

Tax Shelter ALERT

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No third-party disclosure protection for shelter investors

The IRS' investigation of abusive tax shelters reaches far and wide to capture as many key players as it can, especially promoters and their investors. During an examination of one investor, the IRS often discovers information identifying other investors and promoters. The Chief Counsel recently described when the IRS can use information obtained from third parties in a judicial or administrative proceeding against a tax shelter investor in CCN 2006-006.

Comment: The Chief Counsel used examples to help to clarify CCN 2006-003, which laid out the rationale behind the release of information from a third party's tax return within the context of a tax-shelter investigation. Investors have to be more than "similarly situated" taxpayers to justify release of third-party information. Something more, some type of nexus, must be present. The October notice described two tests—the item and the transaction tests—to justify release of information.

'Cookie cutter' transactions

An investor files suit in the Tax Court claiming that the IRS wrongfully disallowed a loss related to a transaction. The IRS obtained promotional material and an opinion letter that had been given to the investor by a promoter. The promotional materials describe how big of a loss investors can expect depending on the size of their investment.

The IRS is also examining another investor's return. It discovers the same or similar promotional material and an opinion letter. The IRS concludes that the promotional material and opinion letter tend to prove that the promoter had a routine practice of promoting abusive transactions, specifically, transactions generating tax losses without any economic effect to the investor.

According to the Chief Counsel, the IRS can disclose the promotional material and opinion letter given to the second investor in the first investor's case. The promotional materials relate to the liability of the first investor because they are evidence that the investor purchased a "cookie cutter" deal.

Fee schedule

In 2000, an investor entered into a listed transaction. During its examination of the investor's return, the IRS discovers a fact sheet issued by a bank and a law firm, co-promoters of the transaction. The fact sheet describes the entities and transactions that will be used to effectuate the investor's transaction and the losses for the past two years. The fact sheet also discloses the fees that the bank

and the law firm charge. The law firm's fees cover issuance of an opinion letter.

The IRS is also examining a second taxpayer, who invested in a similar transaction. It uncovers an opinion letter issued by the same law firm, but is unable to obtain the fact sheet describing the transaction and the fees.

The IRS can disclose the fact sheet obtained from the first taxpayer during its examination of the second taxpayer. The Chief Counsel explained that the fee schedule pertains not only to the first investor's transaction, but also to similar transactions promoted by the law firm as well.

Emails

An investor in a listed transaction seeks to prevent an opinion letter from being disclosed after the IRS issues a summons. The investor claims the letter is protected by attorney-client privilege.

During the course of its examination of another investor, the IRS discovers an email from the law firm that produced the first investor's opinion letter. The email reveals that the law firm routinely discloses its opinion letters to co-promoters of the listed transaction.

The email to the second investor can be disclosed in the summons enforcement action for the first investor. The Chief Counsel explained that the email is evidence that the opinion letter was disclosed to third parties.

Investor lists

A promoter is under examination for penalties related to investor lists. The lists were required to be maintained for three shelter transactions with three individual investors. The IRS can disclose the three investors' tax information related to the transactions in the Code §6112 soft letter issued to the promoter. Tax information regarding the transaction between the three investors and the promoter affects the outcome of the promoter's examination, in which penalties relating to the transactions are the focus of the examination, the Chief Counsel explained.

Welfare and similar plans

An employer deducts payments to a trust arrangement, which is purportedly a Code §419(A)(f)(6) welfare benefit fund. The IRS disputes this. During its examination, the IRS finds promotional materials, an opinion letter, the employer's enrollment package, individual insurance contracts purchased by the trust and the transactional accounting records for the plan and trust. The documents reveal the operations of the plan and how the employer and other employers interact with it.

The IRS is also examining another employer. The second employer made and deducted payments to the same trust arrangement, which the second employer also argues is a Code §419(A)(f)(6) welfare benefit fund.

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The IRS can disclose the promotional materials, opinion letter and other documents obtained in its examination of the first employer to the second employer. The Chief Counsel explained that the documents pertain to the economics of the plan to which both employers have made payments. The documents show that employers participating in the purported welfare benefit fund do not share economic risk.

