec. 4965 imposes an excise tax upon tax-exempt entities that enter into prohibited tax shelters. Furthermore, tax-exempt entities are required to report such participation to the IRS under Code Sec. 6033(a)(2), including the identities of co-participants in the transaction. Taxable organizations are also required to disclose the participation of a tax-exempt entity in a prohibited tax shelter to the IRS.

Temporary regs

The temporary regs under Code Sec. 6033(a)(2) require tax-exempt entities participating in a prohibited tax shelter to file Form 8886-T, *Disclosure by Tax-Exempt Entity Regarding Prohibited Tax Shelter Transaction*. As required by Code Sec. 6033(a)(2), the form must confirm that the tax-exempt is participating in a listed transaction under Code Sec. 6707A(c)(2) or prohibited reportable transaction under Code Sec. 6707A(c)(1).

Tax-exempt entities must report participation in a tax-shelter for each single instance of participation. A tax-exempt party is considered to have participated in a prohibited tax shelter transaction if it facilitated the transaction by reason of its tax-exempt, tax-indifferent or tax-favored status. Tax-exempts that enter into a listed transaction, or

have returns that indicate a reduction or elimination of liability for federal employment, excise or unrelated business income tax that is derived from a listed transaction must also report their involvement in a prohibited tax shelter. Finally, as a catch-all rule, tax-exempts must report their participation if they are described in any published guidance as a party to a prohibited tax shelter.

The disclosure rules under the temporary regs are not required if the tax-exempt entered into a prohibited tax-shelter before May 17, 2006. However, there are transition rules for prohibited tax shelter transactions occurring after May 17, 2006, and before January 1, 2007. For these transactions, the facilitating tax-exempts must disclose participation before November 5, 2007, and tax-exempts reporting reduced liability from tax-shelters must report the transaction on or before November 5, 2007, or the due date for the first return reflecting the tax savings.

In addition, tax-exempts entering into a transaction that is subsequently classified as a listed transaction must file disclosure on or before May 15 of the calendar year following the close of the calendar year during which the transaction became a listed transaction.

Proposed regs

The IRS also published proposed regs under Code Sec. 4965 detailing excise taxes on the tax-

exempts involved with prohibited tax shelters. In Notice 2006-65, the IRS alerted taxpayers to the new tax-exempt reporting requirements in TIPRA regarding prohibited tax shelters. In Notice 2007-18, the IRS provided interim guidance on when tax-exempts would be treated as participating in, and the allocation of net income and proceeds to, tax shelter transactions. In response to comments, the IRS issued the recent proposed regs.

The IRS declined to carve out exceptions to the excise taxes on prohibited tax shelter transactions, despite comments that the proposed definition was harsh and would punish routine transactions. The IRS chose to rely on the definition of a reportable transaction in Code Sec. 6011. However, several comments were received suggesting that the proposed regs establish a safe harbor, or rule that would limit the application of Code Sec. 4065 in instances where tax-exempts indirectly invest in a transaction deemed to be a prohibited tax shelter. The IRS pointed that, to become a party to a prohibited tax shelter, the tax-exempt would have to do more than simply invest in the transaction. This would require facilitation or an attributable reduction in the exempt's tax liability. The IRS sought further comments on this issue.

Manager-level penalties. Code Sec. 4952(a) imposes an excise tax on the manager of a tax-exempt entity if the manager approves of an

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action or causes the entity to take an action that would make it a party to prohibited tax shelter transaction. Under the proposed regs, the manager must display an affirmative action and have the authority to commit the entity to the transaction to be held liable for this tax. The regs also expand the definition of “entity manager” to include those given authority by the manager to act on behalf of the tax-exempt. Finally, the proposed regs indicate that the manager-level excise tax under Code Sec. 4965 is not subject to joint and several liability between the manager and the tax-exempt entity.

Entity-level penalties. The IRS pointed out that manager-level excise tax penalties are imposed under Code Sec. 4965(b) if the manager knew, or had reason to know, it was committing the tax-exempt entity to a prohibited tax-shelter transaction. A similar rule exists for entity-level excise taxes under Code Sec. 4965(b)(1). The tax-exempt entity must have known, or had reason to know, at the time it entered into the transaction that it is becoming a party to a prohibited tax shelter. The proposed regs specify that if an entity manager knew, or had reason to know, that it was committing the tax-exempt entity to a tax shelter transaction, then the entity itself is deemed to have known or had reason to know.

