

Tax Compliance – A Practitioner’s Viewpoint

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Introduction

- Final Treasury regulations require the reporting of potential tax shelters, the registration of confidential corporate tax shelters, and the maintenance of investor lists by tax shelter promoters
- Current Federal legislative proposals would impose penalties for failure to disclose reportable transactions, increased accuracy penalties on certain nondisclosed transactions, and penalties for failure to maintain investor lists
- Current Federal legislative proposals also include “codification” of economic substance and related penalties
- California has enacted its own reportable transaction disclosure, registration, and penalty regime, with other states considering varying regimes
- Various states have codified, or proposed, various economic substance standards
- Varying state tax shelter regimes and economic substance laws that conflict with Federal law and practice could greatly complicate state administration and frustrate taxpayer and practitioner compliance efforts

Federal: Six Categories of Reportable Transactions

- Final Treasury regulations adopted Feb. 27, 2003 under I.R.C. Secs. 6011, 6111(d), and 6112 establish six broad categories of reportable transactions
- One category is “listed transactions,” where the IRS has already determined that a particular type of transaction is potentially abusive
- The five other categories will require the reporting of many common business transactions
- These categories represent attributes the IRS believes can be found in many of the potentially abusive transactions it has identified as “listed”
 - Confidential Transactions
 - Transactions with contractual protection
 - Loss Transactions
 - Transactions with a significant book-tax difference
 - Transactions with a brief asset holding period

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Status of Federal Tax Shelter Legislation

- S. 1637, JOBS Act, passed Senate, May 11, 2004
- H.R. 2896, House likely to act this Summer, other bills in play
- Bills contain reportable transaction penalty, understatement penalty, and list maintenance provisions, with limited differences
- Unlike S. 1637, H.R. 2896 does not contain “codification” of economic substance or the related penalties

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Some Examples From Current S. 1637, as passed the Senate, May 11, 2004

- Per se penalty for failure to disclose listed transaction
 - \$200,000 for “large entity” or “high net-worth individual”
 - \$100,000 for others
 - SEC reporting requirement
- Penalty for failure to disclose reportable transaction
 - \$100,000 for “large entity” or “high net-worth individual”
 - \$50,000 for others
 - Limited discretion to rescind penalty
- Accuracy-related penalty on “reportable transaction understatements”
 - Disclosed transaction: 20%
 - Nondisclosed transaction: 30%
 - Limited “reasonable cause” exception
 - SEC reporting requirement
- Would allow the Secretary to disclose company names and the amount of 1) penalties imposed for failure to disclose a listed transaction, 2) 30% enhanced understatement penalties, and 3) all penalties imposed with respect to non-economic substance transactions

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Current S. 1637 (con’t)

- Each material advisor with respect to any reportable transaction must maintain a list identifying each person with respect to whom the advisor acted as such a material advisor
- Penalty for failure to make such list available within 20 business days after the date of the Secretary’s request would be \$10,000 for each subsequent day
- Penalty for promoting abusive tax shelters not to exceed 100 percent of the gross income derived (or to be derived) from such activity
- Penalty for failure to furnish information
 - For listed transactions, the greater of \$200,000 or 50% of the gross income derived from aid, assistance, or advice which is provided with respect to the listed transaction
 - For other reportable transactions, \$50,000

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Implications for State Tax Shelter Laws and Administration

- Generally, the Federal regime conforms the common key definitional rules for taxpayer disclosure and material advisor list maintenance
- Penalties for failure to disclose are an essential element of the regime
- However, discretion to waive penalties for substantial compliance adds needed flexibility to administration and fosters cooperation
- Conformity with the Federal regime and uniform state laws and procedures eases administration and compliance difficulty
 - Time frames and other procedures for reporting among the various states
 - “Nexus” rules among the various states (inclusion in the investor list)
 - Document retention rules among the various states

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Implications for State Tax Shelter Laws and Administration (con't)

- To ensure full consideration of these and other issues
 - Taxpayers and practitioners should work with the States with regard to developing uniform standards
 - Uniform bills should receive public comment before recommendation to state legislatures
- The IRS and Treasury have incorporated taxpayer and tax advisor comments into the regulations and have issued new regulations to address pertinent issues raised by the tax community
 - The continued ability of taxpayers and advisors to constructively comment and for regulators to address the comments is key to making the regulatory framework work

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Background – Economic Substance

- Under present law, there is no Federal statutory requirement that all transactions demonstrate economic substance
- The judicial standard for establishing economic substance varies among the U.S. Circuit Courts and is often considered in conjunction with another common law doctrine, the “business purpose” test
 - United Parcel Service (11th Cir.)
 - Winn-Dixie (11th Cir.)
 - Compaq (5th Cir.)
 - Rice’s Toyota World (4th Cir.)
- There is a lack of uniformity regarding
 - Definition of the doctrine - “Two-prong” economic substance/business purpose test versus either economic substance test or business purpose
 - When the test(s) should be applied
 - What level of profit potential is necessary

