POINTS TO **REMEMBER**

Editor's Note: The three **POINTS** in this issue begin domestically with issues that affect our practices and our client's investments, and conclude globally, with highlights from a new tax treaty. First, David Pratt guides us through the intersection of listed transactions that affect benefit plans and the proposed amendments to Circular 230. Alex Drapatsky then reminds us that some of the tax benefits of owning real estate are sometimes overlooked. Finally, Nancy Beckner describes our new tax treaty with Japan and explains the important ways in which it differs from the old treaty as well as from other more recently negotiated treaties.

IS THAT AN **EMPLOYEE BENEFIT PLAN** OR A **TAX SHELTER**?

by David Pratt, Albany, NY

In a Special Report published in the NEWSQUARTERLY last year, Alvin D. Lurie discussed a report prepared by the TE/GE Abusive Tax Shelters Involving Tax-Exempt and Government Entities Project Group and made it clear that employee benefits practitioners, whether specialists or dabblers, need to follow these developments. Alvin D. Lurie, "Special Report, Benefits Tax Shelters: In Eye of the Beholder or Eye of the Storm?," Summer 2003, available at http://www.abanet.org/tax/pubs/newsletter/nl01sum/nl01sum; the Project Group's Report can be found on the IRS web site at www.irs.gov/pub/irs-tege/act_rpt2_part2.pdf. This Point builds on Mr. Lurie's work by discussing the benefits-related listed transactions identified by the Service and the potential impact of recent proposed changes to Circular 230 on benefits practitioners who come across such transactions.

THE LISTED TRANSACTIONS

The Service has identified eight employee benefit plan transactions as listed transactions [see www.irs.gov/retirement/article/0,,id=119551,00.html]. These transactions include: accelerating deductions for contributions to 401(k) plans; S corporation ESOPs; donations of S corporation stock to an exempt organization, such as a governmental retirement plan; attempts to avoid the deduction limits for welfare benefit funds; abusive Roth IRA transactions; and deductions for excess life insurance in a defined benefit plan.

Pursuant to Treas. Reg. §1.6011-4, taxpayers who have participated, directly or indirectly, in a listed transaction (or other reportable transaction) must disclose the transaction to the Service by attaching a statement (Form 8886) to their tax return for each taxable year for which their federal income tax liability is affected by participation in the transaction. Starting in 2003, the regulations also authorize the Service to require disclosure of listed transactions involving federal estate, gift and employment taxes, as well as transactions that raise pension or exempt organization issues.

A listed transaction is a transaction that is the same as, *or substantially similar to*, one that the Service has determined to be a tax avoidance transaction and has identified by a notice or other published guidance. The parties to a listed transaction may be required to (1) disclose the transaction, as required by the regulations, (2) register the transaction with the Service, and/or (3) maintain a list of investors in the transaction and provide the list to the Service on request.

It is not always easy to tell whether a client participates in a listed transaction within the meaning of the regulations. Under 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." Treas. Reg. §1.6011-4(c)(3). Tax benefits specifically include "exclusions from gross income" and "status as an entity exempt from federal income taxation." Treas. Reg. §§1.6011-4(c)(6), 301.6112-1(d)(6).

It is also not always easy to determine whether a transaction is the same as, or substantially similar to, one that the Service classified as a listed transaction. Some welfare benefit funds *are* legitimate. If a taxpayer uses a traditional IRA rather than a Roth IRA, is that "substantially similar" to the Roth IRA listed transaction? Under the regulations, the term substantially similar includes "any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy" and "must be broadly construed in favor of disclosure." Treas. Reg. §1.6011-4(c)(4).

When the determination is unclear, the practitioner has a dilemma: recommending disclosure is likely to upset the client, but failure to disclose may expose the client to accuracy related penalties. The regulations provide that a taxpayer's failure to disclose a reportable transaction is a strong indication that the taxpayer failed to act in good faith. Although the Service will rule on whether a specific transaction is a listed transaction that should be disclosed and it is therefore possible to obtain a definitive answer, the time and cost involved in obtaining such determinations will make it unlikely that many taxpayers will seek them.

The benefits-related listed transactions can affect both small and large

clients, and do not always involve large amounts. The tax advisor may be only peripherally involved, if at all, in a transaction that is strongly recommended by another advisor. The client may be unwilling to pay for a thorough review of a proposed transaction, but may ask the attorney just to take a quick look at it. If the proposed new standards for tax shelter opinions are finalized in their present form, the prudent attorney will decline any such invitation.

