Chaire de recherche
en fiscalité et
en finances publiques

Effective Responses to Aggressive Tax Planning

What Canada Can Learn from Other Jurisdictions

Instalment 8: The United States – Disclosure Rules

Gilles N. Larin
Robert Duong
Marie Jacques

This instalment is the eighth in a series that presents a detailed study on aggressive tax planning. It underpins the issuance of *Tax Paper No. 112* published in July 2009 by the Canadian Tax Foundation (CTF). As mentioned in the preface of the book in order to keep publishing costs reasonable and to avoid delaying its publication, the CTF has given us permission to publish this document in French and English on our Website.

July 2009

UNIVERSITÉ DE SHERBROOKE

The Mission of the Research Chair in Taxation and Public Finance

The **Research Chair in Taxation and Public Finance** (RCTPF) was formed on April 15, 2003 via an unconditional grant from the Québec Government, to whom we are grateful. We are specifically thankfull to the Government for having given us total freedom in selecting topics we thought were important, thus expressing its confidence in the selection of our projects. In Québec, there are few official forums where practitioners, public-sector executives and researchers can discuss new issues in taxation and public finances. In addition, research in these fields generally focuses on a single discipline to the detriment of the multi-disciplinary aspect of relations between the state and its taxpayers. The **Research Chair in Taxation and Public Finance** was formed in response to these two realities. Its primary mission is to stimulate interdisciplinary research and training by bringing together professors and researchers interested in the political economy of taxation. For more information on the **Research Chair in Taxation and Public Finance**, visit its official Website at: http://www.usherbrooke.ca/adm/recherche/chairefiscalite/.

Gilles Larin holds the RCTPF. Marie Jacques is a full professor at the Université de Sherbrooke. Robert Duong[1] was a research professional with the RCTPF when this study was produced.

We wish to express our gratitude for their observations and suggestions to four readers who wished to remain anonymous. Of course, the opinions expressed herein are those of the authors, who assume full responsibility for the comments and interpretations in this study.

1 Robert Duong, who is a lawyer, was a research associate with the Research Chair of Taxation and Public Finance at the University of Sherbrooke when this study was done. He is now working with the federal Department of Finance as a policy officer in the area of income tax. The views expressed in this publication are those of the authors and do not in any way represent the position of the Department of Finance of Canada. The material contained in this publication is not intended to be advice on any particular matter. No subscriber or other reader should act on the basis of any matter contained in this publication without considering appropriate professional advice. The publisher, and the authors and editors, expressly disclaim all and any liability to any person, whether a purchaser of this publication or not, in respect of anything and of the consequences of anything done or omitted to be done by any such person in reliance upon the contents of this publication.

Abstract

Instalment 8: The United States – Disclosure Rules

In 2005, the Research Chair in Taxation and Public Finance initiated studies on aggressive tax planning in light of concerns expressed by tax administrations, the courts, taxpayers and tax advisers ("**stakeholders**"). This project analyses the tools developed by some of Canada's major trading partners in response to aggressive tax planning schemes put into effect by taxpayers and tax advisers.

This study aims to spark thinking among the various stakeholders in Canada by taking a comprehensive and pragmatic approach to the issues inherent in aggressive tax planning. In view of the scope of the subject, its complexity and the specific features of the tax systems of foreign countries, our study should be seen as a reflection on aggressive tax planning rather than an exhaustive analysis of each of the tools examined and all the associated issues. This project was written over a more than a two year period. As the underlying logic was the key element we wished to convey, we wish to emphasise that these documents do not necessarily represent the state of tax legislation or jurisprudence.

As part of this project, the Chair held a symposium in 2006 on the risks inherent in aggressive tax planning for all stakeholders and published a discussion paper detailing the major issues of these schemes.

This project is being pursued here by a study of the tools developed by Australia, United States, United Kingdom and European Union. Our goal is to assess whether it would be worthwhile for Canada to adopt one or more of these tools to safeguard its tax system. The assessment was carried out taking into consideration the point of view of each stakeholder, according to generally recognized principles of tax administration.

The study consists of 10 instalments detailing the study framework that guided our analysis of the tools developed in other countries and our study of each of the selected tools. The 10th instalment which was to be the conclusions for Canada, is not published here, because it was recast and augmented to become Tax Paper No. 112, published in July 2009 by the Canadian Tax Foundation: *Effective Responses to Aggressive Tax Planning – What Canada Can Learn from Other Jurisdictions*.

We refer the reader to Instalment 1, "Study Framework", for an overview of our thinking throughout the instalments.

This instalment focuses on disclosure rules in the United States, which differ significantly from the disclosure rules that prevail in Canada. This section pinpoints the key parameters of this tool and the questions inherent in its application for all stakeholders in the United States. In light of its observations, the Chair has pinpointed in a preliminary manner possible solutions for Canada. The conclusions that we formulate concerning the application of disclosure rules will be considered in the formulation of its general conclusions and recommendations in the wake of an examination of the entire array of foreign tools.

In our opinion, the tax administration is in a better position to detect aggressive tax planning schemes when taxpayers file information on transactions whose details diverge from those usually found in normal commercial transactions. This approach allows the tax administration to pinpoint in a predictable, flexible manner those schemes that present a risk of avoidance. We have noted that the American tax administration has declared on an *ad hoc* basis that over 30 transactions included a risk of abusive tax avoidance and that the taxpayers and advisers who participated in them had to file detailed information of their transactions. This procedure implies that the tax administration possesses the tools necessary to collect from different sources detailed information on these transactions before it makes a public statement. The efficacy of the disclosure rules for the tax administration centres on the use of these resources to collect the information necessary and optimize its use by the tax administration's auditors.

For the U.S. tax administration, reportable transactions for the purposes of the disclosure rules appear abusive essentially because of the transactions' apparent lack of economic substance. In Instalment 6 of this study, we observed that the courts differ in opinion on the criteria of the economic substance doctrine. Because of the uncertainty surrounding a legal doctrine that has yet to be codified in the tax law, all groups of stakeholders, including the courts, may differ in opinion on the application of this doctrine to the facts and characteristics of reportable transactions in a given case. Taxpayers and tax advisers then face the obligation of filing information returns in respect of transactions that may very well comply with the purposes of the tax law. The codification of the economic substance doctrine would not entirely dissipate uncertainty over the application of this doctrine to each situation but would help to make it more predictable for all groups of stakeholders. Indirectly, it would partly mitigate the uncertainty inherent in the application of the disclosure rules.

Procedures governing the penalties applicable for the purposes of the disclosure rules are established in a way that encourages taxpayers and their advisers to file information. The penalty thresholds are high both for taxpayers and advisers. For taxpayers, this incentive takes the form, among other things, of a penalty rate for under-stating tax payable that is higher than the general rate and the impossibility of avoiding the penalty in the event of non-compliance with the disclosure rules. For the tax administration, a penalty for under-stating tax payable that targets aggressive taxpayers reinforces the disclosure rules.

The effectiveness of the disclosure rules is closely linked to the weight of the taxpayers' privilege of confidential communication in the realm of taxation. We are of the opinion that the general scope of the taxpayers' privilege of confidential communication as regards taxation must be qualified under a self-assessment tax system. Under such a system, taxpayers must file information concerning the facts and the structure of the transaction underlying the tax benefits that they are claiming. The tax administration targets specific transactions in respect of which it believes that the economic substance doctrine may apply or with regard to which it may in all likelihood levy a penalty for under-stating tax payable. Since both the doctrine and the penalty centre in part on the purposes of the taxpayers in a planning scheme, the courts must ascertain whether the documents containing information on these purposes are protected by the taxpayers' privilege of confidential communication. According to the jurisprudence, the courts might conclude that such privileges apply to documents that could support the application of this doctrine and this penalty to a transaction carried out by a taxpayer, when the tax administration publicly declares its intention to rescind the tax benefits by applying the doctrine and the penalty in respect of transactions that are identical or similar to the one in dispute.

For the sake of fairness and predictability, the tax administration must minimize the additional compliance burden imposed by the disclosure rules on taxpayers and advisers in order to apply them coherently according to the purposes of the law. It must minimize the compliance burden for taxpayers who engage in routine commercial transactions. To minimize differences of opinion between taxpayers and the tax administration on the obligation to disclose information according to the economic substance doctrine, taxpayers and their advisers should file detailed information on the sequence of the transactions carried out in a planning scheme to support their tax consequences, e.g. the adjusted cost base of shares or the fair market value of assets traded.

Table of Contents

1

General Context

We refer the reader to Instalment 5 of this study, entitled “The United States - General Context and Presentation of the American Broad-Spectrum Approach.”

Instalment 5 presents an overview of the tools applied by the US tax administration, using in particular case law to illustrate the application of these tools.

2

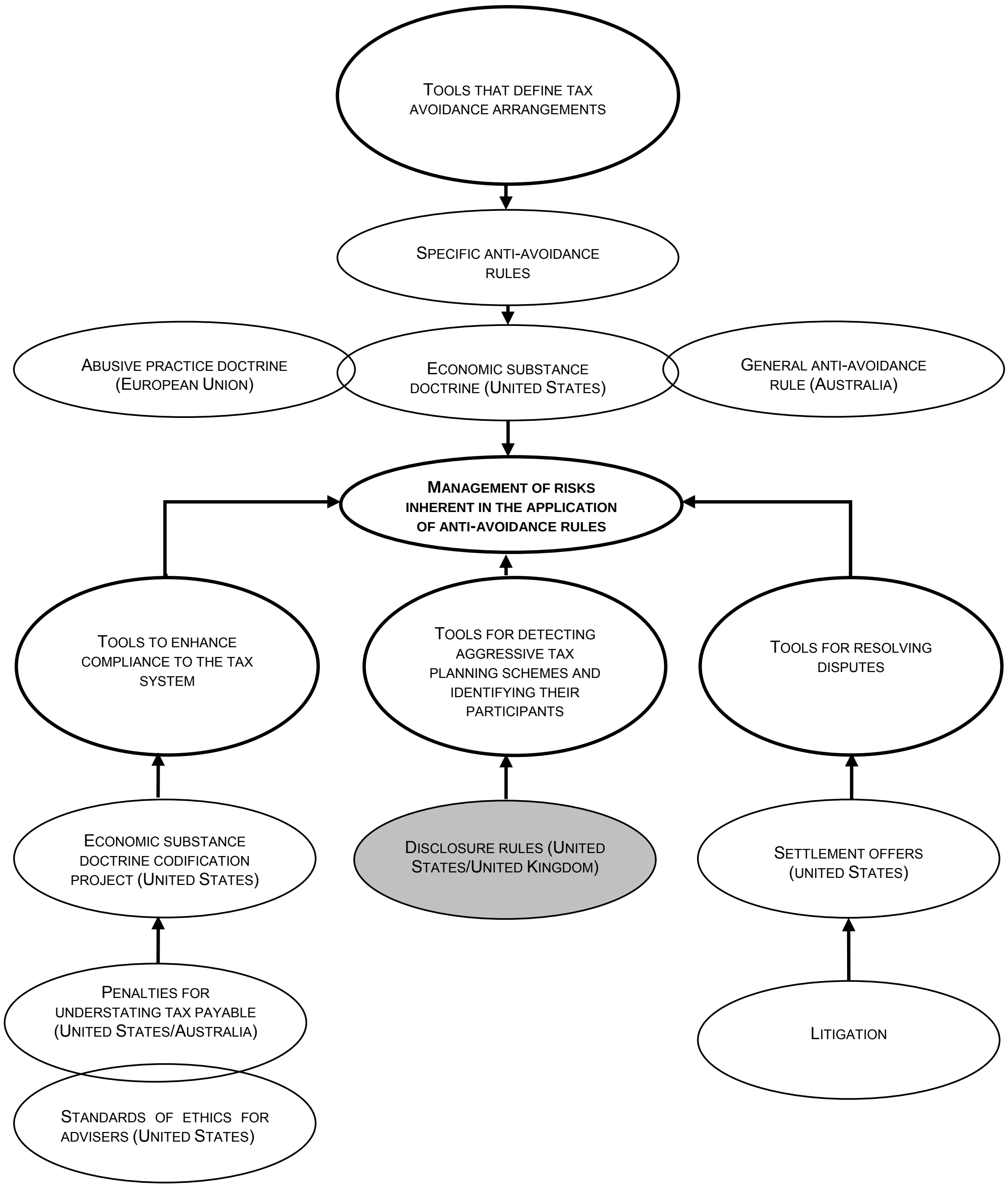
Context of the Disclosure Rules

As discussed in Instalment 1, “Study Framework,” of this study, there are a number of tools available to the tax administration to better curb tax avoidance arrangements and increase risks for aggressive taxpayers and advisers. These tools can be divided into the following spheres of intervention of the tax administration:

- tools that define tax avoidance arrangements;
- tools to enhance compliance to the tax system;
- tools designed to detect aggressive tax planning schemes and identify their participants;
- tools that focus on resolving disputes.