Accommodation party

An investor files suit in federal district court for a refund. The investor had invested in a transaction facilitated by a promoter and executed by an accommodation party. While examining a second investor, the IRS uncovers documents from the accommodation party. The documents reveal that the two investors had entered into the transaction to generate a loss, and the transaction did not reflect economic reality. The documents tend to show that the transaction lacked economic substance.

The IRS can use the documents in the first investor's refund suit. The documents show the lack of economic substance of the transaction, the Chief Counsel explained.

No nexus to justify disclosure

A taxpayer invests in a listed transaction. An IRS examination uncovers promotional materials describing the size of the losses investors can expect. Later, another taxpayer files suit in the Tax Court claiming that the IRS wrongly disallowed his losses from the same listed transaction. The shelters were marketed and sold by two different promoters.

The IRS cannot disclose the promotional materials discovered in its examination of the first investor in the second investor's suit. No evidence exists of any link between the two promoters. The two investors are merely similarly situated taxpayers. ❖

Employee plans are no small part of global tax shelter settlement initiative

The IRS' one-time global settlement for taxpayers to resolve the tax treatment of abusive transactions cuts across a wide swath of transactions. Administrators of employee plans should be aware of the IRS' global tax shelter settlement initiative, agency officials are saying. Among the numerous transactions eligible for settlement, are several relating to employee plans.

"The goal of the IRS and Employee Plans is unwinding all abusive transactions," Carol Gold, director of IRS Employee Plans recently said in *Employee Plan News*. Gold's words were echoed by James Holland, manager of IRS Employee Plans, Technical, during a recent webcast. Holland described what plan administrators can expect if they participate in the settlement initiative.

Limited window to participate

The global settlement initiative was launched on Oct. 27, 2005. Taxpayers have a short window to apply for participation in the settlement. The settlement closes on Jan. 23, 2006.

In exchange for conceding 100% of the taxes owed, the IRS is offering limited penalty relief to parties that agree to the settlement. Some transaction costs, including professional and promoter fees, will be allowed as an ordinary loss.

Several transactions in the global settlement relate to employee plans. They are:

- Rev. Rul. 2004-20 (Situations 1 and 2),
- Rev. Rul. 2004-21,
- Rev. Rul. 2004-4 (abusive ESOP-owned S corporation arrangements with no benefit to the rank and file),
- Rev. Rul. 2003-6 (arrangements involving the transfer of ESOPs holding stock in an S corporation to claim eligibility for the delayed effective date of Code §419(p) and
- Management S corporation transactions.

Comment: The IRS is reminding retirement plan administrators to carefully review the transactions eligible for the global settlement. Some other transactions may be of interest to retirement plan administrators. They are abusive Roth IRA transactions (Notice 2004-8), tax problems raised by certain trust arrangements seeking to qualify for exception to collectively bargained welfare benefit funds (Notice 2003-24) and tax problems raised by certain trust arrangements seeking to qualify for an exemption from Code §419.

Rev. Rul. 2004-20

Situation 1 in Rev. Rul. 2004-20 looks at a pension plan that isn't a 412(i) plan, because the amounts accumulated under life insurance contracts and annuities exceed benefits payable. Situation 2 in the same revenue ruling addresses a pension plan that fails to satisfy nondiscrimination requirements due to differences in the value

of the participants' rights to purchase life insurance contracts from the plan.

Example of Situation 1: ABC Co. maintains a plan, which it intends to be a 412(i) plan. The plan is funded solely by life insurance contracts and annuities with level annual premiums for each participant commencing with the date the individual becomes a participant in the plan or, in the case of an increase in benefits, commencing at the time the increase becomes effective. The amounts that will be accumulated under the insurance contracts and annuity contracts for the benefit of a participant at normal retirement age will provide for benefits in excess of the participant's benefits at normal retirement age under the terms of the plan.

The plan is not a 412(i) plan. Benefits under a 412(i) plan must be equal to the benefits provided under each contract at the plan's normal retirement. In this case, the participant's benefit under the plan payable at normal retirement age is not equal to the amount provided at normal retirement age with respect to the contracts held on behalf of the participant.

Example of Situation 2: ABC Co. maintains a plan, which it intends to be a 412(i) plan. The plan provides Alan with a death benefit that meets the definition of an "incidental death benefit" under Reg. §1.401-1(b)(1)(i). The plan's assets include life insurance contracts on the life of Alan. The life insurance contracts have a face value exceeding Alan's death benefit under the plan. Premiums for Alan include an annual premium for the waiver of the entire premium if Alan becomes disabled. Upon the death of a covered employee, the portion of the proceeds of the life insurance contract exceeding the death benefit payable to Alan's beneficiary is applied to the payment of premiums for other plan participants.