STANDARDS OF TAX PRACTICE

Section 10.22 of Circular 230 requires tax practitioners to exercise due diligence when advising clients. Two commentators have suggested that tax practitioners should be "reasonably knowledgeable" about reportable transactions. Burgess J. W. Raby and William L. Raby, *Practitioner "Due Diligence" and Listed Transactions*, 2004 TNT 83-14 (April 29, 2004)

On December 30, 2003, Treasury issued proposed regulations (68 Fed. Reg. 75186) that would amend Circular 230 significantly. The Tax Section welcomed the proposed rules but requested that they be clarified, and their scope limited. The Section's comments appear at Richard A. Shaw, *ABA Comments on Proposed Circular 230 Changes on Tax Shelters*, 2004 TNT 32-28 (February 18, 2004)

First, proposed section 10.33 of Circular 230 prescribes best practices for all tax advisors and all tax advice, including oral advice. These practices consist of (1) establishing the relevant facts, including evaluating the reasonableness of any assumptions or representations, and (2) relating applicable law, including potentially applicable judicial doctrines, to the relevant facts. However, in many cases it will be difficult for tax advisors to be certain that they have identified all "potentially applicable" judicial doctrines and communicated that identification to the client. Also, except in cases where assumptions or representations are clearly unreasonable (e.g. because they are exceptionally aggressive), the tax advisor is unlikely to have the expertise to determine whether they *are* reasonable. In large part because of these difficulties, the Tax Section and other commentators requested that the final regulations clarify that the statement of "best practices" is aspirational only, that the "best practices" are not intended to state enforceable minimum standards of conduct, and that rules stating minimum standards of conduct are necessary.

Second, the proposed revisions include very broad definitions of tax shelter (applying the definition in section 6662) and tax opinion. The Tax Section comments note that the definition is so broad that "[a]ny written advice regarding any tax matter may be treated as a tax shelter opinion," and recommended that the definition be limited to formal written opinions. Similarly, the American College of Tax Counsel recommended that the only opinions subject to section 10.35(a) of Circular 230 be (i) marketed opinions, and (ii) opinions expressly issued for purposes of avoiding a penalty. Louis Mezzullo, *College Of Tax Counsel Address Changes to Circular 230*, 2004 TNT 33-21 (February 19, 2004).

Third, the proposed revisions would establish stringent requirements for all tax shelter opinions. Such opinions would need to:

(1) Identify and consider *all* relevant facts and not rely on any unreasonable factual assumptions or representations;

(2) Relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts and not rely on any unreasonable legal assumptions, representations or conclusions;

(3) Consider all material federal tax issues and reach a conclusion, supported by the facts and the law, with respect to each material federal tax issue; and

(4) Provide an overall conclusion as to the federal tax treatment of the tax shelter item or items and the reasons for that conclusion.

Under the proposed regulations, a material Federal tax issue would be defined as one for which the Service has a "reasonable basis for a successful challenge." This is a lower threshold than the current realistic possibility of success.

Finally, proposed section 10.36 provides that tax advisors with responsibility for overseeing a firm's practice before the Service should take 'reasonable steps' to ensure that the firm's procedures for all members, associates, and employees are consistent with the best practices described in section 10.33. In addition, in the case of tax shelter opinions, a practitioner with this oversight responsibility must take 'reasonable steps' to ensure that the firm has 'adequate procedures' in effect for purposes of complying with section 10.35. Presently, there is no description of what procedures would be adequate, and the inclusion of safe harbors in the final revisions would be welcome.

CONCLUSION

Under the proposed revisions (section 10.35(c)(4)(ii)), the term tax shelter opinion does not include "written advice concerning the qualification of a qualified plan." Nevertheless, because this exclusion appears to be narrower than the current exclusion of annuities, qualified plans, and IRAs from the definition of tax shelter under section 10.33(c)(2), tax or benefits practitioners who advise clients in connection with transactions that benefit plans may enter into are potentially subject to the rules contained in the proposed revisions to Circular 230.

Under the very broad proposed definitions of tax shelter and tax shelter opinion, almost all advice (including, potentially, oral and other relatively informal advice) relating to the tax attributes of an employee benefit program would be subject to the stringent new standards. Even though the claimed tax benefits of several of the listed transactions (notably those involving funded welfare benefit plans and fully insured defined benefit plans) have been highly questionable for years, some vendors are still marketing them aggressively. A client considering the adoption of such a program should be encouraged to seek

legal advice, but if that advice will be a tax shelter opinion, the additional time and expense involved will deter many clients from seeking legal advice at all, and may also deter practitioners from providing such advice. Neither of those results is likely to be in the interests of tax policy or tax administration.

The Service has made clear its intention to shut down listed transactions by denying the tax benefits sought and enforcing more stringent standards of practice. Benefits practitioners are not immune from the effects of these efforts and should pay close attention to future developments.

Postscript: Sections 811 through 822 of the American Jobs Creation Act of 2004 contain tax shelter provisions. Of particular interest to tax practitioners is section 822, which amends 31 U.S.C. section 330 (1) to authorize the Secretary of the Treasury to imposed monetary penalties on representatives and their firms, and (2) to provide that, "Nothing in this section or in any other provision of law shall be construed to limit the authority of the Secretary of the Treasury to impose standards applicable to the rendering of written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement, which is of a type which the Secretary determines as having a potential for tax avoidance or evasion."