Chart 1.1 on the following page provides a concise illustration of the relation between these spheres of intervention in managing the risks inherent in aggressive tax planning. Each sphere of intervention is shown in the chart using a bold border. The foreign tools selected for the purposes of the study are inserted into the appropriate spheres of intervention. The tool considered in this instalment, i.e. the U.S. disclosure rules, is indicated by a grey background to situate its role in the tax administration’s management of the risks inherent in aggressive tax planning.

CHART 1.1
SPHERES OF INTERVENTION OF THE TAX ADMINISTRATION REGARDING AGGRESSIVE TAX PLANNING: SELECTED TOOLS USED BY SOME OF OUR TRADING PARTNERS - ROLE OF AMERICAN DISCLOSURE RULES



Our Chart.

In practice, the tax administration is unable to detect at the appropriate time all planning schemes carried out by taxpayers solely by verifying income tax returns. Certain taxpayers may seize the opportunity to implement an aggressive, innovative tax planning scheme elaborated by their tax advisers simply because of its complexity and the limited risk of detection by the tax administration.[2] In this respect, they may claim tax benefits on their income tax returns in terms that hide the existence of aggressive tax planning schemes.[3]

The *Long Term Capital Holdings* case[4] clearly illustrates the difficulties that the tax administration faces when it examines a tax return reflecting tax benefits stemming from complex planning schemes.

In this case, the taxpayer and various corporations concluded a series of asset rental and sub-rental transactions to generate a capital loss on the order of US$106 million. In this series, two corporations acquired assets from three businesses which were used in the course of their commercial operations. These corporations granted a foreign corporation leases in respect of these assets. The foreign corporation simultaneously granted the three abovementioned businesses leases pertaining to the assets which they had initially transferred. These businesses paid the foreign corporation a total of $400 million as advance payments on the leases, which corresponded to roughly 93% of the present value of the leases. However, this amount was not taxable at that time in the hands of the foreign corporation neither pursuant to the US *Internal Revenue Code*, nor pursuant to the national tax code applicable to the foreign corporation. The foreign corporation deposited this amount as security in respect of its creditors pursuant to the head leases.

---

2 US, Department of the Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals*, Washington, DC (July 1999) [Treasury, Corporate Tax Shelters (1999)], pages 61-64, 79.

3 For an illustration of the ambiguity inherent in certain tax returns about items that present tax avoidance risks, see the observations of the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs in respect of certain tax planning schemes, in its report *The Role Of Professional Firms In The U.S. Tax Shelter Industry* (S. Rep. No. 109–54) Washington, DC, United States Government Printing Office, April 13, 2005 [Committee on Homeland Security, *Role of Professional Firms*], pages 60-62.

4 *Long Term Capital Holdings* v. *United States*, 330 F. Supp. 2d.122, 2004 U.S. Dist. LEXIS 17159 (D. Conn. 2004) [*Long Term Capital Holdings* (D. Conn. 2004)], ruling upheld on appeal by 150 Fed. Appx. 40, U.S. App. LEXIS 20988 (2nd Cir. 2005).

Thereafter, pursuant to rollover rules, the foreign corporation transferred to a related corporation the amount received as advance payments on the rents to be paid under the leases and its rights and obligations inherent in the leases, in return of preferred shares, with a value of $4 million, issued by the related corporation. Under the rollover rules, the adjusted cost base of the preferred shares for the foreign corporation was equal to the adjusted cost base of the amount that it received as advance payment on the rents, i.e. $400 million.

The foreign corporation subsequently disposed of the preferred shares in favour of a general partnership of which the taxpayer was a member in exchange for an interest in that partnership. The foreign corporation then transferred its partnership interest to the taxpayer. In the end, the general partnership transferred a fraction of the preferred shares in favour of a bank and the proceeds of disposition stood at $1 million. The taxpayer claimed a capital loss of $106 million, since the adjusted cost base of these shares at that time was equivalent to $107 million.

The tax administration rescinded the tax benefits pursuant to the step transactions doctrine and levied a penalty for under-stating tax payable on the general partnership. The Connecticut District Court upheld the notice of assessment issued by the tax administration and the penalty imposed. The court concluded that the general partnership could not claim to have acted in good faith and avoid the penalty since it had filed its income tax return in such a way as to avoid raising the tax administration's suspicion concerning the nature of the planning scheme:

> Noe's explanation of Long Term's use of the term "Net Unrealized Gains" on line 6 is a transparent attempt to conceal Long Term's efforts to keep the huge tax losses claimed from raising a red audit flag. Long Term sold the Quest and Rorer stock and claimed losses from the sale so there was nothing "unrealized" about them. Furthermore, Long Term certainly did not pass the losses through to partners as "gain," rather it used them to reduce the partners' tax liability. The sale of the Rorer and Quest stock resulted in virtually no action on Long Term's books, and, the little activity there constituted a loss, not, as reported by Long Term, "book income not included [in taxable income]."If Noe and the collaborating consultants were properly concerned about accurately reporting the technical difference between a loss that offsets gain and thereby reduces taxes and a deduction that reduces taxes, Long Term should have put the amount in line 7 and labelled it to that effect, e.g., "tax losses offsetting gains." There is no justification for reporting approximately $106,000,000 in tax losses under the misleading titles and labels used. Given that Long Term's characterization contravenes a central purpose for the M-1 195 schedule - - to notify the IRS of tax losses not charged to book income, it is of little moment that its disingenuous choices were counselled or encouraged by consultants.[5]
>
> [our extracts]

[5] *Long Term Capital Holdings* (D. Conn. 2004), *Ibid.,* pages 194-195 of the ruling published by the court.

To quickly detect aggressive tax planning schemes, in 1984 the tax administration adopted disclosure rules in order to collect information on these planning schemes from tax advisers.[6]

Briefly, the tax administration targeted tax shelters that were subject to solicitation by tax advisers. A tax shelter was defined according to the number of investors, the amount invested and the value of the tax deductions and credits that the investors claimed. More specifically:

- at least five investors had to participate in the tax shelter;
- the value of the investment had to exceed $250,000;
- the combined value of the deductions and tax credits (multiplied by 350 in the latter instance) that a taxpayer could claim had to exceed twice the amount that the taxpayer had invested and this value had to be determined at the end of any taxation year ending within five years of the time at which the tax shelter was offered on the market.[7]

The promoters had to register the tax shelter with the tax administration at the latest on the day on which they solicited clients for the first time. They had to submit a description of the tax shelter and the presentations made to investors. The tax administration subsequently issued to the promoters a registration number that the investors had to record on their income tax returns.[8]

Promoters of tax shelters who did not register them could incur a penalty corresponding to the greater of $500 or an amount equivalent to 1% of the amount invested by their clients. Moreover, the promoters could incur a penalty of $250 for failing to give the investors the registration number of the tax shelter assigned by the tax administration. Promoters who failed to maintain a list of their clients were liable to a penalty of $50 per client, up to a maximum of $100,000 per calendar year.[9]

---

6 See Treasury, *Corporate Tax Shelters (1999)*, *supra* note 2, pages 60-64.

7 26 U.S.C. § 6111, before the amendments made by section 815 of the *American Jobs Creation Act of 2004*, Pub. L. No. 108-357 (October 22, 2004) [AJCA 2004].

8 *Ibid.*

9 See *supra* note 6.

Taxpayers could incur a $250 penalty for failing to indicate on their income tax returns the registration number of the tax shelter.[10]

Despite the adoption of the disclosure rules, the tax administration was unable to collect the anticipated volume of information. Tax advisers and tax consulting firms did not appear to uniformly and constantly comply with these rules. According to observations made to the tax administration, certain reasons could have led tax advisers to avoid registering transactions that could be considered tax shelters:

- The amount of the penalties could be minimal compared with the fees that the advisers could derive from the implementation of tax shelters by their clients. Both the tax administration and certain groups of professionals were of the opinion that these penalties did not encourage tax advisers to fulfil their duties pursuant to the disclosure rules.[11]

- The tax administration itself appeared to be reluctant to apply the tax shelter rules. Moreover, it did not have the resources necessary to do so.[12]

The tax administration has broadened the scope of the disclosure rules in order to protect the integrity of the tax system faced with the innovation and the proliferation of aggressive tax planning schemes implemented by taxpayers, including corporations.[13]

In 2000, the tax administration amended the disclosure rules to enhance the detection of transactions that, in its opinion, carried avoidance risks.[14] These rules imposed obligations both

---

10 *Ibid*.

11 See the report submitted by the New York State Bar Association (Tax Section) to the Department of Treasury, entitled *Report on Disclosure by Material Advisors*, Report No. 1080 (February 23, 2005) [NYSBA, Report on Disclosure (Material Advisors) (2005)], online on the NYSBA Website: <http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1080rpt.pdf>.

12 The U.S. Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs collected this information during an investigation of advisers involved in the most aggressive tax planning schemes: see Committee on Homeland Security, *Role of Professional Firms*, *supra* note 3, pages 57-58, 89 and 125. However, it should be emphasized that the tax administration levied in 2007 penalties totalling nearly $116 million on two tax consulting firms for their solicitations of clients and for failing to fulfil their obligations pursuant to the disclosure rules: see Internal Revenue Service, IR-2007-103, "Sidley & Austin LLP Pays IRS $39.4 Million Penalty" (May 23, 2007); IR-2007-71, "Jenkens & Gilchrist Admits It Is Subject to $76 million IRS Penalty" (March 29, 2007).

13 US, Department of the Treasury (Internal Revenue Service), Temporary Regulations T.D. 8877, "Tax Shelter Disclosure Requirements," 2000-11 I.R.B. 747 (March 13, 2000), [Treasury, "Temporary Regulations on Tax Shelter Disclosure (March 2000)"], online on the IRS Website: <http://www.irs.gov/pub/irs-irbs/irb00-11.pdf>.

on advisers and taxpayers. The tax administration nonetheless sought to avoid their having to disclose routine commercial transactions.[15]

First, the promoters had to submit to the tax administration an information return concerning any transaction offered to corporations on a confidential basis and one of whose significant purposes falls within the province of avoidance, if they could collect fees exceeding $100,000. The promoters had to file the information return at the latest on the day on which they solicited clients for the first time.[16]

Next, the promoters of transactions in which one of the significant purposes falls within the province of avoidance and which was offered to corporations had to maintain a register including the list of investors and all of the documents used for the purposes of the solicitation.[17]

Corporations had to append to their tax returns an information return concerning a transaction that they implemented and from which stemmed tax benefits that they claimed on their tax returns, when such a transaction could be considered what the tax administration declares to be a reportable transaction.[18]

---

14 In 1997, the US Congress adopted section 6111(d) in the US *Internal Revenue Code*, thus delegating to the Department of Treasury the power to prescribe for the purposes of the disclosure of transactions one of whose significant purposes falls within the province of tax avoidance. See US, H.R. Rep. No. 148, 105th Cong., 1st Sess. 469 (1997); S. Rep. No. 33, 105th Cong., 1st Sess. 148 (1997): “In enacting section 6111(d), Congress added confidential corporate tax shelters as a type of tax shelter that must be registered under section 6111. Congress intended the provision to improve tax compliance by giving the Treasury Department earlier notification of transactions that may not comport with Federal tax law and by discouraging taxpayers from entering into questionable transactions.”

15 US, Department of the Treasury (Internal Revenue Service), Announcement 2000-12 “Disclosure Requirements for Corporate Tax Shelters,” 2000-12 I.R.B. 835 (March 20, 2000), [Treasury, “Disclosure and Corporate Tax Shelters (March 20, 2000)”], page 836: “The regulations are intended to require disclosure of transactions that should be subject to careful scrutiny by the Service. The regulations are designed not to require disclosure of customary business transactions or transactions with tax benefits that the Service has no reasonable basis to challenge.” Press release distributed online on the IRS Website: <http://www.irs.gov/pub/irs-irbs/irb00-12.pdf>.

16 See US, Department of the Treasury (Internal Revenue Service), Temporary Regulations T.D. 8876, “Corporate Tax Shelter Regisatration,”2000-11 I.R.B. 753 (March 13, 2000), and Notice of Proposed Rulemaking and Notice of Public Hearing (REG-110311), “Corporate Tax Shelter Registration,” 2000-11 I.R.B. 767 (March 13, 2000), online on the IRS Website: <http://www.irs.gov/pub/irs-irbs/irb00-11.pdf>. See also Treasury, “Disclosure and Corporate Tax Shelters (March 20, 2000),” *ibid.*

17 Treasury, “Disclosure and Corporate Tax Shelters (March 20, 2000),” *supra* note 15.

18 Treasury, “Temporary Regulations on Tax Shelter Disclosure (March 2000),” *supra* note 13.

The tax administration initially divided reportable transactions into two categories.