To compute the penalties against the tax-exempt, the proposed regs specify different definitions for the entity’s proceeds. For tax-exempt entities that facilitate tax shelter transactions for the benefit of others, the proposed regs define “proceeds” as the gross amount of the tax-exempt entity’s consideration for facilitating the transaction, not reduced by costs or expenses attributable to the transaction. For tax-exempt entities involved in the tax shelter to reduce their tax liability, proceeds are defined as the amount of tax savings the transaction generates and are claimed by tax-exempt.

Disclosure. Code Sec. 6011(g) was modified by TIPRA to create a reporting duty on the party of taxable entities in transactions with tax-ex-

empts. The taxable entity has a duty to notify the tax-exempt entity that it is involved in a prohibited tax shelter transaction. The proposed regs establish that the taxable entity must notify the tax-exempt entity within 60 days after the later of either of the following:

- the date the taxable party became a party to the transaction; or
- the date the taxable party knew, or had reason to know, that the tax-exempt is a party to the transaction.

The proposed regs do not require the taxable party to disclose if the taxable party does not know, or had no reason to know, the tax-exempt entity is a party to the transaction before the date the

transaction is required to be disclosed by the IRS.

As required by TIPRA, the proposed regs apply the reporting requirements for tax-exempt entities and taxable parties for tax-shelter transactions entered into after May 17, 2006. The proposed regs only apply relevant excise taxes upon proceeds from the

transactions for periods ending on or before August 15, 2006. The regs apply the 100-percent entity-level excise tax under Code Sec. 4965(b)(1)(B) and the manager-level excise tax under Code Sec. 4965(b)(2) to prohibited tax shelter transactions occurring after May 17, 2006. Noticeably, the proposed regs do not apply either of these excise taxes to tax shelter transactions, which subsequently become listed transactions. In final form, the proposed regs will be effective for tax years ending after July 6, 2007.

Non-plan entity regs

The IRS also released final and temporary regs regarding the filing requirements for non-plan tax-exempt entities. These tax-exempts are described by Code Sec. 4065(c)(1), (2) and (3). Both the entity and managers who are liable for the excise tax must file Form 4720, *Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code*. The return must be filed on or before the date any annual return under Code Sec. 6033(a)(1) is required to be filed. If

“A tax-exempt party is considered to have participated in a prohibited tax shelter transaction if it facilitated the transaction by reason of its tax-exempt, tax-indifferent or tax-favored status.”

no such annual return is due, Form 4720 must be filed before the 15th day of the fifth month following the close of the manager's tax year during which the entity entered into the tax shelter transaction.

The regs also require managers of non-plan entities liable for Code Sec. 4965 taxes to file Form 5330, *Return of Excise Taxes Related to Employee Benefit Plans*. This is also due on the 15th day of the fifth month following the close of the manager's tax year during which the entity entered into a prohibited tax shelter. ❖

Chief Counsel labels "OpCo" strategy as impermissible tax shelter

IRS Chief Counsel recently determined that a system of national and regional cooperatives formed by a corporation to negotiate vendor contracts on behalf of the corporation's subsidiaries was an impermissible attempt to defer income under the consolidated group regulations. The anti-avoidance provision of the consolidated group regulations governing intercompany transactions, Reg. §1.1502-13(h)(1), applied to prevent the taxpayer from taking advantage of the cooperative provisions of Code Sec. 1382, which, outside the context of a consolidated group, would have allowed deferral of some income. Chief Counsel indicated that it will recognize similarly structured transactions for their true form as intercompany transactions that require income to the members from patronage dividends and deductions by the cooperatives to be recognized in the same tax year.

Background

The taxpayer did business in the United States through a series of subsidiaries. A promoter approached the taxpayer with a tax strategy entitled "Operations Consolidation Strategy `OpCo'."

Comment. Before the taxpayer received the tax shelter promoter's proposal, taxpayer's subsidiaries paid normal fair market value for the goods it ordered directly from vendors. The vendors paid negotiated rebates, discounts and promotional funds to the parent, who then passed these amounts along to the subsidiary through its procurement division.

In response to the promoter's proposal, the taxpayer separated itself from the vendor discount system by forming a system of cooperatives. A national cooperative, owned by foreign companies, negotiated the vendor contracts and then passed the discounts down to a set of regional cooperatives. Each of these regional cooperatives in turn passed on the discounts to its three U.S. subsidiary-members. While the cooperatives took over the role of distributing the vendor's rebates, discounts and promotional funds to the subsidiaries, it did so in the terms of what the taxpayer coined to be patronage dividends.