This plan is a 412(i) plan, even though the life insurance contracts on the life of Alan provide for death benefits in excess of the death benefits under the plan. However, a portion of ABC Co.'s contributions is attributable to the purchase of life insurance that is in excess of the incidental death benefit payable under the plan. This por-

tion is not normal costs and is not deductible.

The nondeductible portion of ABC Co.'s contributions for life insurance for Alan is carried over. This portion would be deductible when ABC Co. uses excess death benefits to pay future premiums on other participants. Similar treatment would apply to ABC Co.'s contributions to pay premiums for the disability waiver for Alan.

Comment: Situation 2 is a "listed transaction."

Rev. Rul. 2004-21

Rev. Rul. 2004-21 addresses pension plans that fail to satisfy the nondiscrimination requirements because of differences in the value of participants' rights to

purchase life insurance contracts from the plan.

Example: ABC Co. maintains a plan, which it intends to be a 412(i) plan. The plan provides an incidental death benefit for each

participant. It funds the incidental death benefit with a life insurance contract on the life of each participant. Highly compensated employees can purchase life insurance contracts from the plan at cash-surrender value before retirement benefits are distributed. This plan does not satisfy the requirements of Code §404(a)(4) prohibiting discrimination in favor of highly compensated employees.

Settlement terms

Holland explained some of what plans that participated in these transactions can expect from the settlement. Along with the plan agreeing to the IRS' terms, participants may have to come onboard as well. Insurance contracts generally must be distributed to participants. Distributions will be reflected in a participant's income at fair market value. The IRS will permit some deductions, depending on the circumstances. Plans may also qualify for some penalty relief.

Comment: According to Holland, the IRS is looking beyond the current pool of employee plans under examination for settlement candidates. Plans that are not under examination may be contacted by the IRS as well, to educate them about the settlement. ❖

“The IRS is looking beyond the current pool of employee plans under examination for settlement candidates.”

■ MORE CIRCULAR 230 QUESTIONS

Circular 230's application to foreign transactions raises questions

The scope of the new tax shelter rules of practice in Circular 230 are unclear and could have a broad impact, tax practitioners said at the Institute on Current Issues in International Taxation, cosponsored by the IRS and George Washington University, in Washington, D.C., on Dec. 9.

Philip West of Steptoe & Johnson said the new Circular 230 rules have many ambiguous concepts and raise a number of questions. He noted that the rules may, in effect, require practitioners to meet the "highest quality standards" for giving advice, even though this principle is expressed solely as an aspirational standard.

International ramifications

According to West, the international ramifications of the new rules are not clear. Circular 230 applies to the handling of U.S. federal income tax issues by U.S. practitioners. Suppose, West said, a U.S. attorney is part of a team of international specialists assisting a French practitioner to provide advice. The U.S. attorney must comply with Circular 230, but it is unclear whether the French attorney must similarly comply regarding the portion of the tax advice on U.S. law.

West discussed other ambiguities in the new rules. Circular 230 exempts tax advice filed with the Securities and Exchange Commission. It is not clear, however, whether this type of exemption applies to advice that is included in a filing submitted in a foreign country. Circular 230 applies to transactions that have a "significant purpose" of avoiding or evading tax. It is unclear whether the same standards apply if there is a significant purpose to avoid or evade foreign tax.

Other problem areas

In addition to the above-mentioned concerns, West asked whether a Schedule K-1 filed by a pass-through entity is regarded as written advice. He said, the view "on the street" is that completed tax forms are written advice subject to Circular 230.

West pointed out an inconsistency in the Circular 230 language. The regulations con-

GLOBAL TAX-SHELTER SETTLEMENT INITIATIVE: IRS PLAYS POKER

IRS remains tight-lipped regarding how many tax shelter participants are coming forward under the global settlement initiative in progress until Jan. 23, 2006 (Announcement 2005-80). Preliminary results could be released early in 2006, which will show whether the global settlement is shaping up as successfully as past ones. In the meantime, IRS appears to be doing its best to convince taxpayers to participate. Chief Counsel Donald Korb warned on December 8, 2005, that the IRS has no plans of offering any further settlement programs. Korb stated that the Jan. 23, 2006, deadline represents the "last chance" for taxpayers to come forward on these transactions.