The first category targeted tax avoidance arrangements that:

- allowed a coporation to reduce its tax payable by more than $5 million in a given taxation year or more than $10 million over several taxation years; and
- displayed at least two of the following six characteristics defined for the purposes of the disclosure rules:
    - the corporation implements a transaction on a confidential basis;
    - the transaction includes an indemnity clause in favour of the corporation;
    - the transaction is subject to solicitation activities of an adviser who could derive fees of more than $100,000 provided that the tax benefits materialize;
    - the tax and accounting treatments of the transaction display a difference of more than $5 million during a given taxation year;
    - a third party participates in a transaction, which, because its tax status differs from that of the corporation, allows the latter to claim tax benefits stemming from the transaction;
    - the US tax treatment of a transaction from the standpoint of the corporation displays disparities with the tax treatment of the transaction from the standpoint of another party to the transaction under foreign tax law.[19]

The second category targeted listed transactions. A corporation had to file an information return when:

- it had implemented a transaction that was identical or substantially similar to one of the listed transactions;[20] and
- the transaction enabled it to reduce its tax payable by more than $1 million in a given taxation year or by more than $2 million in several taxation years.[21]

---

19 *Ibid., page* 748.

20 At that time, the tax administration had declared roughly a dozen transactions to be aggressive for the purposes of the disclosure rules: see US, Internal Revenue Service, Notice 2000-15, "Listed Transactions,"2000-12 I.R.B. 826 (March 20, 2000), online on the IRS Website: <http://www.irs.gov/pub/irs-irbs/irb00-12.pdf>.

21 See Treasury, "Temporary Regulations on Tax Shelter Disclosure (March 2000)," *supra* note 13, page 748.

However, briefly stated, corporations did not have to file an information return in respect of transactions that fell under the first category when:

- they carried out a transaction in the normal course of their business activities in keeping with generally recognized commercial standards and independently of the tax benefits; or
- when the structure of the transactions was generally deemed to comply with the US *Internal Revenue Code*.[22]

In addition to filing an information return, taxpayers had to maintain a register of all the relevant documents pertaining to a prescribed operation that they carried out until the expiry of the period of limitation of the first taxation year in respect of which they had to file the information return. The documents prescribed by the tax administration included, among others, the analyses of the transaction conducted to ascertain the advisability of implementing the transaction, the documents that explained the tax structure of the transaction, and the documents that made it possible to identify the transaction's business purposes.[23]

However, taxpayers did not incur any penalty if they did not file the prescribed information return. Nonetheless, those who filed the information return were in a better position to demonstrate that they had exercised a degree of due diligence in complying with the tax laws so as to avoid a penalty for under-stating tax payable.[24]

The tax administration then temporarily revised the disclosure rules on several occasions before prescribing the final regulations in February 2003. It sought to more precisely define the reportable transactions by taking into consideration taxpayers' and advisers' comments.[25]

Thus, since April 23, 2003, the tax administration has prescribed seven categories of reportable transactions covered by the disclosure rules:

---

22 *Ibid*.

23 *Ibid*.

24 For a discussion of the disclosure rules as they existed prior to 2003, see US, Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters* (JCX-19-02), Washington, DC, United States Government Office, March 19, 2002, page 30.

25 See US, Department of the Treasury (Internal Revenue Service), Final Regulations T.D. 9046 "Tax Shelter Regulations,"2003-12 I.R.B. 614 (March 24, 2003), online on the IRS Website: <http://www.irs.gov/pub/irs-irbs/irb03-12.pdf>. Rectifications were made on April 2, 2003.

- listed transactions;
- confidential transactions;
- transactions with contractual protections;
- loss transactions;
- transactions with a significant book-tax difference;
- transactions involving a brief asset holding period;
- transactions of interest.

The adoption by the tax administration of the *American Jobs Creation Act* (*AJCA*)[26] on October 22, 2004 led to a series of modifications to the disclosure rules:

- all taxpayers who have carried out a reportable transaction must attach to their income tax returns an information return describing this transaction;
- taxpayers are subject to a penalty when they fail to file an information return concerning their participation in a reportable transaction;
- should they fail to comply with the disclosure rules, the taxpayers are subject to a specific penalty for under-stating tax payable of 30% instead of 20%, without the possibility of arguing that they displayed due diligence in order to avoid it;
- tax advisers who participated in the implementation by their clients of a reportable transaction must maintain an information register on such clients;
- the tax administration raised the thresholds of the penalties applicable to advisers who fail to maintain a register of the reportable transactions carried out by their clients.

To act upon the modifications that the *AJCA* made to the disclosure rules, the tax administration published a series of transitional regulations before finalizing them, successively, on November 2, 2006, August 3, 2007, and September 26, 2007. The next section focuses on the disclosure rules in force since 2003, bearing in mind the modifications adopted or proposed since then.

26 See AJCA 2004, *supra* note 7.

3

Description

Pursuant to the disclosure rules, taxpayers and advisers must file information returns when they participate in what the tax administration deems to be reportable transactions, which, in its opinion, present a risk of avoidance.[27]

3.1. Reportable transactions for the purposes of the disclosure rules

Taxpayers and advisers must file an information return with the tax administration when they implement or participate in a transaction that falls into one of the seven categories of reportable transactions discussed earlier, which were briefly mentioned at the end of section 2. Certain of these categories have been withdrawn since the date of their introduction and others have been added.

3.1.1 Listed transactions

A listed transaction is a transaction that is identical or substantially identical to one of the planning schemes prescribed by the tax administration in a press release in which it concludes that, in its opinion, this planning scheme presents a risk of avoidance.[28] In June 2006, the tax administration declared 31 tax planning schemes to be aggressive for the purposes of the disclosure rules.[29] Since then, the tax administration has declared three other transactions to be aggressive, bringing the total to 34 transactions. Moreover, it is proposing to add to the list

---

[27] 26 U.S.C. § 6011; 26 C.F.R. §§ 1.6011-4(a), 1.6111 and 1.6112.

[28] 26 C.F.R. § 1.6011-4(b)(2). Instalment 5 illustrates the procedures surrounding a declaration by the tax administration that a transaction is deemed to be aggressive for the purposes of the disclosure rules.

[29] David M. Walker (Comptroller General of the United States), testimony before the U.S. Senate Finance Committee, *Tax Compliance: Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting* (GAO-06-85IT) Washington, DC, United States Government Printing Office, June 13, 2006, page 11.

transactions subject to a patent. Table 3.1 briefly lists each of the transactions that the tax administration has declared to be aggressive since 2003.

TABLE 3.1
BRIEF LIST OF RECOGNIZED REPORTABLE TRANSACTIONS

REFERENCE	DESIGNATION	DATE
Revenue Ruling 90-105	Certain Accelerated Deductions for Contributions to a Qualified Cash or Deferred Arrangement or Matching Contributions to a Defined Contribution Plan	28.02.2000
Notice 95-34	Certain Trusts Purported to be Multiple Employer Welfare Funds Exempted from the Lists of §§ 419 and 419A	28.02.2000
ASA Investering Partnership v. Commissioner	-Transactions similar to that described in the ASA Investering litigation and in ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir. 1998)	28.02.2000
Treasury Regulation § 1.643(a)-8	Certain Distributions from Charitable Remainder Trusts	28.02.2000
Notice 99-59	Transactions involving the distributions of encumbered property in which losses claimed for capital outlays have been recovered (aka BOSS transactions).	28.02.2000
Treasury Regulation § 1.7701(l)-3	Fast Pay or Step-Down Preferred Transactions	28.02.2000
Revenue Ruling 2000-12	Debt Straddles	28.02.2000
Notice 2000-44	Inflated Partnership Basis Transactions (Son of Boss)	11.08.2000
Notice 2000-60	Stock Compensation Transactions	16.08.2000
Notice 2000-61	Guam Trust	21.11.2000
Notice 2001-16	Intermediary Transactions	18.01.2001
Notice 2001-17	§351 Contingent Liability	18.01.2001
Notice 2001- 45	§302 Basis-Shifting Transactions	16.07.2001
Notice 2002-21	Inflated Basis "CARDS" Transactions	18.03.2002
Notice 2002-35	Notional Principal Contracts	06.05.2002
Notice 2002-50	Partnership Straddle Tax Shelter	25.06.2002
Revenue Ruling 2002-69	Lease In / Lease Out or LILO Transactions	28.02.2000
Revenue Ruling 2003-6	Abuses Associated with S Corp ESOPs	17.12.2002
Notice 2003-22	Offshore Deferred Compensation Arrangements	04.04.2003
Notice 2003-24	Certain Trust Arrangements Seeking to Qualify for Exception for Collectively Bargained Welfare Benefit Funds under § 419A(f)(5)	11.04.2003
Notice 2003-47	Transfers of Compensatory Stock Options to Related Persons	01.07.2003
Notice 2003-55	Accounting for Lease Strips and Other Stripping Transactions	28.02.2000
Notice 2003-77	Improper use of contested liability trusts to attempt to accelerate deductions for contested liabilities under IRC 461(f)	19.11.2003
Notice 2003-81	Offsetting Foreign Currency Option Contracts	04.12.2003
Notice 2004-8	Abusive Roth IRA Transactions	31.12.2003
Revenue Ruling 2004-04	Prohibited Allocations of Securities in an S Corporation	23.01.2004
Revenue Ruling 2004-20	Abusive Transactions Involving Insurance Policies in IRC 412(i) Retirement Plans	13.02.2004
Notice 2004-20	Abusive Foreign Tax Credit Transactions	17.02.2004
Notice 2004-30	S Corporation Tax Shelter Involving Shifting Income to Tax Exempt Organization	01.04.2004
Notice 2004-31	Intercompany Financing Through Partnerships	01.04.2004
Notice 2005-13	Sale-In Lease-Out transactions	11.02.2005

REFERENCE	DESIGNATION	DATE
Notice 2007-57	Loss Importation Transaction	20.06.2007
REG-129916-07 (Proposed[30])	Patented Transactions	26.09.2007
Notice 2007-83	Abusive Trust Arrangements Utilizing Cash Value Life Insurance Policies Purportedly to Provide Welfare Benefits	17.10.2007
Notice 2008-34	Distressed Asset Trust (DAT) Protection	27.02.2008

Source: Adaptation by the authors of the tax administration's list of reportable transactions as published on the IRS Website on March 1, 2008: <http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html>.

3.1.2 Confidential transactions

A confidential transaction is a transaction offered by an adviser to a taxpayer on a confidential basis and in respect of which the taxpayer pays fees of at least $50,000, or at least $250,000 in the case of a corporation. A transaction is issued on a confidential basis if, in particular, the adviser prohibits the taxpayer from disclosing details of the transaction to any other person.[31]

3.1.3 Transactions with contractual protections in favour of the taxpayer

A transaction with contractual protections is a transaction carried out by a taxpayer on the advice of an adviser in accordance with an agreement between these parties that includes either of the following indemnity clauses:

- the taxpayer is entitled to claim from his adviser the full or partial reimbursement of the fees he has paid the adviser if the taxpayer is unable to claim all or part of the anticipated tax benefits;
- the payment by the taxpayer of fees to this adviser is subject to the taxpayer's obtaining the anticipated tax benefits.[32]

3.1.4 Loss transactions

A loss transaction is a transaction in which the taxpayer may deduct in computing his income a business or capital loss when such loss reaches a predetermined threshold:

30 See US, Department of Treasury (Internal Revenue Service), "Patented Transactions," REG-129916-07, RIN 1545-BG76 (September 26, 2007), 72:186 FR 54615. The tax administration held a public hearing on February 21, 2008 to obtain taxpayers' and advisers' comments on this proposal: "Patented Transactions: Hearing," REG-1299916-07, RIN 1545-BG76 (January 10, 2008), 73:7 FR 1851.

31 26 C.F.R. § 1.6011(b)(3).

32 26 C.F.R. § 1.6011(b)(4).

- in the case of a corporation, this threshold corresponds to $10 million for a taxation year or $20 million for a period of six consecutive taxation years beginning in the year in which the transaction was implemented;
- in the case of an individual, this threshold corresponds to $2 million for a taxation year or $4 million for a period of six consecutive taxation years beginning in the year in which the transaction was implemented.[33]

3.1.5 Transactions with a significant book-tax difference (withdrawn on January 6, 2006)

A transaction with a significant book-tax difference is a transaction carried out by a company listed on the stock exchange or that has assets with a value of at least $250 million and in respect of which stems a disparity of over $10 million for a given taxation year between the value of income, a gain, an expenditure or a given loss according to:

- the US *Internal Revenue Code*, on the one hand; and
- generally accepted American accounting principles, on the other hand.[34]

3.1.6 Transactions involving a brief asset holding period (withdrawn on August 3, 2007)

In such a transaction, a taxpayer holds an asset for a period of 45 days or less and claims a tax credit for an amount greater than $250,000 in respect of this asset.[35]

---

33 26 C.F.R. § 1.6011-4(b)(5).