The cooperatives elected a tax-year end date that was four months after the year end of the members. Code Sec. 1382 allowed the cooperatives to pay dividends to the subsidiaries up to 8 ½ months after the end of the cooperative's tax-year-end as long as they deducted the dividends during the tax year paid. Due to the discrepancy between tax years and the delayed patronage dividend payments, the subsidiary-members did not have to recognize the income from the patronage dividends paid for supplies they bought during the tax year. This nonrecognition of income allowed the subsidiaries to report and deduct the cost of their goods sold with the amount they physically paid to the vendors during this time period. They did not have to adjust the cost of goods sold for the patronage dividends until they were received in a later tax year (which was the same tax year as when the dividends were paid for the cooperative).

Chief Counsel's analysis

The taxpayer claimed the cooperative was a "non-consolidatable entity" because no subsidiary owned an interest with 80 percent of the voting power in the cooperative, as required by Code Sec. 1504(a)(2); thus, it excluded the national cooperative from its consolidated group filings. However, Chief Counsel pointed out that, in reality, the taxpayer, the system of cooperatives and the subsidiaries were all members of a consolidated group. The regional cooperatives, through which the ownership of the subsidiaries was diluted, were mere passthrough entities that conducted no substantial business operations. According to Chief Counsel, had each subsidiary held a direct membership interest in the national cooperative, instead of the series of

regional cooperatives, the members would have had sufficient voting power to meet the requirements under Code Sec. 1504(a)(2).

Chief Counsel discovered evidence that the transaction was only structured to achieve the deferral of tax on the amount of the negotiated discounts. The same employees who formerly worked in the taxpayer's procurement division worked for the national cooperative, performing the same duties. The tax shelter promoter did not analyze or suggest business goals, but focused purely on tax savings. All these efforts, Chief Counsel determined, were done through avoidance of the rules on intercompany transactions and with a regional cooperative system that was a "transparent" tax maneuver lacking economic substance.

Since it considers these transactions to have occurred between members of a consolidated group, Chief Counsel indicated that it will assert the timing rules for intercompany transactions under Reg. §1.1502-13. This requires that members of a consolidated group treat income items and deductions as if the members were divisions of the same corporation. Under this rule, the patronage dividend deductions and the income the subsidiary-members later receive must be both taken into account during the same tax year. This prevents the subsidiaries from sheltering income with their inflated cost of goods sold deductions.

Chief Counsel will apply the anti-avoidance rule under Reg. §1.1502-13(h)(1) to taxpayers who attempt similar transactions. This rule calls for adjustments to tax liability instances where a transaction is engaged in, or structured with, the principal purpose of avoiding treatment as an intercompany transaction. For example, in this instance, the taxpayer claimed that the business purpose for the transaction was to increase incentives for its subsidiaries to purchase centrally, centralize accounts payable transactions and to protect the taxpayer from regulatory enforcement actions. ❖

Court dismisses indictments against 13 of 16 KPMG defendants

The United States District Court for the Southern District of New York dismissed charges against

13 of 16 defendants in the KPMG tax shelter case on July 16 (*J. Stein*, DC N.Y., 2007-2 USTC ¶50,549). Prosecutorial misconduct convinced the court to dismiss the charges on grounds that their constitutional rights had been violated. Absent the government's interference, KPMG would not have refused to pay legal fees for indicted employees or placed a cap on fee payments for other employees. The government intends to appeal the decision.

Comment. Formal federal prosecutor **Kurt Stitche**, now a partner at **Levenfeld Pearlstein LLC**, in Chicago, told CCH that this latest incarnation of the KPMG prosecution was a major reflection of all the past factual findings by Judge Lewis Kaplan, as well as ruling on the "Thompson Memorandum" and prosecutorial misbehavior.

KPMG policy

According to the court, KPMG had a "long-standing" policy of paying legal fees and expenses for its employees. Upon initial discovery of the investigation, KPMG's CEO sent a voicemail to all partners, explaining that present and former members called to testify would be represented.

However, the government gave a memorandum to KPMG's counsel stating that advancement of legal fees to employees would be a factor in considering whether the company was cooperating with the government in its investigation or attempting to hide the actions of its employees. The federal prosecutor assigned to the case emphasized that payment of any legal fees would be "looked at under a microscope."

