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Reportable Transactions, Transactions of Interest, and Listed Transactions

Reportable Transactions Defined:

Reportable transactions are defined by Treasury Regulation Section 1.6011-4 and generally include the following categories of transactions. Many times these transactions are perfectly legitimate; however, the government requires disclosure.

Confidential Transactions

These are transactions offered under conditions of confidentiality and for a minimum fee of $250,000 for corporations or partnerships or trusts wholly owned by corporations and $50,000 for all others. Some tax professionals or investment promoters require clients to sign agreements stipulating the client may not disclose a tax strategy to others. Sometimes this is because the professional or promoter does not want competitors to find out about the strategy, but sometimes it is because the professional or promoter does not want the taxing authorities to find out.

Transactions with Contractual Protection

These are transactions with the right to a refund of fees or investment if the transaction's intended tax consequences do not occur. They also include most contingent fee transactions. Sometimes the promoter of an investment will provide for a refund to the investors if promised tax benefits fall short. The IRS apparently views such a transaction as the sale of a tax benefit. Additionally, tax professionals will sometimes perform services on a contingent fee basis, where the amount of the fee is based on the realization of a tax benefit or refund.

Transactions with contractual protection involving the following tax credits are exempt from the reportable transactions disclosure rules:

- Work opportunity and welfare-to-work credits
- Indian employment credit
- Low-income housing credit
- New markets tax credit
- Empowerment zone employment credit
- Renewal community employment credit
- Employee retention credit

Loss Transactions

These are transactions resulting in a loss under Internal Revenue Code 165 (wagering, theft, capital, worthless securities, casualty, disaster, insolvent financial institution and certain other losses) of at least:

1. $10 million in any single taxable year or $20 million in any combination of taxable years for corporations or partnerships wholly owned by corporations.
2. $2 million in any single taxable year or $4 million in any combination of taxable years for all others
3. $50,000 in any single taxable year for individuals or trusts related to foreign currency transactions

The IRS requires disclosure apparently because some of the tax shelters it deems abusive were set up to manufacture large losses of these types.

A loss is not subject to the reportable transactions disclosure rules if all of the following are true:

- The basis of the asset is a “qualifying basis”
- The asset is not an interest in a pass-through entity
- The loss from the sale or exchange of the asset is not an ordinary loss from foreign currency transaction
- The asset has not been separated from any portion of the income it generates
- The asset has never been part of a straddle

A qualifying basis, in general, is one equal to the amount paid in cash for the asset, plus improvements, or acquired in certain tax-free corporate reorganizations, inheritance, gift or a like-kind exchange.

Transactions of Interest

These are transactions that the IRS believes have potential for tax avoidance or evasion, but for which it lacks enough information to determine whether they should be identified specifically as tax avoidance transactions (i.e., listed transactions). See subsection on next page (page 3) for more detail on Transactions of Interest.

Listed Transactions

These transactions (and those substantially similar) are identified by the IRS as potentially abusive and are required to be disclosed. These transactions are complex, and the IRS guidance is technical. A brief summary of these transactions is posted on our web site. For detailed information, see the IRS guidance on its web site at
https://www.irs.gov/Businesses/Corporations/Listed-Transactions

Transactions Involving Tax-exempt Entities

The *Tax Increase Prevention and Reconciliation Act of 2005* also imposed new rules on taxable entities that participate in a reportable transaction involving a tax-exempt entity. Taxable entities must disclose to tax-exempt entities that the transaction is a reportable transaction. Failure to do so subjects the taxable entity to the same penalties as if it falls to disclose a reportable transaction to the IRS.

Transactions of Interest:

Charitable Remainder Trust Sale

Transaction's in which a grantor creates a charitable remainder trust (CRT) and contributes appreciated assets to it in exchange for an annuity or unitrust interest. The trust then sells the assets and reinvests the proceeds in other assets to diversify. This sale is purportedly not taxable because the trust is tax-exempt, but the trust gets a stepped-up basis in the new assets. Then, the grantor and the charity sell their interests in the trust for an amount equal to the value of the trust assets, claiming there is no taxable gain, and the trust terminates. The purported result is a charitable contribution deduction and diversification with little or no tax for the grantor and some income for the charity.

Charitable Contributions of LLC Successor Membership

Transactions built on charitable contributions of successor membership interests. In a typical transaction, Advisor owns all of the membership interests in an LLC that owns real property. Taxpayer purchases a successor (or remainder) interest in the LLC, which entitles Taxpayer to own all of the membership interests in the LLC after a set term of years. After holding the successor interest for more than one year, Taxpayer donates it to charity and claims an inflated deduction.