34 26 C.F.R. § 1.6011-4(b)(6), according to the regulations in force prior to August 3, 2007. The tax administration had announced in a public press release the withdrawal of this transaction from the list of reportable transactions: see US, Department of the Treasury (Internal Revenue Service), IR-2006-06, "Notification of Removal of the Transaction with a Significant Book-Tax Difference Category of Reportable Transaction Under § 1.6011-4" (January 6, 2006).

35 26 C.F.R. § 1.6011-4(b)(7), according to the regulations in force prior to August 3, 2007. On August 3, 2007, the tax administration withdrew this transaction from the list of reportable transactions: see US, Department of the Treasury (Internal Revenue Service), *ACJA Modifications to the Section 6011 Regulations,* RIN 1545-BE24, TD 9350 (August 3, 2007), 72:149 FR 43146 [Treasury, *Final Regulations* (August 3, 2007)], page 43148.

3.1.7 Transactions of interest (category added on November 2, 2006)

This category includes transactions in respect of which the American tax administration wishes to collect additional information in order to determine whether such transactions truly have the potential for tax avoidance. Taxpayers and their advisers carrying out transactions must comply with the disclosure rules when the details of such transactions are identical or substantially similar to those described by the American tax administration,[36] which has prescribed four transactions that fall into this category:

- Contribution of Successor Member Interest;[37]
- Toggling Grantor Trust;[38]
- Sale of Charitable Remainder Trust Interest;[39]
- Subpart F Income Partnership Blocker.[40]

3.2 Duties of taxpayers and penalties

3.2.1 Reporting Taxpayers

Taxpayers must attach to their income tax returns a form prescribed by the tax administration containing information on the reportable transactions in which they have participated.[41]

---

36 26 C.F.R. § 1.6011-4(6).

37 US, Department of the Treasury (Internal Revenue Service), Notice 2007-72, "Transaction of Interest – Contribution of Successor Member Interest" (August 14, 2007), 2007-36 I.R.B. 544 (September 4, 2007), online on the IRS Website: <http://www.irs.gov/pub/irs-irbs/irb07-36.pdf>.

38 US, Department of the Treasury (Internal Revenue Service), Notice 2007-73, "Transaction of Interest – Toggling Grantor Trust" (August 14, 2007), 2007-36 I.R.B. 545 (September 4, 2007), online on the IRS Website: <http://www.irs.gov/pub/irs-irbs/irb07-36.pdf>.

39 US, Department of the Treasury (Internal Revenue Service), Notice 2008-99, "Transaction of Interest – Potential for Avoidance of Tax Through Sale of Charitable Remainder Trust Interests" (October 31, 2008), 2008-47 I.R.B. (November 24, 2008).

40 US, Department of the Treasury (Internal Revenue Service), Notice 2009-07, "Transaction of Interest – Subpart F Income Partnership Blocker" (January 21, 2009), 2009-3 I.R.B. (January 21, 2009).

41 26 C.F.R. § 1.6011-4(e). See US, Department of the Treasury (Internal Revenue Service), *Form 8886 Reportable Transaction Disclosure Statement* (Rev. December 2005) and *Instructions for Form 8886* (Rev. December 2005).

Basically, taxpayers participate in a transaction when their income tax returns reflect the tax benefits stemming therefrom.[42]

3.2.2 Information return

The taxpayer must provide:

- his name;
- his address;
- the category of reportable transaction;
- the contact information of all advisers to whom he has paid fees in respect of the transaction;
- the facts pertaining to the transaction, to enable the tax administration to understand the transaction;
- a description and an estimate of the anticipated tax benefits stemming from the transaction;
- the contact information of the other participants in the transaction.[43]

For the purposes of the disclosure rules, a tax benefit includes the deduction or the exclusion of an amount in the calculation of income, the non-taxation of a gain, a tax credit, an adjustment or the lack of an adjustment to the cost of an asset, a tax-exempt status, and any other consequence that affects the amount, nature or origin of any item pertaining to income, a gain, an expenditure, a loss or a tax credit.[44]

Moreover, the taxpayer must file an information return within 90 days of the date on which the tax administration has listed a transaction that the taxpayer had carried out previously.

---

42 26 C.F.R. § 1.6011-4(c)(3).

43 26 C.F.R. § 1.6011-4(d). Prior to August 3, 2007, taxpayers only had to file the contact information of the other participants in a transaction if the latter was a listed transaction, in accordance with the prescribed return and the tax administration's instructions. However, to act upon the regulations that the tax administration proposed and published on November 2, 2006, taxpayers who implement any of the reportable transactions pursuant to the disclosure rules have, since August 3, 2007, had to file the contact information of all of the participants in the transaction that they have carried out, regardless of the nature of the reportable transaction. See US, Department of Treasury (Internal Revenue Service), Notice of Proposed Rulemaking REG-103038-05, RIN 1545-BE24, *AJCA Modifications to the Section 6011 Regulations* (November 2, 2006) [Treasury, *Proposed ACJA Modifications to Regulations 6011 (November 2, 2006)*]; and Treasury, *Final Regulations* (August 3, 2007), *supra* note 35.

44 See the definition of tax benefits under 26 U.S.C. § 1.6011-4(c)(6).

However, he does not have to file such a return in respect of a given taxation year if that year was outside the reassessment period on the day on which the tax administration has listed the transaction.[45]

3.2.3 Maintenance of a register of documents pertaining to the transaction

The taxpayer must keep all documents containing information that explains the structure of the transaction from which stem the tax benefits claimed in a taxation year. Taxpayers must preserve these documents until the expiry of the reassessment period applicable to the most recent taxation year in respect of which they must file an information return for the purposes of the disclosure rules.

These documents include, among others:

- the analyses and explanations underlying the tax benefits claimed;
- the documents that the taxpayer has used to reach a decision on the transaction;
- documents that refer to the business purposes of the taxpayers;
- communications between the taxpayer and his advisers or any other party to the transaction;
- documents used for the purposes of solicitation.[46]

3.2.4 Penalties for failing to file the prescribed return

The tax administration may levy a penalty on taxpayers who fail to disclose their participation in a reportable transaction. Generally speaking, the penalty stands at $10,000 for individuals and $50,000 for any other taxpayer. However, these penalties reach $100,000 and $200,000, respectively, in the case of listed transactions. Public companies must disclose the amount of this penalty in their financial reports. This penalty is added to any other penalty to which the taxpayer is subject pursuant to the US *Internal Revenue Code*.[47]

---

[45] See 26 C.F.R. § 1.6011-4(e)(2)(i). Initially, taxpayers had to file an information return within 60 days. The tax administration extended this deadline to 90 days since the previous time limit was too short to allow the taxpayers to file the required return: see Treasury, *Final Regulations (August 3, 2007)*, *supra* note 35, page 43148.

[46] 26 C.F.R. § 1.6011-4(g).

[47] 26 U.S.C. § 6707A.

The Commissioner of Internal Revenue may wholly or partially lift the penalty initially imposed on the taxpayer if doing so promotes compliance with the disclosure rules and fosters the sound administration of justice.[48] The taxpayer must petition the tax administration within 30 days of the date on which the tax administration demanded to the taxpayer the payment of the penalty and the filing of the information return that he had to submit.[49]

In order to decide whether a penalty must be rescinded, the tax administration takes into consideration all of the circumstances, including the extent to which the taxpayer has complied with the tax system in the past, the unintentional nature of the taxpayer's mistake in interpreting the facts, and fairness issues. Taxpayers and advisers cannot appeal the tax administration's decision to not rescind the penalty that it initially imposed on them.[50]

However, the tax administration is not empowered to lift the penalty levied in respect of a listed transaction. The tax administration's decision concerning such transactions is final and is not subject to judicial review.[51]

3.2.5 Specific penalty for under-stating tax payable

3.2.5.1 20% or 30% penalty rate

Briefly, taxpayers who under-state their tax payable are liable to a penalty equivalent to 20% of the total amount of tax under-stated when such under-statement is considerable ("general penalty").[52] An amount of under-stated tax payable is considerable in the following cases:

- Generally speaking, the taxpayer's under-statement of tax payable will be considerable if the amount of tax payable that the tax administration determines exceeds that stated by

---

48 26 U.S.C. § 6707A(d).

49 See the procedure that the American tax administration established in this respect in US, Department of the Treasury (Internal Revenue Service), Rev. Proc. 2007-21, 2007-9 I.R.B. 613 (February 26, 2007) [IRS, "Revenue Procedure for Penalty Rescission Request"].

50 See 26 U.S.C. § 6707A(d) and § 6707(c); US, Department of the Treasury (Internal Revenue Service), Notice 2005-11, "New Penalty Section 6707A and Rescission Penalty,"2005-7 I.R.B 493 (February 14, 2005).

51 26 U.S.C. § 6707A(d).

52 We refer the reader to Instalment 6 of Part II of this study for additional information on the general penalty for under-stating tax payable.

the taxpayer by an amount corresponding to the greater of 10% of the tax determined by the tax administration or $5,000.

- In the case of a corporation, the amount of tax under-stated will be considerable if the amount of tax payable that the tax administration determined exceeds that stated by the corporation by an amount corresponding to the lesser of:
  - 10% of the tax determined by the tax administration or $10,000, if this amount is higher; or
  - $10 million.[53]

The amount to which the penalty rate applies corresponds essentially to the amount of the tax payable under-stated determined by the tax administration after the adjustments that it makes to the taxpayer's calculation of income and the tax payable.

However, taxpayers whose under-stated tax is attributable to a reportable transaction for the purposes of the disclosure rules are subject to a specific penalty for under-stating tax payable. Briefly, this penalty is equivalent to:

- 20% of the tax under-stated stemming from a listed transaction or another reportable transaction if, in the latter instance, one of the significant purposes that the taxpayer pursued is tax avoidance;
- 30% of the amount of tax under-stated when the taxpayer fails to comply with the disclosure rules.

The amount to which the specific penalty applies corresponds, by and large, to the amount of tax under-stated by the taxpayer after the tax administration has requalified items pertaining to the transaction indicated in the taxpayer's income tax return (regardless of the other items), multiplied by the highest income-tax rate applicable to the taxpayer. A public company must disclose in its financial statements any penalty that the tax administration levies on it.[54]

---

53 26 U.S.C. § 6662.

54 26 U.S.C. § 6662A. Moreover, the specific penalty applies instead of the general penalty for under-stating tax payable.

3.2.5.2 Possibility for the taxpayer to avoid the specific penalty if he has complied with the disclosure rules

If the taxpayer has complied with the disclosure rules, he may avoid the penalty for under-stating tax payable if he:[55]

- demonstrates his good faith;
- demonstrates that he has complied with the disclosure rules;
- has relied on recognized legal or administrative sources in order to claim the tax benefits when he filed his income tax return;
- demonstrates that he could reasonably believe that the tax treatment claimed more likely than not complied with the tax law and the jurisprudence.[56]

The taxpayer's opinion must be established in a reasonable manner:

- by applying the tax law and the jurisprudence to all the facts;
- without considering the possibility that the tax administration will not audit his income tax return or will not trace the transaction implemented; and
- without considering the possibility of reaching a settlement with the tax administration in order to settle a dispute over a feature of the transaction.[57]

Following the example of the general penalty for under-stating tax payable, a taxpayer may rely on the tax opinion put forward by a tax adviser in order to avoid the specific penalty,[58] but cannot rely on a disqualified opinion.

---

[55] More specifically, a taxpayer who has not complied with the disclosure rules may not then submit a due diligence defence to avoid this penalty.

[56] 26 U.S.C. § 6664(d). Furthermore, the tax administration may prescribe by regulation interpretations of the tax law and the jurisprudence, which, in its opinion, do not allow taxpayers to maintain that their position complies with these legal sources according to the balance of probabilities: 26 U.S.C. § 6662(d)(3).

[57] 26 U.S.C. § 6664(d)(3)(A).

[58] The principles adopted to ascertain whether the taxpayers have displayed due diligence for the purposes of the disclosure rules are similar to the principles applicable for the purposes of the general penalty for under-stating tax payable. Briefly, the taxpayers must rely on an impartial professional opinion if the tax treatment claimed complies with the tax law according to the balance of probabilities, without postulating unreasonable hypotheses with respect to the relevant facts.