Constitutional violations

In determining that the government violated the constitutional rights of the defendants, the court found that the government's actions were outrageous and "shocked the conscience." Because KPMG wanted to cooperate with the government as much as possible, the government's behavior pressured KPMG to restrict its policy of advancing legal fees to any employee who was indicted in the case. The firm decided that it would only advance up to \$400,000 in expenses for employees, cut off reimbursements for any employees that were indicted and refused to sign the contract it had negotiated with a new employee requiring compensation for his legal expenses.

The government knew that KPMG would go as far as to fire employees and refuse to pay their legal fees if they refused to interview with the government, yet chose to take these actions in spite of this knowledge.

Comment. In response to the controversy over the Thompson memorandum, the Department of Justice has begun using the “McNolte” memorandum, Stitche said. However, as Stitche states, this document is very similar to its predecessor. The only change is that the actions of the prosecutors, which were at issue in this case, have to be approved by higher-level management of the U.S. Department of Justice. Stitche pointed out that he has heard comments from various bar associations and business associations that the changes have not gone far enough to prevent deprivation of defendants’ constitutional rights.

Deprivation of counsel

According to the court, the government’s actions deprived three defendants of their counsel of choice. Two employees were fired, and KPMG refused to pay their legal expenses. One employee, who resigned from KPMG before the investigation began, was forced to choose a smaller firm after KPMG refused to reimburse his legal fees after indictment.

In describing why the defendant’s choice of counsel was deprived, the court pointed out that this trial was particularly challenging for counsel. There was an enormous volume of documents; 26 different motions had already been filed, producing over 1,100 pages of legal memoranda; nearly 70 witnesses had been called, and the nature of the tax shelter transactions, transactional documents and tax law involved were extremely complex. Because of these facts, the court quickly dismissed the government’s argument that appointment of counsel under the Criminal Justice Act (CJA) would be appropriate remedy.

As for the remaining defendants, the court found that two failed to show that the government’s actions interfered with their ability to defend themselves. The court was not persuaded that KPMG would have paid the defense costs of the final remaining defendant.

Drastic sanction

“Dismissal based on prosecutorial misconduct is a drastic sanction,” the court noted. “This

indictment charges serious crimes. They should have been decided on the merits as to every defendant. But, there are limits on the permissible actions of even the best prosecutors,” the court found. “The vice of the government’s actions was that the government improperly interfered with the payment of defense costs that KPMG otherwise would have paid.”

Appeal likely

The government intends to appeal the dismissal. According to a statement from Michael Garcia, U.S. Attorney for the Southern District of New York, “the government respectfully disagrees with Judge Kaplan as to whether there was any constitutional violation in this case. We will continue to pursue appellate review.” ❖

Eighth Circuit decides Son-Of-BOSS tax shelter challenge

A Son-of-BOSS (bond and option sales strategy) tax shelter participant recently lost an appeal of a Tax Court decision, which denied the taxpayer’s claimed benefits on the basis that the limited liability company (LLC) at the center of the transaction was a sham. (*RJT Investments X*, CA-8, 2007-2 USTC ¶50,535). Despite the taxpayer’s arguments to the contrary, the Court of Appeals for the Eighth Circuit found that the Tax Court’s recharacterization of the LLC as a sham was properly performed as a final partnership administrative adjustment (FPAA). The validity of a partnership qualified as a partnership item worthy of adjustment under Code Sec. 6231(a)(3).

Background

The taxpayer exchanged loans, and both sold and purchased nearly identical bonus coupons, with a bank for \$20 million. Then, the taxpayer contributed \$1 million in cash and his bonus coupon to an LLC he formed, which was treated as a partnership for federal tax purposes. He also assigned the burden of pay the redemption costs of the bonus coupon to the LLC. The same day, he liquidated his interest in the LLC and received a \$1 million cash distribution of the LLC’s assets.

However, the LLC failed to report the taxpayer's contribution of the bonus coupon and the assignment of the burden to pay the redemption costs on its Form 1065, (Schedule K-1) *Partner's Share of Income, Deductions, Credits, etc.* Furthermore, on his Form 1040, *U.S. Individual Income Tax Return*, he claimed an outside basis in the partnership of \$22 million (presumably from his contributions to the LLC) and reported a short-term capital loss of \$21 million resulting from the liquidation that he allegedly used to shelter other income from taxation.

IRS actions

In correcting the taxpayer's actions, the IRS could not adjust the taxpayer's Form 1040 to match the LLC's Form 1065 because the statute of limitations had lapsed. Instead, the IRS issued a notice of FPAA, amending the LLC's Form 1065. The IRS declared the LLC to be a sham entity, zeroed-out all of the entries on its Form 1065 and imposed penalties for negligence and misrepresentation. The U.S. Tax Court agreed, finding that the LLC lacked economic substance and was formed to artificially inflate the taxpayer's basis for the purpose of tax avoidance.