Appeals route?

As early as Nov. 2, 2005, Andrew Blanche, Jr., Director, Appeals Field Operations-East had been saying that taxpayers would get no better deal by taking their case to Appeals, rather than engaging in the settlement offer. Nevertheless, some practitioners remain adamant that if the shelter has a valuation issue, mitigating circumstances or other unique twist, the taxpayer may do considerably better taking their situation before Appeals and, if unsuccessful, into the courts.

clude that a negative opinion is not a covered opinion. He asked whether this exemption applies when a practitioner does not give either a favorable or unfavorable opinion on a transaction. Circular 230 exempts "written advice that does not resolve a federal tax issue in the taxpayer's favor," thus seeming to allow advice that does not take a stance. However, the preamble to Circular 230 says that, to avoid being a covered opinion, the written advice must conclude that the taxpayer cannot do the transaction.

ABA action

Paul Sax of Orrick, Herrington & Sutcliffe said the tenets for tax shelter opinions under Circular 230 are similar to American Bar Association (ABA) opinion 346 (1981) on the requirements for a non-client, third-party tax shelter opinion: Determine the actual facts; relate the law to the actual facts; give an opinion of each issue; and draw a conclusion as to whether the transaction works. An ABA task force is re-examining the association's professional standards for tax shelter opinions, Sax said.

(Continued on page 7)

■ Updates

SHELTER SETTLEMENT DEADLINES APPROACH IN TWO KEY STATES

Two state tax shelter initiatives are drawing to a close. The Connecticut Abusive Tax Shelter Compliance Initiative ends Dec. 31, 2005, and the New York State Voluntary Compliance Initiative will end on March 1, 2006.

The Connecticut initiative began Oct. 1, 2005, and is open to promoters of abusive shelters and investors. Taxpayers and promoters who come forward are rewarded with penalty relief and avoidance of criminal prosecution. Taxpayers must concede 100% of the underreported income tax liability as a result of their participation in the shelter. Connecticut tax officials warn that after Dec. 31, 2005, the state will target, and aggressively pursue promoters and taxpayers who did not participate in the settlement. New state legislation has increased penalties for promoting "listed transactions," and the statute of limitations for the audit of "listed transactions" has been extended from three years to six years. Taxpayers should file Form CT-ATS, *Election to participate in the 2005 Connecticut Abusive Tax Shelter Compliance Initiative*.

The New York initiative offers similar penalty relief and the possibility of avoiding criminal prosecution. New York is giving taxpayers five months to disclose their participation in abusive tax shelters for years prior to Jan. 1, 2005, and pay unreported tax liabilities and interest attributable to tax-avoidance transactions, without incurring any of the new state penalties for tax shelters. Taxpayers participating in the program may opt to do so with or without appeal rights. Taxpayers declining to participate in the initiative risk additional penalties, including a penalty equal to 100% of the interest attributable to the tax due on the transaction. New York also has extended its limitations period. Taxpayers should file Form DTF-671 for each year the tax-avoidance transaction was used.

OPR CHIEF CHASTISES KPMG FOR SHELTER BEHAVIOR

Cono Namorato, director of the IRS Office of Professional Responsibility, told an audience of government tax officials in London recently that KPMG chose "profits over professionalism at every critical juncture," according to media reports in the United Kingdom. Earlier this year, KPMG acknowledged that it engaged in a fraud that generated more than \$11 billion in phony tax losses, which, according to court papers, cost the federal government at least \$2.5 billion in lost tax revenue. KPMG entered into a \$456 million settlement with the federal government, and the government agreed to defer its criminal case.

EX-JUDGE SENTENCED FOR PROMOTING SHELTERS

Tax shelter promoters John Rizzo, a former judge, and his wife Carol Rizzo were sentenced to prison in December for marketing tax-evasion schemes. The couple pleaded guilty to conspiring to impede and impair the IRS in the collection of income tax, among other charges. As described in plea agreements, John Rizzo was a prominent speaker at offshore seminars promoting tax-evasion schemes. Both he and his wife acknowledged that they provided opinion letters and other documentation to facilitate the schemes. The U.S. Department of Justice reported that John Rizzo appeared at the seminars wearing judicial robes and portraying himself as a judge. "It is tragic when a former member of the judiciary, charged with upholding the law, encourages others to violate those laws," said Paul Charlton, U.S. Attorney for the District of Arizona. John Rizzo was sentenced to 43 months in prison, followed by three years of supervised release. Carol Rizzo was sentenced to 24 months in prison, followed by three years of supervised release. Both have been barred from providing tax advice.