3.2.5.3 Disqualified opinion

To avoid the specific penalty, a taxpayer may rely on the tax opinion formulated by an adviser who:

- is subject to the disclosure rules;
- receives fees from such an adviser;
- receives fees subject to the taxpayer's obtaining the tax benefits stemming from a reportable transaction; or
- has a financial interest in the realization of the reportable transaction, under the circumstances that the tax administration prescribes.[59]

Moreover, a taxpayer may not rely on a tax opinion when the opinion:

- is based on unreasonable factual or legal hypotheses;
- relies in an unreasonable manner on the taxpayer's or any other person's statements;
- does not take into consideration the relevant facts in order to determine the appropriate tax treatment; or
- takes into consideration the likelihood that the tax administration will not trace the transaction implemented or that the tax administration will agree to reach a settlement with the taxpayer.[60]

3.2.6 Suspension of interest accrued in respect of individuals

Both corporations and individuals who have an amount of tax under-stated attributable to a reportable transaction must pay the interest accrued on this amount as of the deadline for filing their income tax return. However, these taxpayers may pay the amount of the tax under-stated or otherwise submit to the tax administration an amount to prevent the accrual of interest on the amount of tax payable that the tax administration determines.[61]

Individuals are eligible for the suspension of the calculation of interest on an amount of tax under-stated attributable to a transaction that is reportable under the disclosure rules when the

---

59 26 U.S.C. § 6664(d)(3)(B)(i) et (ii).

60 26 U.S.C. § 6664(d)(3)(A)(B)(iii).

61 26 U.S.C. § 6601 and § 6603. For an overview of the rules governing the calculation of interest accrued on unpaid tax, see US, Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05) Washington, DC, United States Government Printing Office, May 2005, pages 408-411.

tax administration has not issued a notice of assessment within 36 months of the deadline for filing the income tax return for a taxation year.[62] However, individuals are ineligible for a suspension of interest if the amount of tax under-stated stems from a listed transaction or any other reportable transaction that has not been properly disclosed.[63]

3.2.7 Extension of the reassessment period

The tax administration may audit the affairs of a taxpayer who has not filed his information return beyond the usual three-year audit period. If need be, the tax administration may issue to the taxpayer a notice of reassessment until the expiry of a period of one year starting the day following the day on which the taxpayer fulfils his obligations under the disclosure rules.[64]

3.3 Duties of tax advisers and penalties

3.3.1 Reporting advisers

A tax adviser is subject to the disclosure rules when he:

- formulates on behalf of a taxpayer a tax statement when the taxpayer carries out a reportable transaction;[65]
- participates in the organization, management or the implementation of the transaction, solicits taxpayers to carry out the transaction or gives a taxpayer an tax result protection whose purpose is to ensure the tax benefits that the taxpayer may anticipate from the transaction; and
- derives gross income from the transaction that exceed the following thresholds:
    - in the case of a reportable transaction other than a listed transaction, \$50,000 when the tax benefits are substantially attributable to one or more individuals and \$250,000 in other cases;[66]

---

62 26 U.S.C. § 6404(g)(3), as amended by the *Small Business and Work Opportunity Tax Act of 2007*, Pub. L. 110–28 (May 25, 2007), section 8242.

63 26 U.S.C. § 6404(g)(2)(E).

64 26 U.S.C. § 6501(c)(10).

65 A tax statement includes any oral or written statement that affects an aspect of a transaction that makes it a reportable transaction for the purposes of the disclosure rules: 26 C.F.R. § 301.6111-3(b)(2)(ii). In principle, an adviser who formulates an opinion after the taxpayer has filed his income tax return reflecting the tax benefits of a reportable transaction is not subject to the disclosure rules: 26 C.F.R. § 301.6111-3(b)(2)(iii)(B).

66 When individuals participate in a reportable transaction, the American tax administration usually deems the tax benefits stemming therefrom to be substantially attributable to them when 70% or

- in the case of a listed transaction, $10,000 when the tax benefits are substantially attributable to one or more individuals and $25,000 in other cases;
- in the case of a transaction that can potentially be considered as tax avoidance, the tax administration may prescribe lower gross income thresholds than those generally applicable to reportable transactions.[67]

3.3.2 Information return and penalty for failing to file

Briefly, reporting advisers must file with the tax administration a return prescribed by the tax administration concerning a reportable transaction that their clients have carried out.[68] This return must contain the same information as those that taxpayers file with the tax administration for the purposes of the disclosure rules. The reporting advisers must also reveal the identity of other reporting advisers if they knew or should have known that the latter also participated in the transaction.[69]

These advisers must file quarterly information returns. More specifically, they must file such a return no later than the last day of the month following the end of a quarter in the calendar year during which the taxpayer carried out a reportable transaction in which they participated.[70] When a taxpayer has engaged in a transaction in which the adviser participated and the tax administration subsequently declared it a listed transaction, the adviser must then file an information return in respect of the transaction inasmuch as he could have been considered a reporting adviser on the day that the taxpayer carried out the transaction.[71]

---

more of these benefits are directly or indirectly attributable to one or more of them: see 26 C.F.R. § 301.6111-3(b)(3)(i)(D).

67 See 26 U.S.C. § 6111; 26 C.F.R. § 301.6111-3(b)(2)(i) and (3). The American tax administration may apply a lower gross income threshold depending on the circumstances of a transaction. If the American tax administration prescribes low thresholds, greater numbers of advisers will be subject to the disclosure rules.

68 See 26 C.F.R. § 301.6111-3(a) and (b)(4).

69 See 26 C.F.R. § 301.6111-3(d). See the form prescribed by the Internal Revenue Service, US, Internal Revenue Service, Form 8918, *Material Advisor Disclosure Statement* (Rev. October 2007), and the directives from the US Internal Revenue Service, Instructions 8918, *Instructions for Form 8918* (Rev. October 2007). The advisers previously had to file the form prescribed for the purposes of the preceding disclosure rules on tax shelters (form 8264), following the directives issued on an interim basis by the tax administration: see US, Department of the Treasury (Internal Revenue Service), Notice 2004-80, "Temporary Rules Under Sections 6111 and 6112" (November 16, 2004) [IRS, "6111 and 6112 Temporary Regulations (2004)"].

70 26 C.F.R. § 301.6111-3(e).

71 See the advisers' obligations in respect of listed transactions and transactions that allow an interest deduction, as indicated in the proposed regulation: see US, Department of Treasury

When several reporting advisers are involved, they may designate one of their number to file the information returns.[72]

The reporting advisers who do not file the information return in the prescribed manner within the prescribed period are liable to a $50,000 penalty. However, in the case of listed transactions, this penalty corresponds to the greater of $200,000 dollars or 50% of the gross income that the adviser derived from the implementation of the transaction (75% if he intentionally omitted to file the information in the prescribed manner).[73]

As is the case for taxpayers, the tax administration may, under exceptional circumstances, lift the application of the penalties levied on the advisers, but solely in respect of reportable transactions other than listed transactions.[74]

3.3.4 Registration number concerning the transaction disclosed

Once the advisers have filed the information return, the tax administration must send them a registration number concerning the transaction disclosed. The advisers must transmit to their clients this number on the day on which the clients finalize the transaction or, otherwise, within 60 days of the tax administration's sending the number. The issuing of the registration number does not in any way confirm that the adviser has filed a return in accordance with the disclosure rules or that the tax administration has recognized the validity of the transaction for tax purposes.[75]

(Internal Revenue Service), Proposed Regulations REG-103039-05, RIN 1545-BE26, "ACJA Modifications to the Section 6111 Regulations" (November 2, 2006) [Treasury, *Proposed ACJA Modifications to Regulations 6111 (November 2, 2006)*], § 301.6111-3(4)(iii).

72 26 C.F.R. § 301.6111-3(f).

73 26 U.S.C. § 6707. See the following proposed regulation: US, Department of Treasury (Internal Revenue Service), Proposed Regulations REG-103043-05, RIN 1545-BE28, *ACJA Modifications to the Section 6112 Regulations* (November 2, 2006) [Treasury, *Proposed ACJA Modifications to 6112 (November 2, 2006)*], §301-6112-1. The American tax administration previously issued directives on an interim basis.

74 26 U.S.C. § 6707A(d) and § 6707(c). See the procedure established by the tax administration in this respect in IRS, "Revenue Procedure for Penalty Rescission Request," *supra* note 49.

75 26 C.F.R. § 301.6111-3(d)(2).

3.3.5 Register of participants in a disclosed transaction and penalty for failing to maintain this register

The advisers must maintain a register for each reportable transaction that their clients have carried out in respect of which the advisers are reporting advisers.[76] They must maintain this register for a period of seven years starting on the day on which the adviser formulates a tax statement concerning a reportable transaction or, if it occurs earlier, the day on which the client carried out this transaction.[77]

The register must contain the following information in such a way that the tax administration can identify it readily or without undue delay:

- a declaration that includes each of the following headings:
  - the name of the reportable transaction, the reference to the declaration by the tax administration that a transaction is a listed transaction or that it falls into the category of transactions that have the potential for tax avoidance, and the registration number of the reportable transaction;
  - the name, address and tax identification number of the clients who implemented the transaction;
  - if the reporting adviser knows it, the date on which each client implemented the transaction;
  - if the reporting adviser knows it, the amount that each client invested in the transaction implemented;
  - a brief description of the tax benefits claimed or anticipated by each client;
  - if the reporting adviser knows it, the name of the other reporting advisers who participated in the implementation of the transaction;
- a detailed description of the tax structure of the transaction and the anticipated tax benefits;
- a copy of any relevant document that explains the tax structure of the transaction and the anticipated tax benefits, including the tax opinions;
- a copy of any agreement between the reporting advisers that designates one of them to ensure compliance with the disclosure rules.[78]

When a taxpayer implements a transaction in which the adviser has participated and the tax administration subsequently declares it to be an aggressive planning scheme or includes it in

---

[76] 26 C.F.R. § 301.6112-1(a).

[77] 26 U.S.C. § 6112 and 26 C.F.R. §301.6112-1(d).

[78] See 26 C.F.R. § 301.6112-1(b)(2) and (3).

the category of transactions that have the potential for tax avoidance, the adviser must maintain a register concerning this transactions insofar as:

- the adviser can be considered a reporting adviser on the day on which the taxpayer carried out the transaction; and
- the taxpayer carried out this transaction within a period of six years preceding the time at which the tax administration declared it to be a listed transaction or included it in the category of transactions that have the potential for tax avoidance.

The reporting advisers who participated jointly in the implementation of a transaction may designate one of them to fulfil the obligations pursuant to the disclosure rules but they all remain liable to the tax administration if the designated adviser fails to fulfil his commitments.[79]

Reporting advisers incur an administrative penalty if they do not file with the tax administration the list of clients within 20 days of the date on which the tax administration formulates a request in this respect.[80] The penalty stands at $10,000 a day for each day of infraction. The advisers may only avoid this penalty if they establish reasonable grounds.[81]

The US tax administration has prescribed a form that the advisers may use to maintain the register required pursuant to the disclosure rules. However, the advisers may maintain a register in another form, provided that it contains the prescribed information under the disclosure rules.[82]

---

79 26 C.F.R. § 1.6112-1(f).

80 26 C.F.R. § 1.6112-1(e)(1).

81 26 U.S.C. § 6708(a). For a discussion of the concept of reasonable grounds, see NYSBA, "Report on Disclosure," *supra* note 11.

82 See US, Department of the Treasury (Internal Revenue Service), *Form 13976: Itemized Statement Component of Advisee List* (April 2008), and Rev. Proc. 2008-20, 2008-20 I.R.B. 980 (May 19, 2008), in which the American tax administration provides more extensive information on the use of the prescribed form and the obligations of advisers who are subject to the disclosure rules.

4

Observations

The disclosure rules offer the US tax administration the advantage of evaluating objectively and in a timely manner the risk of avoidance in certain transactions. Groups of stakeholders usually acknowledge the need to enhance the transparency of income tax returns and the information filed with the US tax administration. Both members of the tax administration and advisers have nonetheless expressed concerns over the application of the disclosure rules. These concerns stem, among other things, from the lack of precision of the criteria used to define reportable transactions and to delineate the duties of taxpayers and tax advisers. The proliferation of proposed regulations and directives regarding the application of the disclosure rules since 2004 is making it harder for taxpayers and their advisers to comply with those rules.

Despite concerns over the scope of the disclosure rules and their constant adaptation, the US tax administration appears to have collected a significant amount of information. Instead of systematically adopting specific anti-avoidance rules as the United Kingdom has done, the American tax administration is relying instead on the application of the existing tax rules taken as a whole and, above all, on the application of the economic substance doctrine and the penalty for under-stating tax payable.

More specifically, the American tax administration is constantly declaring that transactions are aggressive (listed transactions) by precisely describing the main details of the transactions and its intention to apply the tax rules, the economic substance doctrine and the penalty for under-stating tax payable. The proliferation of listed transactions ultimately risks creating a contentious situation between the tax administration, on the one hand, and taxpayers and their advisers, on the other hand.