Toggling Grantor Trust

"Toggling" grantor trust transactions in which grantors attempt to avoid recognizing gain, or claim a loss greater than any actual economic loss by purportedly terminating and then re-establishing grantor status. These grantor trust transactions usually occur within 30 days. One variation involves a trust funded with gain and loss options; another variation involves a trust funded with cash or securities.

Domestic partnership used to shield subpart F income

If a U.S. taxpayer conducts business abroad through a foreign corporation, there is normally no U.S. taxation until and unless the earnings of the foreign corporation are distributed to the U.S. taxpayer. However, in general, under subpart F of the Internal Revenue Code, certain U.S. taxpayers are taxed immediately on passive investment income and income derived from dealings with related corporations earned by certain foreign corporations they control (controlled foreign corporation or CFC). This immediate taxation under subpart F generally does not apply to income from a U.S. partnership.

In an attempt to defer immediate taxation of subpart F income, a complicated strategy using a U.S. partnership has been employed by some. In a typical transaction, a U.S. taxpayer wholly owns two CFCs (CFC1 and CFC2), CFC1 and CFC2 are partners in a domestic partnership (US Partnership). US Partnership owns 100% of the stock of another CFC (CFC3). Some or all of the income of CFC3 is subpart F income.

As part of the transaction, Taxpayer takes the position that the subpart F income of CFC3 is currently included in the income of US Partnership (which is not subject to U.S. tax) and is not included in the income of Taxpayer. The result of the claimed tax treatment is that income that would otherwise be taxable currently to Taxpayer under subpart F of the code is not taxable to Taxpayer because of the interposition of a domestic partnership in the CFC structure. Without the interposition of US Partnership, the income inclusion resulting from the subpart F income of CFC3 would be taxable currently to Taxpayer.

In some variations of the transaction, there may be more than one person that owns the stock of CFC1 and/or CFC2, US Partnership may own less than all of the stock of CFC3, a domestic trust may be used instead of a domestic partnership, or other similar arrangement.

The IRS and Treasury Department believe that the position there is no income inclusion to Taxpayer in above arrangements is contrary to the purpose and intent of the provisions of subpart F of the Code.

Backdated Retirement Plan Contributions: A transaction in which a taxpayer claims a deduction for contributions made to a qualified retirement plan even though the related compensation is not earned by plan participants until after the end of the taxable year. The transaction is listed even if the employer's liability to make the contribution is fixed before end of the year.

Purported Multiple Employer Welfare Benefit Funds: Certain trust arrangements that purportedly satisfy the requirements for the 10-or-more employer plan exemption under IRC SS419 and 419A but where contributions are determined in a way that insulates each employer from the experience of other subscribing employers.

ASA Investing Partnerships: Transactions involving contingent installment sales of securities by partnerships to accelerate and allocate income to a tax-indifferent partner, such as a tax-exempt entity or a foreign person, and to allocate losses to a taxable partner.

Short-term Charitable Remainder Trusts: Transactions in which a donor contributes highly appreciated assets to a charitable remainder trust that has a short-term and a high-payout rate. The trustee borrows money and sells the assets in the second or third year, i.e., quickly. The borrowed funds are distributed early on, usually in the first year, and efforts are made to characterize these as tax-free distributions.

"BOSS" (Bond and Option Sales Strategy): Transactions involving the distribution of encumbered property in which taxpayers claim tax losses for capital outlays they have in fact recovered. These transactions typically involve taxpayers acting through a partnership to contribute cash to a foreign corporation in exchange for the corporation's common stock. The corporation then borrows money from a bank, giving the bank a security interest in the stock acquired by the foreign corporation that has a value equal to the amount borrowed. The corporation then distributes the security interest to the partnership, and this distribution reduces the value of the remaining stock to zero or to a trivial amount.

Fast-pay Stock Arrangements: Fast-pay stock is stock that is structured so dividends are economically (in whole or in part) a return of the holder's investment, as opposed to on the holder's investment. Stock is presumed to be fast-pay if it has a dividend rate that is reasonably expected to decline, as opposed to fluctuate or remain constant, or if it is issued for an amount that exceeds the amount at which the holder can be compelled to dispose of the stock.

Bull & Bear Note Transactions: Transactions involving the acquisition of two debt instruments that are structured so that value of one debt instrument increases, while the value of other instrument decreases. These transactions attempt to recognize loss on the sale of the instrument that decreases in value, while not recognizing gain on the instrument that increases in value.

Son of Boss: Transactions generating losses by artificially inflating the basis of partnership interests. These transactions typically involve either a taxpayer borrowing money at a premium, with the partnership assuming the debt and the taxpayer contributing proceeds to the partnership,

or a taxpayer buying and writing options, and then creating positive basis in its partnership interest by transferring the option positions to the partnership.

