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Reportable Transactions: Changes to Reporting and Disclosure Requirements

On November 2, 2006, the Internal Revenue Service (“IRS”) issued proposed and temporary regulations that modify the rules regarding reportable transactions, material advisors and list maintenance requirements. The new regulations were required in part to implement the provisions of the American Jobs Creation Act of 2004 (“AJCA”) that affected reportable transactions. Although the new regulations eliminate certain categories of reportable transactions, they also remove some favorable taxpayer reporting provisions. In addition, the proposed regulations create a new category of reportable transactions, called “transactions of interests,” which gives the IRS broad discretion in designating new types of reportable transactions.

Background. The AJCA required taxpayers and material advisors involved in certain potentially tax abusive transactions, classified as “reportable transactions” to file returns disclosing detailed information about such transactions. Generally, the reportable transaction rules provide as follows:

§6011 - Reportable Transactions. Internal Revenue Code (“Code”) §6011¹ imposes disclosure requirements on a taxpayer who participates in a reportable transaction, even if the taxpayer had no tax motivation for the transaction. Under current Treas. Reg. §1.6011-4(b), reportable transactions include the following types of transactions:

- *Listed Transactions:* a transaction that the IRS has identified as a tax avoidance transaction (or is the same or substantially similar thereto);
- *Confidential Transactions:* a transaction offered to a taxpayer under conditions of confidentiality and that requires the taxpayer to pay the advisor a minimum fee;
- *Transactions with Contractual Protection:* a transaction (1) entitling the taxpayer to a refund of fees if the intended tax consequences do not result or (2) for which fees are contingent on the taxpayer's realization of certain tax benefits.
- *Loss Transactions:* a transaction where the taxpayer claims a loss under §165 over a certain threshold (e.g., corporation - \$10 million in any single tax year or \$20 million in multiple tax years; individuals, S corporations, or trusts - \$2 million in any single tax year or \$4 million in multiple tax years).

¹ Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.



- *Transactions with Significant Book Tax Difference:* a transaction in which the amount for tax purposes of any item(s) of income, gain, expense, or loss differed by more than \$10 million on a gross basis from the amount of such item(s) for book purposes in any tax year.²
- *Transactions Involving a Brief Asset Holding Period:* a transaction where the taxpayer claims a tax credit exceeding \$250,000 on an asset held for 45 days or less.

A taxpayer who participates in a reportable transaction must disclose the transaction on Form 8886, “Reportable Transaction Disclosure Statement,” and attach the form to the tax return for the taxable year of the transaction.

§6111 - Material Advisor. In addition to disclosure obligations for taxpayers, the AJCA modified §6111 to require each material advisor, in connection with any reportable transaction, to file a return reporting:

- information identifying and describing the transaction;
- information describing any potential tax benefits of the transaction; and
- any other information prescribed by the IRS.

A “material advisor” is any person who:

- “provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction;” and
- receives gross income in excess of a threshold amount for such aid, assistance or advice (\$50,000 in the case of a reportable transaction involving tax benefits for natural persons and \$250,000 in any other case).

Changes under the Proposed Regulations. The current Treasury Regulations do not reflect the AJCA’s changes to the Code. Furthermore, practitioners repeatedly requested clarification from the IRS regarding the interpretation and application of the reportable transaction rules. Thus, to address these issues, the IRS issued temporary and proposed regulations that include the following significant changes to the reportable transaction rules (*See* Treas. Reg. §§1.6011-4T and 301.6111-3T, and Prop. Reg. §§1.6011-4, 301.6111-3, and §301.6112-1):

² As discussed below, the proposed regulations delete this category.



Changes to Reportable Transactions. Prop. Reg. §1.6011-4 includes the following modifications to the treatment of reportable transactions under §6011.

- *Addition of “Transactions of Interest”:* Reportable transactions will now include a new category, called “transactions of interest,” which involves a transaction the IRS believes has a potential for tax abuse, but for which it has insufficient information regarding the transaction to make a final determination. This category allows the IRS to gather information about transactions without requiring the participating taxpayers to comply with the strict reporting rules for listed transactions. The IRS will identify transactions of interest in published guidance and require disclosure under the reportable transaction rules. **Note:** The proposed regulations require disclosure for a transaction that becomes a “transaction of interest” even after the filing of the tax return reporting the transaction, if the statute of limitations for the year in which the taxpayer received the tax benefit from the transaction is still open. The taxpayer must report the transaction to the Office of Tax Shelter Analysis (“OTSA”) within 60 days of the published guidance identifying the transaction.
- *Elimination of Transactions with a Significant Book-Tax Difference:* Reportable transactions will no longer include transactions with a significant book-tax difference. Schedule M-3, “Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More” will provide the necessary disclosure for C corporations and the IRS intends to extend this filing requirement to partnerships and S corporations. Effective for transactions subject to disclosure on or after January 6, 2006.
- *Modification to Transactions Involving a Brief Asset Holding Period:* This category will no longer include transactions resulting in a claimed foreign tax credit.
- *Partners, Shareholders, and Beneficiaries:* If a taxpayer in a partnership, S corporation or trust receives a timely Schedule K-1 less than 10 calendar days before the extended due date of the taxpayer's return, and based on the K-1, the taxpayer determines that it participated in a reportable transaction, the taxpayer has 45 calendar days from such due date to disclose the transaction by filing a disclosure statement with the OTSA. If the taxpayer complies with the above, it does not need to file an amended return. Taxpayers may currently rely on this proposed regulation in satisfying their disclosure requirements.
- *Protective Disclosures:* Protective disclosures (which claim that a transaction is not subject to these disclosure rules) will not be effective unless the taxpayer provides the IRS with all the information requested under Prop. Reg. §1.6011-4.