The following subsections present several observations stemming from the tax administration's adoption of this tool:

- The tax administration seeks to strike a balance between the taxpayers' and the advisers' duty of compliance and the need to protect the integrity of the tax system.

- The tax administration targets tax avoidance both in light of circumstancial factors as well as objective characteristics that are specific to the transactions.
- The listed transactions appear to be those that present the highest risks of avoidance, in particular because they do not appear to comply with the economic substance doctrine.
- Opinions may differ among groups of stakeholders on the presence of a reportable transaction in a given situation, especially in the case of a listed transaction.
- By compelling taxpayers and advisers to file information, the US tax administration is seeking to match the information filed with the income tax returns of taxpayers who have carried out a reportable transaction.
- Tax and non-tax advisers may be subject to the disclosure rules, although their participation does not focus directly on the elaboration of a reportable transaction.
- Uncertainty persists over the scope of the duties of tax consulting firms or partnerships under the disclosure rules.
- The tax administration may identify a greater number of taxpayers who have carried out a reportable transaction through an extended reassessment period.
- Taxpayers and their advisers voice concerns about the applicable penalties, in particular the higher penalties for listed transactions.
- The courts must reconcile the tax administration’s audit authority and the taxpayers’ privilege of confidential communication by taking into consideration both that the tax system is a self-assessment system and that these two groups of stakeholders potentially find themselves in a contentious situation during the audit stage.

4.1 The search for balance between taxpayers’ and advisers’ duty of compliance and the protection of the integrity of the tax system

According to the tax administration, tax advisers usually fulfil their obligations pursuant to the disclosure rules.[83] Professional organizations acknowledge the relevance of administrative tools

[83] In conjunction with its audits, the tax administration has reached agreements with tax advisers who undertook to fulfil their obligations pursuant to the disclosure rules. See the transcript of the testimony of Mark Everson, Internal Revenue Service Commissioner, on abusive tax planning schemes before the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, entitled “Prepared Testimony of Commissioner of Internal Revenue Mark W. Everson Before the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate Hearing on Abusive Tax Shelters” (November 20,

such as the disclosure rules compared with other tools such as the codification of the economic substance doctrine.[84] In recent years, professional corporations have completed a sweeping reform of their organizational structure so that all of their advisers fulfil their duty of disclosure.[85]

Taxpayers also appear to have complied with their duty of disclosure. During the period between January 1, 2000 and September 30, 2003, the IRS counted 2845 information returns filed by taxpayers pursuant to the disclosure rules.[86] The tax administration's declaration that certain transactions were aggressive planning schemes appears to have curbed solicitations by advisers, but this impact cannot ultimately be evaluated. Anecdotal circumstances reveal that advisers deemed it appropriate to cease their solicitations as soon as the tax administration declared a transaction subject to solicitation to be a listed transaction. Certain advisers even reimbursed their clients the fees received to implement such a transaction.[87]

2003) [Everson, *Senate Hearing on Abusive Tax Shelters*], page 8, online on the IRS Website: <http://www.irs.gov/pub/irs-utl/shelters-nov20.pdf>.

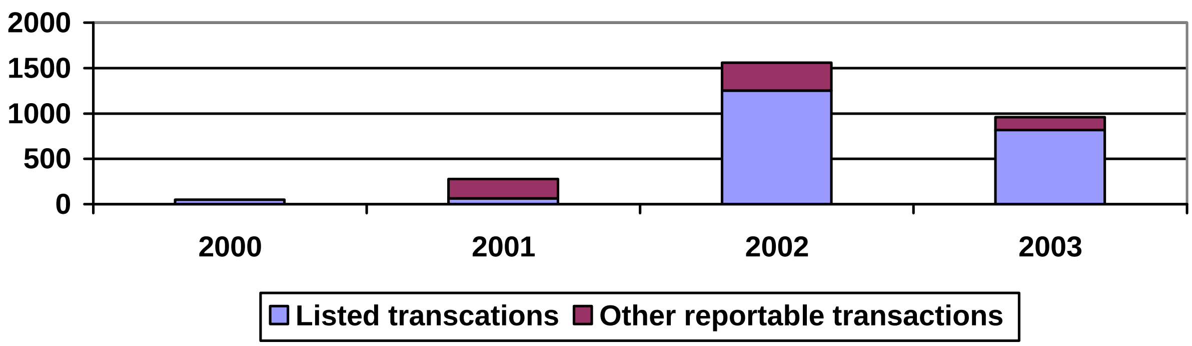
84 See the letter of January 10, 2006 from the Tax Executives Institute, Inc. to the Senate Committee on Finance concerning the U.S. Senate's proposed codification of the economic substance doctrine, entitled *S. 2020 - Tax Relief Act of 2005,* online on the TEI Website: <http://www.tei.org/dman/Document.phx?documentId=zy01806153814028>. See also the testimony of Samuel Thomson Jr., Director of the Law Center, University of California, given before the Subcommittee on Select Revenue Measures (House Committee on Ways and Means) (May 9, 2006), online on the House Committee on Ways and Means Website: <http://waysandmeans.house.gov/hearings.asp?formmode=view&id=4940>. Instalment 6 of this study presents the key details of the economic substance doctrine and the proposed codification, and questions pertaining to their application.

85 See the measures adopted by certain tax consulting firms in the report of the Committee on Homeland Security, *Role of Professional Firms*, *supra* note 3, pages 76-76, 85-86, 93-95, and 100.

86 See the testimony of Michael Brostek, Director of the Internal Revenue Service, before the U.S. Senate Committee on Finance (Committee on Finance, U.S. Senate): Michael Brostek, Testimony, "Challenges Remain in Combatting Abusive Tax Shelters, before the Committee on Finance, U.S. Senate (GAO-04-104T) October 21, 2003, pages 24-25. The updating of these data would allow us to better evaluate this tool's impact.

87 The report produced by the U.S. Senate Permanent Subcommittee on Investigations concerning an investigation of the role that tax consulting firms play in the realm of aggressive tax planning schemes in the United States provides examples: Committee on Homeland Security, *Role of Professional Firms*, *supra* note 3, pages 83, 92 and 93.

Figure 4.1
Annual breakdown of the number of information returns filed by taxpayers pursuant to the disclosure rules for the period from 2000 to September 30, 2003



Source: Table elaborated by the authors drawn from information in the documents reproducing testimony by Michael Brostek, Director, Tax Issues, entitled *Internal Revenue Service: Challenges Remain in Combatting Abusive Tax Shelters*, statement before the Committee on Finance, U.S. Senate (GAO-04-104T), October 21, 2003, pages 24-25.

The tax administration seeks to display flexibility by modifying on an *ad hoc* basis the list of reportable transactions in order to target only transactions that entail high risks of avoidance and to avoid encumbering the duties of taxpayers and advisers overall.[88] In principle, a targeted approach makes it possible to confine the field of application of the disclosure rules to transactions that entail the greatest risk of avoidance.

However, we have noted that the number of withdrawals and exclusions from the list of reportable transactions falls significantly below the number of transactions added to the list. The number of listed transactions increased from 10 in 2000 to 34 as of March 1, 2008. Moreover, the tax administration has added to the list of reportable transactions those that may possibly be likened to avoidance with the objective of better assessing their level of compliance with the tax law.[89] The constant addition of transactions to the list of reportable transactions creates practical difficulties for taxpayers and advisers, since they must ensure that they fulfil their duties of

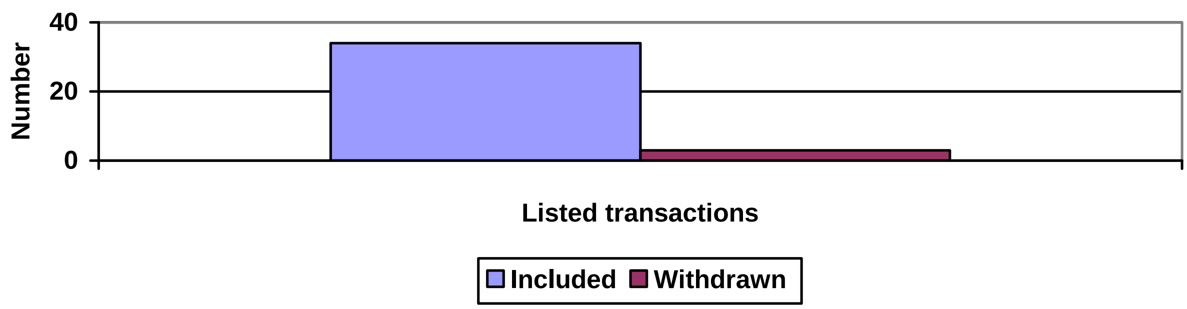
88 US, Department of Treasury (Internal Revenue Service), IR-2006-167, "Treasury, IRS Issue Regulations on Requirement for Disclosing Reportable Transactions and Maintaining Lists" (November 1, 2006).

89 In light of the information that the tax administration collects, it may either withdraw a category from the list of reportable transactions, declare transactions to be listed transactions, or permanently add transactions to the list of reportable transactions. See Treasury, *Proposed ACJA Modifications to Regulations 6011* (November 2, 2006), *supra* note 43 under *B. Transactions of Interest* and *Proposed Amendments to Regulations §1.6011-4(b)(6) Transactions of Interest.*

disclosure in respect of transactions that were completed even before such transactions were included on the list.[90]

On the other hand, the tax administration has withdrawn from the list of reportable transactions those that it did not deem to pose specific risks.[91] In particular, it has withdrawn from this list transactions carried out by large corporations when disparities arise between the accounting and tax treatments since another information return filed by these taxpayers makes it possible to collect the relevant information.[92] The tax administration has also made provision for exceptions for transactions that are apparently comparable to reportable transactions.

Figure 4.2
Comparison of the number of transactions appearing on the list of listed transactions and the number of transactions withdrawn from this list from 2000 to February 1, 2008



Source: Figure elaborated by the authors in light of the list of listed transactions and those withdrawn from this list by the American tax administration as published on the IRS Website, consulted on January 4, 2008.

---

90 See the duties of taxpayers and advisers in respect of listed transactions and as regards transactions of interest spelled out in the following proposed regulations: Treasury, *Proposed ACJA Modifications to Regulations 6011* (November 2, 2006), *supra* note 43 § 301.6011-4(e)(2)(i); Treasury, *Proposed ACJA Modifications to Regulations 6111* (November 2, 2006), *supra* note 71 § 301.6111-3(4)(iii); Treasury, *Proposed ACJA Modifications to 6112* (November 2, 2006), *supra* note 73 § 301.6112-1(b)(2).

91 See US, Department of Treasury (Internal Revenue Service), IR 2004-138, "Treasury and IRS Issue Guidance on New Requirements for Disclosing Reportable Transactions" (November 16, 2004) [IRS, "Disclosing of Reportable Transactions (2004)"], and Rev. Proc. 2004-65 to 2004-68 linked to this press release: online on the IRS Website: <http://www.irs.gov/newsroom/article/0,,id=131368,00.html>.

92 US, Department of the Treasury (Internal Revenue Service), Notice 2006-6, "Notification of Removal of the Transaction with a Significant Book-Tax Difference Category of Reportable Transactions under 1.6011-4" (January 6, 2006), online on the IRS Website: <http://www.irs.gov/newsroom/article/0,,id=152676,00.html>; Treasury, *Proposed ACJA Modifications to Regulations 6011* (November 2, 2006), *supra* note 43.

Taxpayers and advisers are concerned about the cost of complying with the disclosure rules. The tax administration is of the opinion that the compliance burden centres primarily on large public companies and this burden does not seem significant.[93] It seeks to avoid the proliferation of information filings in the case of these corporations when the statements targeted are part of the information included in the public documents submitted to the Securities Exchange Commission.[94] The relatively high thresholds for the fees as well as for the losses, deductions and tax credits that trigger the application of the disclosure rules reduce the risks that small and medium-sized enterprises and individuals have to assume additional administrative duties.[95] The fact remains that the burden of complying with the disclosure rules might prove to be significant both for large corporations and for small and medium-sized enterprises and individuals.

The tax administration has estimated the time that taxpayers must devote to fulfilling their obligations pursuant to the disclosure rules. The number of hours that they must devote to grasping the scope of their duties, filling out the information return and maintaining the register of relevant documents increased from 8 hours in 2004, to 17 hours in 2005 and to 22 hours in 2007. This time varies according to each taxpayer's circumstances. The tax administration wishes to collect more extensive information in order to estimate in a more representative manner the time required to ensure compliance with the disclosure rules.

---

[93] See Treasury, "Temporary Regulations on Tax Shelter Disclosure (March 2000)," *supra* note 13, page 749.

[94] See Treasury, *Proposed ACJA Modifications to Regulations 6111* (November 2, 2006), *supra* note 71 under § 301.6111-3(b)(2)(iii)(C).

[95] See subsection 4.3.2 dealing with the criteria adopted to define the transactions that display a risk of tax avoidance.

