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Report 14

THURSDAY, JANUARY 8, 2004 (CONTINUED)

Reporter: John Warnick Esq.

11:30 a.m. - 12:15 p.m.
Tax Shelters - The Ethical Dilemma
Andrew H. Weinstein

He did not follow the outline but rather provided an overview of the new tax shelter regulations and the related enforcement provisions.

The outline materials were only up-to-date through November. There are significant developments which took place at the end of December. By January they will have updated materials which will be made available to all attendees who request the updated outline by e-mail [to Holland & Knight].

What is the ethical dilemma involving tax shelters? It has been suggested that there is no ethical dilemma because tax shelters are unethical per se or there is no ethics in the marketing of tax shelters.

When he first started looking at tax shelters in the 70's it was easy to spot a tax shelter. Anyone could look at the shelters and tell they were bogus. By the 1990's the IRS's focus was on collection and there were many strategies which technically didn't appear to be tax shelters. These new transactions were sophisticated and at least offered the appearance of being grounded within the code.

Now we all have to worry and what do we do about it?

He doesn't have a magic formula. But it starts with one simple premise: Please guide yourself appropriately.

The Office of Tax Shelter Analysis ("OTSA")is the focal point for the IRS' tax shelter compliance initiative. OTSA is headed by Nicholas J. DeNovio who will join me this afternoon in the workshop. He is responsible for planning and coordinating tax shelter initiatives. OTSA generally serves as a clearing house for information reported to or through the IRS through taxpayer and promoter disclosures.

In 2001 the IRS announced an anti-tax shelter initiative. This was focused on disclosure, guidance and perhaps most importantly increased tax shelter training for agents. This strategy was supplemented in 2003 with its continuing pursuit of promoters, targeted audits and litigation against taxpayers and its offering of settlement initiatives.

Mr. Weinstein noted that a meaningful discussion of whether the substance of a tax strategy will be respected by the IRS is beyond the scope of his presentation. He was going to discuss estate planning considerations, the tax shelter regulations and the consequences to taxpayers if the tax consequences of their strategy are not respected. He will also discuss list maintenance, penalties, and ethics. He will not cover registration of tax shelters.

What we need to understand is how the substantive law affects our clients:
1. Will the transaction trigger the tax shelter regulations;
2. Whether the taxpayer's tax position will be respected;
3. The consequences to the taxpayer if his position is not respected; and
4. Claims of privilege.

Second, we must understand how the substantive law affects us as advisors
1. Whether our advice on the tax advice of the transaction is correct;
2. Whether the transaction will trigger obligations for us as advisors under the tax shelter regulations;
3. Whether we will be subject to penalties under the regulations or under revised Circular 230; and
4. Claims of privilege.

Third, we must understand our ethical obligations. Tax shelter rules make our ethical duties more complicated. Especially if we are called upon to render an opinion.

Mr. Weinstein's hope is that after he has concluded his remarks that we will understand how the tax shelter regulations affect us and our clients and we will understand what we must do and should do to meet these new requirements.

Estate planning considerations

So far the focus of the IRS has been on the identification and dismantling of tax shelters. Designers and promoters of tax shelters are looking for uncharted territory. To date the IRS focus has been on income tax shelters. But logic suggests that we should see a growing number of transfer tax shelters promoted to our clients. Promoters will contact us as the closest advisors to high net worth individuals. They will present us with products, ideas and concepts and ask us to introduce them to our clients.

Eventually the IRS focus will reach estate and gift tax matters. The IRS is estimating that estate and gift tax matters will be the third highest area of growth for accounting firms.

The IRS focus on transfer tax shelters is in its infancy. But there are certain abusive trust strategies which the IRS has identified. The characteristics that the IRS is looking for include: reduction or elimination of tax; deductions for personal expenses paid by the trust; depreciation deductions of an owner's personal residence; stepped-up basis for property transferred to a trust; reduction or elimination of self-employment taxes; reduction or elimination of gift and/or estate taxes. While specific guidance has not been issued by the IRS, Mr. Weinstein feels we should anticipate the IRS to pay increasing attention to abusive trust and abusive insurance transactions which significantly reduce any type of tax.

Estate planners must be aware of what will trigger the tax shelter regulations.

The current IRS regulations are not triggered by most transfer tax strategies unless they are substantially similar to listed transactions or fit into one of the other five categories of reportable transactions. In the afternoon session we will be discussing with Nick what "substantial similarity" means.