ENTREPRENEURS PLEAD GUILTY TO TAX EVASION

Two brothers, who owned more than two dozen fast-food franchises, have pleaded guilty to tax fraud and other charges related to their business operations. The two men engaged in a scheme to evade income and payroll taxes in connection with their business by disguising the salaries of some employees as nontaxable expense reimbursements, submitting false W-2 and payroll tax forms, and failing to file corporate and partnership tax returns as well as personal returns. The brothers evaded more than \$1.5 million in payroll and income taxes. Sentencing is scheduled for early 2006. Both men face a maximum sentence of five years in prison and a maximum fine of \$1 million on the tax evasion charges.

IRELAND LEADERS DISPUTE 'TAX HAVEN' LABEL

Business and government leaders in Ireland are disputing recent media reports that the country is a tax haven because of its low 12.5% corporate tax rate. Irish media have been reporting that the IRS is taking a keen interest in Ireland because of the large number of U.S. companies using their operations there to minimize tax liabilities. According to published reports in Ireland, the IRS is seeking nearly \$500 million from one U.S. business with operations there.

Speaking in the United States in November, Brian Cowen, the Irish Minister of Finance, indicated that the corporate tax rate would not be changed. "This government's policy of low corporation tax rates has been central to our strategy and vital in attracting U.S. investment in the manufacturing area," Cowen told the U.S. Chamber of Commerce in Washington, D.C. The minister told the audience that the Irish government is also not in favor of a common consolidated European Union corporate tax base. "Ireland believes that it is important that rights in relation to taxation are retained at the national level," Cowen said. Leaders of the Irish computer and software industries have also criticized the connection between the country's low corporate tax and labeling it a "tax haven."

Circular 230 *(Continued from page 5)*

KPMG agreement

Phillip Mann of **Miller & Chevalier** said the KPMG deferred prosecution agreement, which establishes ongoing supervision of KPMG's actions, is a new kind of agreement for tax shelter violations. This type of agreement is more common for a supervised industry, such as the banking industry. He noted that legislation (S1565) introduced by Sen. Carl Levin, D-Mich., would further increase penalties for improper tax shelters.

OPR activity

Ted Setzer, from the Office of the IRS Associate Chief Counsel (International), discussed the operation of the IRS' Office of Professional Responsibility (OPR). The OPR is currently looking at two types of issues:

1. whether the practitioner exercised necessary due diligence for issuing a covered opinion; and
2. whether the practitioner engaged in disreputable behavior, such as failure to file personal tax returns.

The OPR has 12 attorneys who investigate violations of Circular 230 and other improper actions. Referrals come from IRS revenue agents, Justice Department attorneys and other sources.

When a complaint is filed, the OPR sends an allegation letter to the practitioner, who can contest the facts or provide mitigating facts for the practitioner's actions. If the OPR makes an adverse determination, it contacts the practitioner to attempt to resolve the case. If there is no resolution, the case goes to a formal hearing chaired by administrative law judges from the National Labor Relations Board. Attorneys from the IRS' General Legal Services office represent the OPR at the hearing. If the practitioner wants to contest the hearing decision, he or she can appeal to Chief Counsel Donald L. Korb, as the designee of the IRS, and can then file suit in U.S. District Court. ❖

IRS updates adequate disclosure procedure to expose more tax shelters

Disclosure is one of the IRS' principal weapons against tax shelters. It is no surprise, therefore, that the agency continues to fine-tune the description of those circumstances under

which disclosure is considered adequate to avoid penalty liability. Rev. Proc 2005-75 updates Rev. Proc. 2004-73, and provides the latest requirements for identifying circumstances under which the disclosure on a taxpayer's return with respect to an item or position will be deemed adequate for purposes of:

1. reducing the Code §6662(d) penalty for understatement of income tax, relating to the substantial understatement aspect of the accuracy-related penalty, and
2. avoiding the Code §6694(a) preparer penalty, relating to understatements attributable to the taking of unrealistic positions.