Taxpayer's appeal

In his appeal, the taxpayer presented the novel argument that the Tax Court could not determine a partnership to be a sham because this was not a permitted partnership item adjustment under Code Sec. 6226. He also argued that determining a partnership to be a sham could not be made at the partnership level, rather than at the partner level under Code Sec. 6231.

Court's analysis

The Court of Appeals rejected the taxpayer's arguments as "unavailing and contrary to TEFRA's language and intent." It found that the validity of a partnership met the definition of a partnership item under Code Sec. 6231(a)(3) because it was required to be taken into account for income tax calculation purposes. Although the definition referenced items to be taken into account as "under any provision in subtitle A," the court found that this was an overarching concept that provided room for partnership items that may not be explicitly mentioned in subtitle A, but are necessary for income tax calculation.

The court also found that treating the sham determination as a partnership item adjustment was consistent with the Congressional intent of preventing inconsistent and inequitable income tax treatment between partners in the same partnership. Determining the validity of the partnership at the partner level could result in conflicting determinations of partnership level items for each individual taxpayer.

Finally, the court stated that finding a partnership to be a sham was appropriately determined at the partnership level as described in Reg. §301.6231(a)(3)-1(b) because it was a legal determination underlying the determination of the amount, timing and characterization of items of income, credit, gain, loss or deduction. ❖

IRS seeks comments on information requests after latest settlement initiative

The IRS is requesting comments on Son-of-BOSS Settlement Initiative (Announcement 2004-46) regarding information reporting. According to the IRS, the initiative was designed to offer settlement to individuals and businesses that participated in transactions deemed to be abusive tax shelters of the Son-of-BOSS variety.

Background

Rather than engage in prolonged litigation, and to promote efficient tax administration, the IRS chose to offer settlements for alleged tax liabilities in 2004. For taxpayers who were willing to concede all tax benefits claimed, plus interest, the settlement initiative required them to pay penalties that measured either 10 percent or 20 percent, depending on their history of participation in tax shelters. In return, the IRS allowed them to deduct the fees paid to the shelter promoter and tax advisor and avoid the costs of virtually guaranteed litigation with the IRS, in which a 40 percent penalty for substantial valuation misstatement, no fee deductions and a possible 75-percent fraud penalty would have been at risk.

Comments sought

Now, with regard to this settlement initiative, the IRS seeks comments from the public on the following issues:

- whether collection of more information is necessary for the IRS to properly perform,
- how accurate is the IRS's estimate of the burden of collection of more information,
- suggested ways of enhancing the quality, utility and clarity of information collected,
- suggested ways of minimizing the burden of collecting information on taxpayers, such as through the use of automated collection, and
- estimates of capital or start-up costs and costs of operation, maintenance and purchase of services to provide information.

Taxpayers have until September 11, 2007, to reply. ♦

■ PRACTITIONER PRIVILEGE EXPANDED

Tax shelter exception not limited to corporate tax shelters

The Seventh Circuit Court of Appeals has rejected claims that the tax shelter exception to the tax practitioner privilege in Code Sec. 7525 applies only to corporate tax shelters. Although Congress had corporate tax shelters in mind, the exception does not apply only to corporate tax shelters. (*BDO Seidman, LLP, CA-7, 2007-2 USTC ¶150,530*).

Background

The accounting firm in this case allegedly planned and promoted listed transactions without following the reporting and record-keeping requirements of Code Sections 6111 and 6112. In response, the IRS issued summonses for the production of documents, testimony of employees and the identification of clients who invested in the transactions.

Although the accounting firm refused to comply and argued that the summonses were a violation of the attorney-client and tax practitioner privileges, the IRS successfully enforced them in federal court. The court ordered the firm to produce all documents for in camera inspection by the court.

However, when the accounting firm notified its clients of this action, many of them intervened to assert the tax practitioner privilege against the disclosure of their identities.

Tax shelter exception

Prior to 2004, Code Sec. 7525 provided with respect to tax advice, the same common law protections of confidentiality that apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner, to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. Code Sec. 7525(b) provided that the privilege would not to apply to communications regarding corporate tax shelters.