What is a tax shelter? "It is a deal done by very smart people which absent tax considerations would be considered very stupid." The good tax shelters do have economic benefits. So those of us who thought that we only had to test a tax shelter for economic substance, need to realize that we have to learn how to ride our bikes again.

The final tax shelter regulations were issued in February 2003. Even the application of these regulations depends on whether a transaction is deemed a reportable transaction. The substantive merits of the taxpayer's position have nothing to do with whether the tax shelter regulations apply.

Think of tax shelters not as a definable term but as a concept. The concept is a transaction that complies with the black letter of the code but violates the spirit of the code.

For instance , § 6662 (the accuracy related penalties) defines "tax shelter" as basically any plan which has tax avoidance as a significant purpose. This could cover virtually anything the estate planner does.

The tax shelter disclosure regulations do not have a definition of tax shelter. Rather their application depends on whether the transaction is a "reportable transaction".

The List Maintenance regulations apply to "abusive tax shelters", a term which is defined as "confidential corporate transactions" and "reportable transactions." Neither of these terms are similar to the definition in § 6662.

Mr. Weinstein strongly suggested you look at the Winter 2002 issue of the Tax Law Review and particularly the article entitled "Ten Truths About Tax Shelters" by Professor David Weisback. The following are paraphrased highlights of comments from Professor Weisback as quoted by Mr. Weinstein in his talk.

"There is no constitutional right to engage in tax planning"

"The right to minimize taxes is not a basis principle of moral philosophy".

"Tax planning does not rank with freedom of thought, speech, association or religion."

"There is no social benefit to tax planning...tax planning is like polluting because polluters pollute too much."

"Tax advisors do, however, serve a few socially valuable functions in limited tax planning situations, in adversarial practice and in compliance."

"Tax planning deserves little or no protection. Disclosure is not enough. It just increases complexity, eliminates the tax shelter 'du jour' and makes the law even more unstable."

Treasury issued the final tax shelter regulations in February, 2003. The regulations basically require three things: disclosure by taxpayers, list maintenance by tax advisors and promoters, and registration by promoters and sellers. The regulations are intentionally overbroad.

A tax professional's failure to advise a client on the necessity of disclosure can have serious consequences. The tax advisor must be mindful of the fees received in order to comply with the list maintenance requirements. The tax advisor also needs to be aware of the limits on privilege. The regulations are clearly a trap for the unwary.

Disclosure statements (Form 8886) must be filed by taxpayers who participate in "reportable transactions".

There is a four prong analysis to determine if disclosure is necessary. (SEE 14-6) The critical date for this analysis is whether the transaction was entered into on or after February 28, 2003. Reporter's Note: in the materials at footnote 26 citing Treas. Reg. § 1.6011-4(b)(2) Mr. Weinstein offers this comment: "If a transaction involving estate or gift tax entered into on or after January 1, 2003 is identified as a listed transaction in published guidance, the transaction must be disclosed in the matter described in such published guidance."

If the answer to all four questions in this analysis is in the affirmative then the taxpayer must disclose.

Reportable transactions don't have any connection to whether the transaction has a defensible tax position.

There are six categories of reportable transactions: listed transactions; confidential transactions; transactions with contractual protection; loss transactions; transactions with a significant book-tax difference; and transactions involving a brief asset holding period. (SEE 14-7)

The IRS is going to give "green light notices" for transactions which the IRS determines are legitimate. The IRS is also going to try to give advance notice to taxpayers of transactions which it considers abusive. "Yellow flag" notices will be issued when the IRS determines it is likely to issue guidance in a particular area. "Red light" notices will be issued for transactions which the IRS considers abusive tax shelters, and will most likely include these strategies within the "Listed Transactions" category.

A "Listed transaction" is a transaction which is the *same or substantially similar* to one of the types of transactions that the IRS has determined to be a tax avoidance transaction and identified by published guidance as a listed transaction. The most recent comprehensive publication of the transactions the IRS has identified as "listed transactions" is Notice 2003-76 which identified 24 transactions. The latest guidance is Notice 2004-8 dealing with abusive Roth IRA transactions. The IRS also posts a list on its web site.

The listed transactions cover a wide variety of fact patterns. Here is a list of some of these transactions that should be of particular interest to estate planners: 1) deductions for contributions to retirement plans; 2) allocation of income to tax different parties; 3) distributions from charitable remainder trusts; 4) artificial inflation of outside partnership basis; 5) Guam trusts; 6) selling corporate assets through an intermediary; 7) 351 contribution of high basis assets; 8) reinsurance arrangements; and 9) trusts for contested liabilities. The materials' list is current only through November, 2003. See 14-7 to 14-11.