TABLE 4.1
TAX ADMINISTRATION'S ESTIMATE OF THE TIME THAT A TAXPAYER MUST DEVOTE TO FULFILLING HIS OBLIGATIONS PURSUANT TO THE DISCLOSURE RULES
(IN HOURS AND MINUTES)

NATURE OF THE OBLIGATION	ESTIMATED NUMBER OF HOURS		
	2004	2005	2007
ANALYSIS OF THE DISCLOSURE RULES AND THE FORM	2 hours and 28 minutes	4 hours and 28 minutes	4 hours and 28 minutes
PRESERVATION OF THE DOCUMENT REGISTER	3 hours and 6 minutes	6 hours and 13 minutes	12 hours and 54 minutes
PREPARATION AND FILING OF THE INFORMATION RETURN	2 hours and 39 minutes	4 hours and 46 minutes	4 hours and 52 minutes
TOTAL	8 hours and 3 minutes	17 hours and 7 minutes	22 hours and 14 minutes

Source: Table prepared by the authors based on the document entitled "Instructions for Form 8886 Reportable Transaction Disclosure Statement" of the Internal Revenue Service (according to the versions revised in December 2004, December 2005 and December 2007).

To fully measure the efficacy of the disclosure rules, the tax administration should provide estimates concerning the amounts of tax, interest and penalties that it intends to collect from taxpayers identified pursuant to these rules. In May 2004, the tax administration estimated at $43 billion the overall value of taxes at stake in respect of 12,261 transactions implemented by taxpayers, including large corporations, which, in its opinion, can be considered listed transactions. However, these amounts may be reduced during an audit, an objection or a dispute.[96]

In this regard, the tax administration is experiencing difficulty in completing its audits and issuing notices of assessment within the assessment period, despite the extension of this period for the purposes of the disclosure rules.[97] According to a report produced by the tax administration, it takes an average of nearly two and a half years following the identification of the taxpayer to audit an income tax return and issue a notice of assessment to a taxpayer who has carried out a reportable transaction. The tax administration might find it impossible to issue a notice of

96 US, Government Accountability Office, Report to the Ranking Minority Member, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs (U.S. Senate), *Tax Shelters: Services Provided by External Auditors* (GAO-05-171), February 2005, page 12, Table 3, online on the GAO Website: <http://www.gao.gov/new.items/d05171.pdf>. This study focuses on the advice that the external auditors of companies on the Fortune 500 list of the biggest American companies provide in respect of aggressive tax planning schemes.

97 See subsection 3.2.7.

assessment within the three-year assessment period. The extended assessment period might prove to be too short since it extends only over a period of one year after the date of filing of the taxpayer's information return. Among the factors contributing to the extended duration of audits is a shortage of tax agents and the complexity of the transactions.[98]

4.2 The tax administration targets tax avoidance arrangements both in light of circumstancial factors and the specific characteristics of the transactions

Taxpayers and advisers must file an information return depending on the circumstances under which a tax planning scheme is carried out (circumstancial factors) or according to the characteristics of the realization of the scheme (direct factors).

4.2.1 Risk of avoidance because of circumstancial factors surrounding the business relationship between the taxpayer and the adviser

Except for listed transactions and transactions that have the potential for tax avoidance, reportable transactions are usually defined by circumstancial factors. Thus, taxpayers and advisers must file information returns concerning a transaction according to the following factors:

- the existence of hold harmless or confidentiality clauses;
- when the value of the fees of reporting advisers or the amounts of business or capital losses deducted by a taxpayer exceed the prescribed thresholds;
- when the holding period of property exceeds the prescribed duration.

---

98 US, Treasury Inspector General for Tax Administration, *The Settlement Initiative for Investors in a Variety of Bond and Option Sales Strategies Was Successful and Surfaced Possible Next Steps for Curtailing Abusive Tax Shelters* (2006-30-065), March 2006 [TIGTA, *Settlement Initiative and Abusive Tax Shelters*], pages 6-8, online on the TIGTA Website: <http://www.treas.gov/tigta/auditreports/2006reports/200630065fr.pdf>. See also the transcript of the statement by the Hon. J. Russell George, Treasury Inspector General for Tax Administration, made on July 26, 2006 before the Subcommittee on Taxation and IRS Oversight (under the aegis of the U.S. Senate Committee on Finance): Hon. J. Russell George (Treasury Inspector General for Tax Administration), "A Closer Look at the Size and Sources of the Tax Gap," hearing before the U.S. Senate Committee on Finance Subcommittee on Taxation and IRS Oversight, Washington, DC, July 26, 2006, online on the TIGTA Website: <http://www.treas.gov/tigta/congress/congress_07262006.pdf>.

The application of these factors usually poses few problems for groups of stakeholders. These factors can be measured objectively and merely reflect the possibility that taxpayers and their advisers have participated in a tax avoidance arrangement. Despite the presence of these factors, these transactions might prove to comply with the tax rules or the economic substance doctrine.

An approach centred on circumstancial factors implies that the taxpayers and the advisers must file information returns even if they only carry out routine commercial transactions that comply with the purposes of the tax law. In this respect, the tax administration has excluded on an *ad hoc* basis certain transactions from the list of reportable transactions. In particular, it has excluded transactions that allow the deductibility of losses in the calculation of the taxpayer's income when such losses display disparities in their tax and accounting treatment and concern assets held for a short period. Briefly, the excluded transactions are defined specifically and can apparently be considered routine commercial transactions.[99]

Moreover, the tax administration has excluded certain transactions containing hold harmless clauses focusing on fiscal measures aimed at the realization of socioeconomic objectives.[100] Similarly, it seeks to avoid having advisers file information returns when they participate in the realization of routine commercial transactions accompanied by tax result protection or break clauses in the case of amendments to the tax law or other types of tax result protection or insurance usually used in conjunction with commercial transactions.

The tax administration nonetheless likens the granting of "tax benefit" insurance by a third party to a participation in a reportable transaction for the purposes of the disclosure rules.[101] Thus, advisers who grant insurance to the parties to a reportable transaction from the standpoint of the realization of the anticipated tax benefits become subject to the disclosure rules. According

[99] For illustrations of certain routine commercial transactions, see Rev. Proc. 2004-66, 2004-67 and et 2004-68, appended to the IRS press release, "Disclosing of Reportable Transactions (2004)," *supra* note 91.

[100] See US, Department of the Treasury (Internal Revenue Service), Rev. Proc. 2007-20 (untitled), 2007-7 I.R.B. 517 (February 12, 2007). The measures targeted include, among others, the Work Opportunity Credit, the Welfare-to-Work Credit, the Low-Income Housing Credit, the New Markets Tax Credit, the Empowerment Zone Employment Credit and the Indian Employment Credit.

[101] Treasury, *Proposed ACJA Modifications to Regulations 6111* (November 2, 2006), *supra* note 71, pages 6-7.

to the tax administration, certain taxpayers have implemented listed transactions accompanied by tax result protection from third party suppliers. This extract from the explanatory notes of the statutory regulations governing the disclosure rules illustrates the tax administration's reasoning in this respect:

> Previous comments to the regulations under §1.6011-4 stated that it is inappropriate to require reporting of transactions under the contractual protection filter of §1.6011-4(b)(4) for which the taxpayer obtains tax result protection (sometimes referred to as "tax result insurance") because numerous legitimate business transactions with tax indemnities would be subject to reporting. The IRS and Treasury Department removed tax result protection from that category of reportable transaction but cautioned that if the IRS and Treasury Department became aware of abusive transactions utilizing tax result protection, the issue would be reconsidered.
>
> The IRS and Treasury Department have since become aware of taxpayers who have obtained tax result protection for the tax benefits of a listed transaction from a third party provider. In the AJCA, Congress expressed concern about tax result protection for reportable transactions and included insuring in the list of activities added to the statutory language under section 6111. The IRS, Treasury Department, and Congress have an interest in learning more about the insuring of reportable transactions. Accordingly, while a transaction will not be a reportable transaction simply because there is tax result protection for the transaction, tax result protection provided for a reportable transaction may subject a person to the material advisor disclosure rules under section 6111 because a tax statement includes third party tax result protection that insures the tax benefits of a reportable transaction.[102]
>
> [our extracts]

4.2.2 Risk of avoidance according to the application of the tax rules and the economic substance doctrine to a type of planning scheme

In the tax administration's opinion, listed transactions present a risk of avoidance in light of the tax rules and the economic substance doctrine.

On the one hand, the tax administration applies the specific rules, which, in its view, withdraw the tax benefits stemming from a transaction that taxpayers claim. However, these rules entail interpretation difficulties since the taxpayers may also rely on the rules to claim tax benefits. The interpretation problems stem, among other things, from the inconsistency of various rules that apply concomitantly to a transaction.[103]

---

102 *Ibid*.

103 See *Coltec Indus., Inc.* v. *United States*, 454 F.3d 1340 (Fed. Cir. App. 2006), 2006 U.S. App. LEXIS 24771 (Fed. Cir. App. 2006), (July 12, 2006) U.S. Court of Appeals for the Federal Circuit, 05-5111, cert. denied by the US Supreme Court: *Coltec Indus.* v. *United States*, 2007 U.S. LEXIS 2087 (U.S., 2007). See also *Black & Decker Corp.* v. *Commissioner*, 436 F.3d 431, 441 (4th Cir. 2006); No. 05-1015*,* CA-02-2070-WDQ (February 2, 2006). We refer the reader to Instalment 6 of

On the other hand, the tax administration may declare that a transaction is aggressive if it does not seem to conform to the economic substance doctrine. Briefly, the transactions that the tax administration declares to be aggressive are devoid of economic substance and appear to solely or primarily concern the deduction by a taxpayer of tax losses or other amounts.[104]

The groups of stakeholders must apply the economic substance doctrine according to the facts of a transaction. According to these facts, the transaction might conform to the law compared with the transaction that the tax administration has declared to be aggressive. Taxpayers may then find themselves in a situation in which they must file an information return even though their transactions display only minimal or non-existent risks of avoidance. The tax administration wishes, among other things, to collect the observations of groups of stakeholders so that taxpayers carrying out routine transactions involving commercial leases on tangible personal property do not have to file an information return pursuant to the disclosure rules:

> These proposed regulations also eliminate the special rule for lease transactions. Under the current regulations this special rule provides that certain customary commercial leases of tangible personal property described in Notice 2001-18, 2001-1 C.B. 731, are excluded from all of the reportable transaction categories except listed transactions. Notice 2001-18 originally was published prior to the AJCA to provide exceptions from the confidential corporate tax shelter registration requirements under section 6111(d) and the list maintenance requirements under section 6112. The special rule for lease transactions that cross-references Notice 2001-18 was added to §1.6011-4 in TD 9046 in February 2003. At that time, the IRS and Treasury Department were concerned that customary commercial lease transactions routinely would fall under the significant book-tax difference category of reportable transaction. The public also expressed concern that many customary leasing transactions would trigger the confidential transaction category of reportable transaction that was published in the temporary regulations under §1.6011-4T in TD 9017 in October 2002 (and in the February 2003 regulations). Since the publication of the February 2003 regulations, the IRS and Treasury Department amended the confidential transaction category of reportable transaction in the December 2003 regulations, the AJCA removed the confidential corporate tax shelter provision in section 6111(d) in October 2004, and Notice 2006-6 signaled the removal of the significant book-tax difference transaction category of reportable transaction.
>
> … the IRS and Treasury Department believe that leasing transactions should be subject to the same disclosure rules as other transactions. While the IRS and Treasury Department do believe the disclosure rules should apply to all leasing transactions, the IRS and Treasury Department also believe that most customary commercial leasing transactions will not meet the reportable transaction requirements and will not be subject to disclosure. The IRS and

---

Part II of this study, which briefly examines the issues at stake in these cases and the problems inherent in the interpretation of the tax law.

104 See Joe Walsh, "Circular 230 Sets Stringent Requirements for Written Advice" (2005) 75:4 Practical Tax Strategies 196, pages 200-201.

> Treasury Department intend to obsolete Notice 2001-18 when these proposed regulations are finalized. Comments regarding the removal of this exception, the transactions that will have to be disclosed as a consequence, if any, and the possibility of exceptions for specific types of leasing transactions as to each category of reportable transaction are requested.[105]
>
> [our extracts]

4.3 For the tax administration, listed transactions are those that display the highest risk of avoidance

The tax administration emphasizes the listed transactions category:

- The fee thresholds applicable to ascertain whether an adviser is subject to the disclosure rules are lower in respect of listed transactions than for any other category of reportable transaction. Consequently, greater numbers of advisers are subject to the disclosure rules concerning listed transactions.

- Penalties for failing to file information returns are higher in respect of listed transactions than for any other category of reportable transaction, which may strongly encourage taxpayers and advisers to file information returns in respect of listed transactions.