The court found that Code Sec. 7525(b) was a true exception. Congress did not understand the promotion of tax shelters to be part of the routine relationship between a tax practitioner and a client. As with any other exception to a claimed privilege, the burden rests on the opponent of the privilege to prove preliminary facts that would support a finding that the claimed privilege falls within an exception.

The intervenors argued that the tax shelter exception applied only to tax shelters that shelter corporate taxes. They relied on Code sec. 7525(b)'s heading and legislative history. The IRS countered that the tax shelter exception, as it existed in 2002, was not so limited.

The Seventh Circuit agreed with the IRS. The title of a statute cannot limit the plain meaning of the text. Although the court found that the legislative history was "unenlightening," it did not appear to show that Congress intended the exception to be limited. The intervenors also provided no support for their argument that the term "corporation," as used in Code Sec. 7525(b), only means "C corporation."

The court further noted that the tax shelter exception applies only to communications between the tax practitioner and the corporate agent. The tax practitioner privilege is limited to communications that would be privileged if they had been made to an attorney. The attorney-client privilege protects only those statements made by the client to the attorney in confidence. A communication is not made in confidence when the client intends that the communication shall be disclosed to unprivileged third parties.

Crime-fraud exception

The Seventh Circuit found that the remaining document was admissible under the crime-fraud

exception to the attorney-client and tax practitioner privileges. It stated that the IRS was not required to make a *prima facie* showing of each element of the crime or fraud (as required by other federal circuits), but only to “give color to the charge” by showing “some foundation in fact.”

The court also decided the district court’s application of the crime-fraud exception to the document was correctly based upon a totality of the circumstances test. In making its decision, the trial court had used eight factors mentioned in previous cases. Yet, the court was satisfied that the district court did not “place dispositive weight” on any one of the factors or limit its analysis strictly to the factors.

Common interest doctrine

While the interveners object to admittance of certain documents into evidence, the accounting firm also objected to the admittance of its own set of documents. With regard to one of the documents, the Seventh Circuit sustained the trial court’s application of the common interest doctrine for supporting attorney-client privilege. Even though a written communication between the accounting firm and one of its clients was shared with a third-party law firm outside of the threat of litigation, the trial court found the two parties shared a common legal interest. This was confirmed by the Seventh Circuit because the taxpayer and the law firm provided services to the same customers, and the document was shared in an effort to determine the best advice to give to their shared clients in light of the other’s actions. Furthermore, the court found that privileged communications within the protection of the common interest doctrine could not be waived without the consent of all the parties involved. ❖

Tax Court imposes interest-penalties in latest Hoyt case

On remand from the U.S. Court of Appeals for the Ninth Circuit, the U.S. Tax Court imposed interest-penalties under Code Sec. 6621(c) to the taxpayer-partners on sheep partnerships and determined that the statute of limitations on assessment had not expired when the IRS is-

sued notices of final partnership administrative adjustment (FPAAs) for the tax years at issue (*River City Ranches #1 Ltd.*, TC Memo. 2007-171, Dec. 56,988(M)). Although Walter Hoyt III inappropriately signed consents to extend the statute of limitations beyond three years due to a conflict of interest, the six-year statute of limitations under Code Sec. 6229(c)(1) applied because of fraud.

Interest-penalties

As instructed by the Court of Appeals for the Ninth Circuit, the Tax Court determined that the sheep partnerships were tax-motivated for purposes of imposing Code Sec. 6621(c) interest-penalties upon the investor-partners. Under that provision, taxpayers who enter into tax-motivated transactions, and incur substantial underpayments of tax as a result, are subject to an increased rate of interest.

In making its determination, the court pointed out that the transactions lacked economic substance because no business purpose existed beyond generating tax benefits. Although the partnerships were allegedly formed to engage in sheep breeding activities, the court found that the partnerships never acquired the benefits and burdens of ownership of the sheep. Even though the partners claimed to have personally assumed promissory notes to purchase the sheep, the court found that the notes did not constitute *bona fide* nonrecourse debt. The partnerships claimed to have entered into a sharecropping agreement with a sheep breeding business for the management of their sheep and payment of related expenses, yet, the court determined that no such management or payment occurred.

Additionally, the court pointed out evidence that the partnerships themselves were a sham. Several of the partnerships lacked signed partnership agreements, or had none at all. And, the sheep partnerships did not maintain separate books, records or assets.

Finally, the sheep partnerships underpaid their tax liabilities by overvaluing their assets and overstating their bases. The sheep the partnerships claimed to purchase often did not exist, or were not of the same quality as sheep that normally sold for the same purchase price. Additionally, the partnerships never gained the benefits and burdens of ownership and the

promissory notes used to acquire the sheep were not valid debt instruments. Thus, the court recharacterized the adjusted bases for the sheep to zero and imposed the interest-penalties under Code Sec. 6621(c).