The second category of reportable transactions is "confidential transactions." This has been the

subject of considerable controversy.
Under the original rule there were two situations where the definition of confidentiality was met: 1) if the taxpayer's disclosure of the tax treatment was limited in any way or 2) if the taxpayers knows or has reason to know that his use or disclosure of the information relating to the tax consequences is limited in any other manner for the benefit of any person who is making a statement about the potential tax consequences.

Under the original definition standard personal injury settlement agreements were caught if they contained language regarding tax effects or treatment of the payments.

Originally it was contemplated there would be a carve out of specific transactions.

Under the new rules which were issued in December 2003 (and which are not covered in the materials handed out at Heckerling) a "confidential transaction" is defined as a transaction offered to a taxpayer under conditions of confidentiality where the taxpayer has paid a minimum fee to an advisor. Conditions of confidentiality exist only when the advisor who receives the minimum fee imposes the limitation on disclosure to protect the advisor's tax strategies. The fact that the confidentiality is not legally binding on the taxpayer is not relevant. The new definition significantly narrows the breadth of the definition and should narrow the concern over the scope of this rule. .

Mr. Weinstein skipped the discussion of the last four categories of reportable transactions as they are adequately covered in the outline in order to focus on disclosure which he feels is very important.

What are the consequences of a taxpayer entering into a reportable transaction? The taxpayer must file a disclosure statement on Form 8886 to his tax return. The taxpayer must retain copies of all documents relating to the transaction until the expiration of the statute of limitations. If a transaction the taxpayer has entered into becomes a listed transaction after the taxpayer entered into the transaction, then the taxpayer must file a disclosure statement to his next tax return if the statute of limitations for the listed transaction has not yet expired.

If you are unsure, file a protective disclosure statement. Failing to disclose significantly increases the likelihood of penalties. Failure to disclose is a strong demonstration of a lack of good faith on the part of the taxpayer.

Disclosure may prompt some type of activity by the IRS such as audit. At this point we don't know exactly what type of IRS activity will occur upon disclosure as the regulations are new. Clients should expect the worst.

How should we advise our clients. Look to the proposed revisions to Circular 230. These are very important. As a tax advisor you should complete a substantive analysis of the tax consequences of the transaction. You should feel comfortable advising them on the substantive merits of the transaction.

The guidance issued by the IRS may serve as authority to invalidate the tax treatment.

The failure to disclose a reportable transaction significantly increases a taxpayer's penalty exposure. § 6662 imposes the accuracy related penalties. Substantial authority for the tax position is usually a defense to the accuracy related penalties. The taxpayer must have a reasonable believe that the tax treatment is "more likely than not".

Even in the case of a tax shelter, the understatement penalty is generally avoid when the taxpayer can demonstrate that there was reasonable cause for the underpayment and that he acted in good faith. Reasonable cause exists when a taxpayer reasonably and in good faith relies on an opinion basis on a professional tax advisor's analysis of the relevant law and facts if the advisor unambiguously concludes that there is a greater than 50% likelihood (the more likely than not standard) that the treatment of the item will be sustained by the IRS.

Under the rules proposed on December 29, 2003, a taxpayer's failure to disclose is a strong indication that the taxpayer failed to act in good faith. Thus the failure to disclose would generally make the taxpayer ineligible for the reasonable cause exception to the imposition of penalties.

Taxpayers should construe the regulations broadly in favor of disclosure.

In its release of the new rules the IRS has announced it will not accept, as evidence of good faith or reasonable cause, reliance on a tax shelter opinion from a tax adviser with a financial interest in the tax shelter or a pre-existing referral agreement with the tax shelter promoter.

Taxpayers engaging in reportable transactions may find themselves facing the fraud penalty and this would be especially so in the context of listed transactions. Mr. Weinstein mentions this by way of future caution because he has seen references to penalties up to 75% and that is the fraud penalty.

List Maintenance rules apply to advisors and promoters - have limited application because of the level of fees that must be received. The rules are discussed in detail in the outline. The fee threshold for advice provided to a non-corporate taxpayer is $50,000 but it is reduced to $10,000 in the case of a listed transaction. All fees for services or advice, whether or not tax advise, in the implementation of the transaction are taken into account. Failure to comply with the List Maintenance rules gives rise to penalties of up to $100,000 per year.