Improper Use of a Subsidiary to Satisfy Parent's Stock-based Compensation Obligations: Transactions involving the purchase of a parent corporation's stock by a subsidiary, followed by a transfer of the purchased parent stock from the subsidiary to the parent's employees and the eventual liquidation or sale of the subsidiary.

Guam Trusts: Transactions in which the shareholders of a pre-existing or newly formed S corporation transfer their stock to a newly formed trust that purportedly qualifies as both a domestic trust under U.S. law and a Guam resident trust for purposes of Guamanian law. Promoters claim these trusts are able to pay income taxes to Guam, instead of to the U.S.-based S corporation. Under certain circumstances, Guamanian law enables the trust to recover all of the taxes paid to Guam.

Intermediary Transactions: These transactions have been used in the sale of a corporate business. Shareholders of a corporation (T) normally face double taxation on the sale of T's asset. (First, T pays tax on the gain from sale of its assets and then T's shareholders pay tax on the gain from the liquidation of T). The liquidation proceeds are reduced by the amount of tax T paid on the sale of its assets. This double taxation does not occur if the shareholders sell their T stock. The shareholders pay tax on their gain from the sale, but T has no tax on the sale of its assets. Therefore, corporate shareholders typically prefer to sell stock rather than the assets of the corporation. Buyers, on the other hand, typically prefer to acquire the assets of the corporation, rather than its stock.

Intermediary transactions attempt to satisfy both the buyer and seller through the use of a tax-indifferent third party. Basically, T shareholders will sell their T stock to a third-party intermediary (M). T, now owned by M then sells some or all of its assets to the buyer (Y). M has a net operating loss, credits or is otherwise not fully taxable on the sale of T assets. The arrangement is such that M makes a profit on the transaction, the old T shareholders purportedly get stock sale treatment and Y gets asset acquisition treatment.

Under one version of this transaction, T is included as a member of the affiliated group that includes M, which files a consolidated return, and the group reports losses (or credits) to offset the gain (or tax) resulting from T's sale of assets. In another form of the transaction, M may be an entity that is not subject to tax (typically due to net operating losses or credits) and M liquidates T, resulting in no reported gain on M's sale of T's assets.

Abusive Section 351 Transfers Using Contingent, Unmatured Liabilities: Transactions involving a loss on the sale of stock acquired in a purported tax-free transfer under S351 of a high-basis asset to a corporation and the corporation's assumption of a liability that the transferor has not yet taken into account for federal income tax purposes.

Foreign Leverage Investment Portfolio (FLIP) & Offshore Portfolio Investment Strategy (OPIS): Transactions in which a purported redemption of stock owned by a tax-indifferent party, e.g. a foreign party, is treated as a dividend. A variety of devices, i.e. forward open contract, options, puts and calls are used to enable the redeemed shareholder to claim that it has continuing interests in the entity that is redeeming its stock. Promoters claim that all or a portion of the basis of the redeemed stock can be added to the basis of stock in the redeeming corporation owned by the taxpayer. Then, the taxpayer sells the stock and claims a loss. A variation of the transaction involves the transfer of the stock with a higher basis to an entity in a carryover basis exchange such as a S351 transaction followed by either a sale of the entity interest or a sale of the stock by the entity.

Abusive Basis-shifting Devices Using Loan Assumption Agreements (CARDs): Transactions involving the use of a loan assumption agreement to inflate the basis in assets acquired from another party to generate tax losses. Generally, these types of transactions have a U.S. taxpayer becoming jointly and severally liable on debt of the transferor of assets, with the debt having a stated principal amount exceeding the fair market value of the assets separately transferred to the taxpayer in consideration for its agreement to pay part of loan. The losses from these types of transactions are not allowable to the extent the taxpayer derives benefit attributable to the basis exceeding fair market value since the parties are liable for loan repayment in accord with their relative ownership of the assets immediately after transfer to the taxpayer.

Abusive Notional Principal Contract: Transactions involving the use of a notional principal contract to claim current deductions for periodic payments made by a taxpayer, while disregarding the accrual of a right to receive offsetting payments in the future.

Abusive Straddles: Three different transactions that are designed to create a permanent noneconomic loss;

1. Transactions involving the use of a straddle, a tiered partnership structure, a transitory partner and the absence of a S754 election to claim a permanent noneconomic loss.
2. Transactions involving the use of a straddle, an S corporation or a partnership and one or more transitory shareholders or partners to claim a loss while deferring an offsetting gain.
3. Transactions involving the use of economically offsetting positions, one or more tax indifferent parties and the common trust fund accounting rules of S584 to allow a taxpayer to claim a noneconomic loss.