Changes Affecting Material Advisors. Prop. Reg. §301.6111-3 adopts much of the interim guidance contained in Notice 2004-80, 2004-2 CB 963 regarding the obligation of material advisors to file information returns and includes the following requirements:

- *Material Advisor Status:* A person becomes a material advisor when:
 - (1) the person provides material aid, assistance or advice by making a tax statement (defined in Prop. Reg. §301.6111-3(b)(2)(ii) as any oral or written statement that relates to a tax aspect of a transaction that causes it to be a reportable transaction under Prop. Reg. §1.6011-4(b);
 - (2) the person derives gross income in excess of the threshold amount; and
 - (3) the transaction is entered into by the taxpayer.
- *Exceptions:* No disclosure under §6111 is required in the following circumstances:
 - (1) The tax advisor provides advice in the capacity of an employee, shareholder, or partner of the taxpayer;
 - (2) The tax statement is contained in documents filed publicly with the SEC; or
 - (3) The tax advisor provided only post-filing advice (*i.e.*, subsequent to the filing of the tax return on which the taxpayer first claimed the tax benefit).
- *Threshold Amounts:* In addition to the \$50,000 and \$25,000 amounts specified under §6111(b)(1), the threshold amount of gross income that a material advisor may derive from a *listed* transaction is \$10,000 in the case of natural persons and \$25,000 in any other case. The IRS may designate reduced thresholds for “transactions of interest.”
- *Deadline for Disclosure Statements:* A material advisor must file Form 8918, “Material Advisor Disclosure Statement,” for a reportable transaction by the last day of the month after the end of the calendar quarter in which the advisor became a material advisor for the transaction.
- *Tax Result Protection:* A transaction that benefits from tax result protection may cause the material advisor disclosure rules to apply to the provider of such protection. “Tax result protection” involves a “tax statement” with respect to the reportable transaction. Accordingly, if a third party (*e.g.*, an insurance company) provides insurance as to the tax result of a reportable transaction, the insurance provider has potentially made a “tax statement” in connection with such transaction and may be subject to the reporting requirements of §6111 as a material advisor.
- *Designation Agreements:* Material advisors may enter into designation agreements (*i.e.*, designating which of several material advisors should file disclosure statements).



Changes Regarding List Maintenance. The proposed regulations under §6112 include the following additions to the list maintenance requirements:

- *Form of List:* The list must be provided to the IRS, upon request, within the prescribed time and include:
 - (1) an itemized statement of information in an easy to understand form;
 - (2) a detailed description of the transaction; and
 - (3) copies of documents relating to the transaction.
- *Privilege:* Regardless of whether a claim of privilege is made, material advisors must maintain the list in accordance with the above requirements.
- *Designation Agreements:* A designation agreement will not relieve other material advisors of their obligation to furnish a list if the designated advisor fails to do so.
- *Penalties:* Failure to provide a list to the IRS within 20 business days after the date of a written request results in a penalty of \$10,000 for each day of such failure.

Other Provisions: For both taxpayers and material advisors, provisions have been made (1) to eliminate the tolling period for disclosure obligations while a ruling request on such obligations is pending and (2) to require full disclosure for any protective disclosure filings.

Effective Date: Unless otherwise specified above, the proposed regulations generally will become effective on or after the date the regulations are published as final. For transactions of interest, however, the final regulations will apply to such transactions entered into on or after November 2, 2006.



Conclusion. The proposed regulations contain some modifications that have a major impact. In particular, the addition of the “transactions of interest” category to the list of reportable transactions gives the IRS broad authority to designate a transaction as potentially tax abusive. A taxpayers involved in such a transactions must comply with the reportable transaction disclosure requirements, even if the transaction is classified as a “transaction of interest” after the taxpayer’s tax return has been filed. Thus, although this new category gives the IRS increased flexibility, it may also cause significant uncertainty and administrative hassle for taxpayers and advisors. In general, advisors should monitor the adoption process for these proposed regulations, and, should the regulations become final, practitioners may particularly want to watch for published guidance designating new “transactions of interest” to see how the IRS will interpret and apply this new category.

*Cites: T.D. 9295, 11/01/2006; ¶152,817, Preamble to Prop. Regs. 11/2/2006, Fed. Reg. Vol. 71, No. 212, p. 64488; ¶152,819, Preamble to Prop. Regs. 11/2/2006, Fed. Reg. Vol. 71, No. 212, p. 64496; ¶152,821. Preamble to Prop Regs. 11/2/2006. Fed. Reg. Vol. 71, No. 212, p. 64501; Treas. Reg. §1.6011-4T; Prop. Reg. §1.6011-4; Treas. Reg. §301.6111-3T; Prop. Reg. §301.6111-3; Prop. Reg. §301.6112-1; Code §§6011, 6111, 6112 and 6078; “Temp and Proposed Regs Liberalize Some Tax Shelter Disclosure Rules but Toughen Others,” Federal Taxes Weekly Alert Newsletter (11/09/2006); Richard M. Lipton and Robert S. Walton, “Treasury Improves the Disclosure Regime by Issuing New Temporary and Proposed Regulations,” 106 J. Tax’n 1, (January 2007).



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