It is recommended that advisors who are subject to List Maintenance requirements fairly and openly advise their clients of this requirement prior to the client entering into the transaction. That warning must include details on what information will be on the list and that it must be given to the IRS upon request, and that if given to the IRS the client should expect an inquiry or audit from the IRS.

Privilege and Work Product Claims. We need to be honest with our clients and bring their expectations of privacy down to the new reality we face as a result of the expansion of the IRS summons power. For now we should assume the identity of a client participating in a tax shelter is not privileged. We need to proceed with caution until the privilege and the work product claims are resolved. We need to be honest with our clients and bring their expectations down to reality. This will reduce countless client conflicts down the line and once clients know what to expect they can act within those parameters. This will no doubt make our malpractice carriers happy as well.

Mr. Weinstein closed with a discussion of the ethical considerations. Circular 230 contains guidelines that an advisor must follow in practice before the IRS. It is obvious that the IRS is going in a certain direction and that is to beef up the best practices it expects from advisors representing taxpayers before it. It mandates disclosure of an advisor's referral agreement or financial interest in the transaction. Disclosure should also be made to the client that the client may not rely on the opinion of any non-independent advisor.

Revised Circular 230 adopts the broad definition of tax shelter contained in § 6662.

We now need to review Circular 230 whenever we are advising a client with respect to a tax shelter or whenever we are preparing a tax opinion. Violations of Circular 230 in connection with tax shelters are punishable by suspension or disbarment if the violation is reckless, willful or the result of gross incompetence.

Disciplinary action begins with the referral of professional misconduct to the Office of Professional Responsibility. The IRS has significantly beefed up their Office of Professional Responsibility. It conducts an informal review. Then it notifies the practitioner and provides the practitioner with an opportunity to respond to the allegations. If the Office of Professional Responsibility institutes a formal proceeding for suspension or disbarment that proceeding takes place before an administrative law judge, whose opinion can be appealed to the Secretary of The Treasury and ultimately to Federal District Court. Mr. Weinstein's advise is to "stay away".
Mr. Weinstein has personally watched through the Standards of Tax Practice Committee of the American Bar Association the evolution of the activity involving the IRS' Office of Professional Responsibility. He feels that we should look forward to substantial enforcement efforts. Until now IRS enforcement has been sporadic. That is now going to change.

He then quoted Commissioner Everson's attack on "fast and loose attorneys" as quoted in David K. Johnston's article in the December 29, 2003 issue of the New York Times

How do the Model Rules apply to us. We must provide timely and competent advice. We must learn and understand what transactions will trigger the tax shelter regulations. It is not an easy task. The sheer volume and technical difficulty involved in conducting a tax shelter analysis is something we now must do. Lawyers are not to assist a client in conduct the attorney knows is criminal or fraudulent. The commentary to Model Rule 1.2(d) explains that this rule applies whether or not the defrauded party (i.e., the IRS) is a party to the transaction, and specifically prohibits a lawyer's participation in a transaction which results in the criminal or fraudulent avoidance of tax liabilities.

Mr. Weinstein cautions that we must ask ourselves: 1) does this rule create an affirmative duty to third parties such as the IRS? 2) is a lawyer's ability to offer advice that falls short of being criminal or fraudulent restricted? Is the fact that the activity is not criminal or fraudulent adequate support for a favorable tax opinion.

Mr. Weinstein also raises the issue of what are the estate planning attorney's responsibilities in the context of the valuation of assets in connection with estate planning transactions. Can the attorney assist the appraiser? Can the attorney indicate to the appraiser that the client needs a low appraisal? Should the attorney recommend an appraiser that he knows will be more accommodating to the client's wishes?

Model Rule 1.4 explains the requirements for proper communications with a client. What type of information should a client know about a tax transaction to make an informed decision? Is the fact that the client may be required to file a disclosure statement with his tax return something the client should be informed of. Mr. Weinstein challenges us to think of what we consider to be "best practices" with regards to the level of disclosure to our clients.

As Mr. Weinstein concluded his remarks Thursday morning, he asked, "is it buyer beware or is it advisor beware?"

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2:00 - 3:30 p.m. - Special Sessions III
Session III-C - Tax Shelters - The Ethical Dilemma
Andrew H. Weinstein
Nicholas J. DeNovio

[**Ed. Note:** These materials are still in the process of being prepared. If they become available in time, they will be sent as part of the Final Report, Report No. 15]

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