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Federal Proposals – Economic Substance

- S. 1637 would establish a “3-prong” test:
 - The transaction changes in a meaningful way (apart from Federal tax effects) the taxpayer’s economic position,
 - The taxpayer has a substantial non-tax purpose for entering into such transaction, and
 - The transaction is a reasonable means of accomplishing such purpose
- Thus, the Senate proposal provides that the economic substance doctrine involves three inquiries:
 - An *objective* inquiry regarding the effects of the transaction,
 - A *subjective* inquiry regarding a taxpayer’s motivation for engaging in the transaction, and
 - A *subjective* evaluation of whether the transaction was implemented in a “reasonable means”
- The Senate Finance Committee & JCT explanations state that the provision does not alter the court’s ability to aggregate, disaggregate or otherwise recharacterize a transaction when applying the doctrine

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Federal Proposals – Noneconomic Substance Transaction Understatements

- S. 1637 would impose accuracy-related penalties on understatements attributable to certain “Noneconomic Substance Transactions”
- “Noneconomic Substance Transactions” are those that:
 - Lack economic substance,
 - Are not respected under the rules relating to tax-indifferent parties, or
 - Fail to meet the requirements of “any similar rule of law” (e.g., a transaction determined to be a “sham transaction”)
- The penalty would be 20% if the transaction were disclosed and 40% if not disclosed.
- No exceptions available under the proposal

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California: Non-Economic Substance Transaction Understatement

- Enacted pursuant to S.B. 614 and A.B. 1601, signed into law on October 2, 2003
- “A transaction shall be treated as lacking economic substance if the taxpayer does not have a valid nontax California business purpose for entering into the transaction.”
- Does not provide further definition, but imports business purpose into the penalty determination
- Likely to be based on common law substance doctrine
- Penalties
 - 40% of the amount of the understatement or
 - 20% of the amount of the understatement, if the relevant facts are adequately disclosed

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Illinois Economic Substance Proposal

- H.B. 848, Senate Floor Amendment 1 (defeated in House, 5/26/04); H.B. 864, Senate Floor Amendment 1 (passed Senate, 5/31/04)
- Unlike California's law, would codify the "economic substance doctrine" as the common law doctrine under which tax benefits are not allowable if the transaction or arrangement that produces the tax benefit does not have economic substance or lacks a business purpose
- "...a transaction or arrangement shall be considered as having economic substance only if
 - (i) the transaction changes in a meaningful way (apart from its tax effects), the taxpayer's economic position, and
 - (ii) the taxpayer has a substantial nontax purpose for entering into such transaction and
 - the transaction is a reasonable means of accomplishing such purpose."
- No penalty provisions comparable to California's non-economic substance transaction understatement penalty

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Massachusetts: "Sham Transaction" Codified

- Under S.B. 1949 (Acts 2003, ch. 4), enacted March 5, 2003 and effective for tax years beginning in 2003, the Commissioner has the discretion to disallow a transaction under the sham transaction doctrine or any "related tax doctrine"
- When the Commissioner exercises this discretion, the burden shifts to the taxpayer to demonstrate by clear and convincing evidence (as determined by the Commissioner) that the transaction had
 - A valid, good-faith business purpose other than tax avoidance; and
 - Economic substance apart from the asserted tax benefit
 - Taxpayers must also show that the asserted non-tax business purpose is "commensurate with the tax benefit claimed"

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Ohio: Burden Shifted to Taxpayer

- Ohio law describes a “sham transaction” as “a transaction or series of transactions without economic substance because there is no business purpose or expectation of profit other than obtaining tax benefits”
- Enacted Ohio legislation (2003 H.B. 95) shifts the burden of proof to the taxpayer when a transaction involves members of a “controlled group”
- The legislation also provides that the tax commissioner may apply the doctrines of “economic reality,” “substance over form,” and “step transaction”

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Some Observations on Economic Substance Codification

- The Federal “economic substance” codification is controversial and has not been adopted
 - Could impact a broad range of well-accepted ordinary business transactions
 - Broadens the common-law test and imports a subjective standard
 - Treasury, IRS oppose current Federal proposal
 - House opposition
- State enactment would import these concerns and uncertainties into the state realm
 - Would bind state courts
 - Would likely result in a lack of uniformity

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Recommendations and the Road Forward

- States enacting tax shelter regimes should conform as closely as possible to the final Federal framework
 - Uniform state regimes, where adopted, will reduce administrative burdens
 - A uniform regulatory environment will aid compliance
- Taxpayers, their advisors, and regulators should actively participate in the dialogue
- The Federal debate over the pros and cons of economic substance codification should be allowed to continue
- Continued communication in these areas will produce a workable result

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