Statute of limitations

Because the partnerships did business with both sheep and cattle, the IRS issued summons for both types of partnerships at the same time. As tax management partner for all of the partnerships at issue, Hoyt informed the agency that he could not produce documents for both cases at the same time. He then executed a Form 872-P, *Consent to Extend the Time to Assess Tax Attributable to Items of a Partnership*, to extend the three-year statute of limitations on partnership-item assessments under Code Sec. 6229.

Agreeing with the investor-partners, the court determined that waivers of the statute of limitations signed by Hoyt were invalid. The court found that Hoyt was allowing his personal interests to interfere with his personal duty to the partnerships when the IRS was investigating him for criminal tax abuses. While it was in the best interest of the investor-partners to receive FPAs as soon as possible, it was in Hoyt's interest to delay issuance of the FPAs so that the partners would not learn about how he took payment for non-existent sheep and claimed tax benefits to which the partnership was not entitled. Since there was evidence the

IRS knew or had reason to know about this conflict at the time the extension was signed, the court found the consent to extend the statute of limitations to be invalid.

Fraud exception

The court applied the six-year statute of limitations exception under Code Sec. 6229(c)(1)(B) for cases of fraud. According to the court, the investor-partners acknowledged that the sheep partnership returns contained false and fraudulent deductions. Hoyt, as tax management partner, participated in the preparation of returns and signed them with the intent to evade taxes of the partners because the transactions were a sham, lacked economic substance and used methods of preparation that created conflicting individual and partnership tax returns. ♦

■ RETURN PREPARER STANDARDS CAUSE CONTROVERSY

Practitioners urge Congress to change reporting standards

The controversial “more likely than not” reporting standards for return preparers in the Small Business and Work Opportunity Tax Act of 2007 (2007 Act) (P.L. 110-28) should apply to tax-avoidance items, and not to routine items, the AICPA told leaders of the House and Senate tax-writing committees in a July 10 letter released on July 13. The AICPA also warned that preparers will become advisors, rather than advocates, because of the new law.

“More likely than not”

The 2007 Small Business tax Act increases the tax return reporting standards under Code Sec. 6694 on undisclosed, nontax avoidance items from the “realistic possibility of success” to “more likely than not.” A preparer must satisfy a higher standard than the standard the taxpayer must satisfy (substantial authority) to avoid the imposition of an understatement penalty, the AICPA observed. In addition, “it is possible for a preparer to be subject to a penalty with respect to a position taken on a return he or she prepared even though the taxpayer would not

IRS ISSUES COMPREHENSIVE FINAL REGS ON 403(B) TAX-SHELTERED ANNUITIES

Long-awaited final regs under Code Sec. 403(b) on tax-sheltered annuity arrangements maintained by schools and tax-exempt organizations have been released. The final regs (T.D. 9340) mostly track the proposed regs but the IRS made some modifications, including newly created written plan document requirements, elimination of previously allowable exclusions from the universal availability rules, elimination of previously allowable contract exchanges and requests to broaden the circumstances under which permissive aggregation is permitted under the controlled group rules.

Planning tip. The IRS previously indicated that the regs would not apply until January 1, 2008, but decided after further consideration of the compliance burdens, not to generally require general compliance with the final regs until January 1, 2009.

be subject to a penalty with respect to that same tax return position.”

Comment. “In addition to the penalty in the statute, practitioners could be in violation of Circular 230 with another penalty and automatic referral to the IRS Office of Professional Responsibility,” AICPA Vice President—Taxation Thomas Ochsenschlager, said.

Preparer’s role

The “more likely than not” approach “results in a fundamental change in the role of a preparer,” the AICPA warned. Preparers become advisors, rather than advocates. The AICPA also cautioned that determining the probable correctness of the treatment of routine items would be extremely difficult, if not impossible. “There sometimes is little guidance for the tax treatment of an item at the time the item must be reported on a return and the proper treatment of an item frequently depends on an analysis of unique or unusual circumstances that were not contemplated in published guidance.”

Corrective action

Congress should equalize the return preparer standards with the taxpayer standards, the AICPA stated. For non-tax-avoidance items, the “substantial authority” standard should apply. The “more likely than not standard” should apply for tax-avoidance items, such as items attributable to any “listed transaction.” The AICPA also recommended an expansion of the authorities that can be relied on in determining if the “substantial authority” is met to include field service advice memoranda, treatises and legal scholarly literature.

