By Lillian Chen

New Disclosure Regulations Examine Even the Most Innocent Transactions

THE PROLIFERATION OF TAX SHELTERS HAS BEEN A growing concern for the federal government for many years. The government's latest quest to curtail taxpayer participation in tax shelters resulted in new disclosure requirements under temporary regulations issued in February 2000, which were designed to require taxpayers to disclose their participation in tax shelters on their tax returns. The early versions not only lacked concise definitions, but also provided many exceptions to disclosure. Consequently, many taxpayers believed the disclosure requirements did not apply to them.

Dissatisfied with the lack of disclosure, the government redefined the scope and issued final tax-shelter regulations on February 28, 2003 that became effective immediately. Despite attempts to limit disclosure to those participating in perceived abusive tax transactions, many taxpayers will find themselves subject to disclosure and reporting requirements for even the most innocuous commercial transactions.

The final regulations provide that if a transaction falls within any one of six categories, it is subject to disclosure. These categories include listed, confidential and loss transactions, transactions with contractual protection, transactions with significant book-tax differences and those involving assets with brief holding periods.

Listed transactions are simply those that have been specifically identified by the IRS as tax-avoidance transactions. Currently, there are 25 transactions requiring disclosure spanning a wide range, from certain mergers and acquisitions, to various financing and leasing arrangements and transactions involving insurance companies, retirement plans and partnerships. While the listed transactions are very specific in nature, the language contained in the final regulations could potentially apply to taxpayers who engage in dealings that are substantially similar to listed transactions.

Any deal offered to a taxpayer under conditions of expressed or implied confidentiality is considered a confidential transaction. This category has broad application. Common arrangements such as private placement agreements, investor transfers or asset acquisitions could fall under the definition. The final regulations provide a limited exception for confidentiality agreements involving mergers, acquisitions and confidentiality required under federal and state regulations.

Other regulatory categories involve transactions with contractual protection, in which fees paid to a tax advisor are contingent upon the intended tax consequences being sustained, and loss transactions that produce losses of at least $10 million in a single year or $20 million over a period of six years. Also requiring disclosure are transactions producing a book-tax difference on any item of more than $10 million in any taxable year. This category only applies to SEC registrants or businesses with $250 million or more in gross assets. And finally, transactions resulting in tax credits of $250,000 or more that arise from an asset held for 45 days or less must also be reported.

The government recognizes that compliance with the final regulations could quickly prove cumbersome if there are no exceptions to the disclosure requirements. Therefore, the IRS has issued a list of 30 exceptions that exclude typical book-tax differences as well as certain other reporting exceptions. In addition, the IRS has been granted authority to periodically update the list of exceptions to include other common types of loss transactions and provide other guidance on reportable transations as needed.

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Taxpayers subject to the disclosure requirements must complete IRS Form 8886 and attach it to their income tax return as well as file an additional copy with the Office of Tax Shelter Analysis, a special unit of the IRS in Washington, DC.

At present, there are no specific statutory penalties for failure to disclose a reportable transaction. However, Congress has proposed legislation to impose severe penalties on taxpayers who fail to disclose. In addition, the IRS has adopted administrative policies to penalize noncompliant taxpayers by prohibiting participation in certain taxpayer-friendly audit procedures and making sure that it routinely requests noncompliant taxpayers' accrual workpapers during an audit.

In the wake of the Sarbanes-Oxley Act and the government's increased focus on tax shelters, real estate companies' management and tax executives should consider implementing enhanced control procedures to carefully analyze potential reportable transactions and ensure compliance with the new disclosure requirements. •

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