Tax-shelter-specific

A number of changes to the adequate disclosure revenue procedure directly address tax shelter situations. They update the last annual procedure, both for new law and for developing loopholes that the IRS wants closed quickly. These updates include:

- a new paragraph cautioning that the entry of an amount on a line will not provide adequate disclosure when an understatement arises from a related-party transaction
- a new paragraph cautioning that the entry of an amount on a line will not provide adequate disclosure for the Code §6662 accuracy-related penalty if the item or position is attributable to a tax shelter or if it does not have a reasonable basis and supporting records and
- elaborating on the rule that where the amount of an item is shown on a line that does not have a preprinted description identifying that item (such as on an unnamed line under an "Other Expense" category) the taxpayer must clearly identify the item by including the description of the item on that line. ❖

Business groups fight to preserve SILO grandfather protections

Removing grandfather protection for SILO transactions has triggered a heated response from banks, financial institutions and other businesses that believed these transactions were protected. The American Jobs Creation Act of 2004 cracked

down on SILOs, but generally only for transactions entered into after March 12, 2004. On Nov. 18, the Senate approved doing away with that protection as part of the Taxpayer Relief Act of 2005 (S2020). The Senate also voted to retroactively repeal grandfather protection for some leasing transactions pending before the Federal Transit Administration (FTA).

Comment: The House has not approved removing these grandfather protections. Differences between the House and Senate versions must be ironed out in a conference. At press time, leaders in the House and Senate have not announced a date for the conference.

Comment: The FTA is in the picture because some of these transactions involve municipal infrastructure, including transportation systems. These transactions were given special protection if they are approved by the FTA before a certain date and other requirements are met.

Prospective, not retrospective, treatment

When Congress passed the 2004 Jobs Act, it understood that retroactive effective dates were inappropriate and the effective date for the change in the law should be prospective, the American Bankers Association, the Financial Services Roundtable and the U.S. Chamber of Congress reminded leaders of the Senate Finance Committee and the House Ways and Means Committee in a Dec. 1, 2005, letter. "We considered this issue resolved after passage of the 2004 Jobs Act," they wrote.

According to the three groups, several transactions were in mid-stream last year. The loss of tax benefits would have had a "tremendous economic impact," they reported.

Comment: According to some estimates, repeal could raise as much as \$5 billion over five years.

Pending before the FTA

The groups similarly believe that repeal of the grandfather protection for transactions pending before the FTA would be unfair and costly. "On the assurance of this grandfathering, mu-

IRS PREVENTS 'ABUSIVE' PARTNERSHIP ALLOCATIONS TO LOOK-THROUGH ENTITIES

To counteract "abuses," recently released proposed regulations by the IRS (*NPRM REG-144620-04*) mandate that partnership allocations take into account the tax attributes of owners of look-through entities when testing the substantiality of the allocation to a partner that is a look-through entity. The regulations follow up on a concern, expressed by the IRS in the preamble to 2004 regulations, relating to the proper allocation of partnership expenditures for foreign taxes.

The regulations also clarify that the after-tax consequences of the allocations under the partnership agreement must be compared to the after-tax economic consequences to that partner if the allocations were made according to the partners' straight-up interest in the partnership.

Comment: The IRS makes it clear it is not considering the tax consequences to an owner of the partnership that result from a partnership allocation if they are inconsistent with the policies underlying the substantial economic-effect doctrine. This doctrine is built directly into Code §704(b).

nicipalities have proceeded with critical investments in transportation infrastructure property. It would be unfair to change the anticipated tax treatment of these transactions after they already received the blessing of Congress and the Treasury Department," the groups stressed.

Comment: Sen. Charles Grassley, R-Iowa, Chairman of the Senate Finance Committee, has been a vocal critic of SILOs and isn't likely to be too receptive to the letter from the three business groups. After Congress passed the 2004 Jobs Act, Grassley praised the crackdown on SILOs. "In these scams, companies pretend to lease taxpayer-funded public works systems, like subways and sewers, and then lease them back to the cities. The companies claim depreciation on these assets, while the cities get upfront money from the shelter promoter that's just chump change compared to what the companies get," Grassley said. ❖