Comment. Ochsenschlager explained that this “major change in tax policy” was made without any congressional hearings. The AICPA, in its letter to House Ways and Means Committee Chairman Charles B. Rangel, D-N.Y., and ranking member Jim McCrery, and

Senate Finance Committee Chairman Max Baucus, D-Mont., and ranking member Charles E. Grassley, R-Iowa, said that the IRS was “blindsided” by the new rule. The IRS issued transitional relief in June (IR-2007-115, Notice 2007-54, I.R.B. 2007-27). At this time, legislation has not yet been introduced in Congress. ♦

REOPENING CLOSED YEARS UNLIKELY

More reopenings of closed years are possible because of FIN 48

Because FIN 48 requires more information to be disclosed, it is possible that reopenings of closed tax years could occur more frequently, a senior IRS official indicated on July 12, while appearing on an Ernst & Young, LLP Thought Center Webcast. Robert D. Adams, Senior Advisor to the Commissioner, IRS Large and Mid-Size Division, also stressed that the Service has not changed its policy of restraint regarding requests for tax accrual workpapers, which covers FIN 48 disclosures. The Tax Council Policy Institute sponsored the webcast.

Closed tax years

Practitioners have expressed concern that FASB Interpretation No. 48 (*Accounting for Uncertainty in Income Taxes*) may encourage the IRS to reopen closed tax years. FIN 48 imposes new rules for recognition, de-recognition, measurement and disclosure of all tax positions. Adams, who was speaking on his own behalf and not on behalf of the IRS, noted that historically, “cases are rarely reopened.” However, there are exceptions.

Comment. The exceptions are described in Rev. Proc. 94-68, I.R.B. 1993-44, I.R.B. 1994-44, 16. The IRS may reopen a case if there is evidence of fraud, malfeasance, collusion, concealment or misrepresentation of a material

“[I]t is possible for a preparer to be subject to a penalty with respect to a position taken on a return he or she prepared even though the taxpayer would not be subject to a penalty with respect to that same position.”

fact. A “clearly defined substantial error based on an established Service position existing at the time of the previous examination” may trigger reopening of a case. Lastly, the IRS may reopen a case if “other circumstances exist that indicate failure to reopen would be a serious administrative omission.”

FIN 48 disclosures could generate more reopenings, Adams indicated, but he did not predict a flood of reopenings. There is “nothing on the horizon” that would change the IRS’s traditional policy of not reopening tax years that have been examined and closed.

Comment. “Reopenings were very remote in the past,” **Chester Abell**, Director of Tax Accrual Services, Tax Accounting and Risk Advisory Services, **Ernst & Young, LLP**, told CCH. Going

forward, the likelihood increases that the IRS will reopen more cases than in the past, he noted.

Tax accrual workpapers

Adams noted that Chief Counsel recently affirmed that FIN 48 workpapers are tax accrual workpapers. They are subject to the Service’s policy of restraint covering tax accrual workpapers. Generally, the IRS does not request tax accrual workpapers as a standard examination technique, with exceptions for some abusive transactions.

The IRS has not changed its policy of restraint, Adams emphasized. The Service is “evaluating its policy of restraint in light of current day events,” he said. “We have not completed that evaluation.”

Effective tax rate reconciliation papers

In related news, Adams stressed that IRS Chief Counsel’s recent determination that effective tax rate reconciliation papers created under FASB Statement 109 (*Accounting for Income Taxes*) are not tax accrual workpapers is not a “backdoor approach” to getting tax accrual workpapers. Roberts spoke at a Washington, D.C., conference on FIN 48 sponsored by Tax Analysts on July 13.

In June, IRS Chief Counsel determined that effective tax rate reconciliation papers do not fall within the category of accrual workpapers, as defined by the IRS (CC-2007-015). Consequently, they are not subject to the IRS’s policy of restraint in asking for tax accrual workpapers.

Tax accrual workpapers are defined as a subset of audit workpapers that relate to the tax reserve for current, deferred and potential or contingent tax liabilities, whether prepared by the taxpayer, the taxpayer’s accountant or the independent auditor. However, the IRS has stated that it did not intend to expand the category of audit workpapers to include all documents prepared by the taxpayer for review by the auditor in the course of an audit. Chief Counsel determined that effective tax rate reconciliation workpapers also do not fall within the category of tax accrual workpapers. ❖

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