As we saw earlier, the economic substance doctrine is the crux of what the tax administration deems to be listed transactions. In Instalment 6, we observed that the application of this doctrine leads to the withdrawal of tax benefits claimed by taxpayers attributable to a planning scheme, even though such a scheme conforms to the tax rules interpreted literally. We have also noted the advantages as well as the difficulties stemming from the application of this doctrine. The following subsection illustrates the impact of the difficulties inherent in the application of the economic substance doctrine on compliance by taxpayers and their advisers with the disclosure rules.

4.4 Opinions may differ among groups of stakeholders on the presence in a given situation of a reportable transaction, especially in the case of a listed transaction

Opinions may differ among groups of stakeholders on the resemblance between a transaction implemented by a taxpayer and a reportable transaction.

---

[105] See Treasury, *Proposed ACJA Modifications to Regulations 6011* (November 2, 2006), *supra* note 43, under *C. Lease Transactions*, pages 5-6. For a discussion of problems in applying the economic substance doctrine, see Instalment 6 of of this study.

These differences of opinion appear less pronounced in the case of reportable transactions that are defined by objective factors. The identification of hold harmless clauses or confidentiality clauses, the measurement of the value of the fees collected by reporting advisers or the amounts of business or capital losses, or the calculation of the holding period of assets usually poses few difficulties for the stakeholders overall. Reliance on such objective factors mitigates the risk that stakeholders will disagree on the status of a transaction for the purposes of the disclosure rules.

However, differences of opinion may be more pronounced in the case of listed transactions and those that have the potential for tax avoidance. Pursuant to the disclosure rules, taxpayers and their advisers must disclose any transaction that is identical or substantially similar to the details of a listed transaction.[106] The tax administration is thus in a better position to pinpoint greater numbers of planning schemes and participants despite the perpetual metamorphosis of the forms of aggressive tax planning schemes. If the disclosure rules applied solely to a specific form of planning scheme, the tax advisers' innovation would complicate the detection by the tax administration of the participants in aggressive tax planning schemes, including large corporations.[107] The following passage from the preamble of an interim regulation adopted by the tax administration concerning the category of transactions that have the potential for tax avoidance (transactions of interest) clearly illustrates the strategy pursued:

> The IRS and Treasury Department believe that providing a specific definition for the transactions of interest category in the regulations would unduly limit the IRS and Treasury Department's ability to identify transactions that have the potential for tax avoidance or evasion. In order to maintain flexibility in identifying a transaction of interest, the description of a transaction of interest will be provided in the published guidance that identifies the transaction of interest. The published guidance identifying a transaction of interest will provide taxpayers with the information necessary to determine whether a particular transaction is the same as or substantially similar to the transaction described in the published guidance and to determine who participated in the transaction.[108]

---

[106] 26 C.F.R. § 1.6011-4(c)(4); Treasury, *Proposed ACJA Modifications to Regulations 6011* (November 2, 2006), *supra* note 43, under § 1.6011-4(c)(4).

[107] US, Government Accountability Office, Report to the Secretary of Treasury, *Financial Audit: IRS's Fiscal Years 2005 and 2004 Financial Statements* (GAO-06-137), November 2005, pages 19 and 53.

[108] US, Department of the Treasury (Internal Revenue Service), Final Regulations RIN 1545-BE24, TD 9350, *ACJA Modifications to the Section 6011 Regulations* (August 3, 2007), 72:149 F.R 43146 [Treasury, *Final Regulations* (August 3, 2007)], page 43147.

One of the difficulties facing the groups of stakeholders is to ascertain the degree of similarity between a transaction carried out by a taxpayer and a listed transaction. Taxpayers and advisers might have difficulty determining whether a transaction is substantially similar to a listed transaction or a transaction that has the potential for tax avoidance when the tax administration does not provide for this purpose sufficiently precise parameters.[109]

In the case of listed transactions, the tax administration describes the facts underlying the targeted transaction, the tax rules applicable to it and the attendant consequences, and its stance with respect to the transaction.[110] The disclosure rules stipulate that the expression "substantially similar" must be interpreted liberally to promote the disclosure of a transaction. The tax administration is of the opinion that a transaction could be substantially similar to a listed transaction when the tax benefits claimed in each of the transactions are similar, although the characteristics of the participants and the tax rules in question differ from those described.[111] Such an interpretation tends more towards the application of the tax rules according to the tax consequences of the taxpayers, such as the adjusted cost base of an asset, than the form of the transaction that allows the taxpayer to claim the tax benefits stemming from it. Certain declarations that the tax administration has made seems to be in keeping with this perspective.[112]

---

[109] See the observations formulated in this respect by the Section of Taxation of the American Bar Association in a letter addressed to the American tax administration: letter from the American Bar Association (Section of Taxation) to the Commissioner of Internal Revenue Service, *Comments Concerning Notice 2004-80 (Interim Guidance Under IRC 6111, 6112 and 6708)*, February 7, 2005 [ABA (Section of Taxation), *Notice 2004-80 on Disclosure Rules*], pages 12-14, online on the ABA Website (<http://www.abanet.org/tax/pubpolicy/2005/050207tstf.pdf>).

[110] Instalment 5 of this study illustrates the details of a declaration by the tax administration that a transaction is deemed to be aggressive for the purposes of the disclosure rules.

[111] See 26 C.F.R. § 1.6011-4(c)(4).

[112] See ABA (Section of Taxation), "Notice 2004-80 on Disclosure Rules," *supra* note 109. The American tax administration declared that certain aggressive tax planning schemes were similar, although the form of the transactions was different. See the details of the listed transaction *Partnership Straddle Tax Shelters* (US, Department of the Treasury (Internal Revenue Service), Notice 2002-50, "Partnership Straddle Tax Shelters" (June 25, 2002), 2002-28 I.R.B 98 (July 15, 2002)) and the details of two transactions declared to be similar the latter, i.e. *Passthrough Entity Straddle Tax Shelter* (US, Department of the Treasury (Internal Revenue Service), Notice 2002-65, "Passthrough Entity Straddle Tax Shelter" (September 25, 2002), 2002-41 I.R.B 690 (October 15, 2002)) and *Common Trust Fund Straddle Tax Shelter* (US, Department of the Treasury (Internal Revenue Service), Notice 2003-54, "Common Trust Fund Straddle Tax Shelter" (July 16, 2003), 2003-33 I.R.B. 363 (August 18, 2003)).

4.5 The tax administration must be able to match the information filed by advisers and taxpayers with the latters' income tax returns

Certain stakeholders are of the view that the duplication of taxpayers' and tax advisers' duties of disclosure unduly encumbers the management of the tax system. They maintain that taxpayers should neither have to file an information return nor record on their income tax returns the registration number assigned to a transaction since the advisers already file an information return in addition to maintaining a register recording the transactions and those of their clients who have participated in them.[113]

In our opinion, the simultaneous issuing of a registration number to the tax adviser and the taxpayer concerning a reportable transaction that the taxpayer has carried out is necessary to allow the tax administration to identify in an income tax return the components of the reportable transaction. Moreover, to simplify compliance with the tax system, the US tax administration obliges tax advisers to provide the registration number assigned to a transaction solely to their clients who carried out the transaction and not to all of the taxpayers to whom they made a statement on the transaction:

> The proposed regulations provide that a material advisor must provide a reportable transaction number to all taxpayers and material advisors to whom the material advisor makes or provides tax statements. Many commentators commented that the requirement to provide the reportable transaction number to all taxpayers and material advisors to whom the material advisor makes or provides tax statements is overly broad and suggested, instead, that the reportable transaction number only be required to be furnished to those for whom the taxpayer acted as a material advisor. One commentator recommended that the regulation be amended to remove the obligation to provide a reportable transaction number. Another commentator recommended that a material advisor should be required to provide the reportable transaction number to taxpayers only in the case of marketed transactions. The commentator also commented that in a purely one-on-one, non-abusive transaction, the use of the reportable transaction number may infringe upon the attorney-client relationship.
>
> The IRS and Treasury Department attempted to balance the need for disclosure of reportable transactions with the resulting burden imposed upon taxpayers. The IRS and Treasury Department do not believe that requiring a material advisor to provide a reportable transaction number to certain taxpayers and material advisors imposes an undue burden upon taxpayers in light of the benefit to tax administration. However, the IRS and Treasury Department recognize that requiring the reportable transaction number to be provided to all persons for whom the material advisor made a tax statement may be unnecessary.

---

113 See the observations formulated by the New York State Bar Association in a letter addressed to the American tax administration: letter from the New York State Bar Association to the Commissioner of Internal Revenue Service, *Re: Report on Reportable Transaction Disclosure and List Maintenance Regulations*, January 22, 2007, pages 20 and 21.

> Therefore, these final regulations state that a material advisor is required to provide a reportable transaction number to all taxpayers and material advisors for whom the material advisor acts as a material advisor.[114]
>
> [our extracts]

4.6 Non-tax advisers may be subject to the disclosure rules

There is a risk in the disclosure rules that non-tax advisers must comply with them and are liable to stringent penalties.[115]

An adviser must comply with the disclosure rules as soon as he makes a written or oral statement to a taxpayer that focuses in any way whatsoever on a tax aspect of a reportable transaction that the taxpayer carries out.[116] We have observed that the tax administration is targeting all of the advisers who contribute directly or indirectly to the implementation of a reportable transaction. The tax administration thus deems a third party to a transaction to participate in its implementation by giving the taxpayer a tax result protection concerning his obtaining the tax benefits stemming from a reportable transaction.[117]

Advisers who are not tax experts may be subject to the disclosure rules if they receive fees in an amount that exceeds the prescribed thresholds. However, such thresholds are but one indicator of the presence of a possible tax avoidance transaction. Consequently, advisers may have to file information returns even though a significant portion of the fees that they have received are attributable to the documentation of the transaction rather than the elaboration of its tax structure.[118]

---

114 US, Department of the Treasury (Internal Revenue Service), Final Regulations RIN-1545-BE26, TD 9351, *AJCA Modifications to the Section 6111 Regulations* (August 3, 2007) [Treasury, *Final 6111 Regulations* (August 3, 2007)], pages 3-4.

115 See NYSBA, "Report on Disclosure (Material Advisors)," *supra* note 11.

116 See Treasury, *Proposed ACJA Modifications to Regulations 6111* (November 2, 2006), *supra* note 71 under § 301.6111-3(b)(4)(iii). Prior to the publication of this draft regulation, the American tax administration had published temporary regulations: see IRS, "6111 and 6112 Temporary Regulations (2004)," supra note 69.

117 See Treasury, *Proposed ACJA Modifications to Regulations 6111 (November 2, 2006)*, *supra* note 71, pages 6-7.

118 For a discussion of this question, see New York State Bar Association (Tax Section), Application of the IRC §§6111 and 6112 Material Advisor Rules to Law and Accounting Firms, Report No. 1109 (May 5, 2006) [NYSBA, Material Advisor Rules to Law and Accounting Firms (2006)], online on the NYSBA Website: <http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1109rpt.PDF>.

Similarly, uncertainty persists concerning the degree of diligence that advisers must display for the purposes of the disclosure rules. More specifically, advisers might be compelled to meticulously verify the information provided by clients who are contemplating carrying out an aggressive tax planning scheme.[119] Some professional organizations have suggested that the statement should be comparable to an opinion intended to determine whether the transaction is a reportable transaction on which a taxpayer could rely to ascertain the appropriateness of implementing it.[120]

4.7 Uncertainty persists on the scope of the duties of tax consulting firms under the disclosure rules

Both advisers and tax consulting firms are subject to the disclosure rules. The partners in a tax consulting firm must ensure that each partner and their employees abide by the disclosure rules. The implementation of a control system applicable to all partners and employees can prove to be complex, especially in a multidisciplinary firm in which the advisers may handle tax aspects indirectly or in a manner that complements their field of expertise.

With this in mind, the responsibility imposed on all of the partners may seem disproportionate to the purposes pursued by the tax administration if the tax consulting firm is subject to a penalty when an adviser has participated without knowing it in a reportable transaction despite an appropriate control system.[121]

---

119 See the observations made in this respect by the Tax Section of the New York State Bar Association: NYSBA, *Report on Disclosure (Material Advisors) (2005)*, *supra* note 11. See also the observations expressed individually by members of the Section of Taxation of the American Bar Association in ABA (Section of Taxation), *Notice 2004-80 on Disclosure Rules, supra* note 109, page 15.

120 *Ibid*.

121 For a discussion of this aspect, see NYSBA, *Material Advisor Rules to Law and Accounting Firms (2006)*, *supra* note 118.

4.8 The tax administration may identify a greater number of taxpayers who have carried out a reportable transaction through an extended reassessment period

As we mentioned in subsection 3.2.7, taxpayers who have carried out a reportable transaction may be subject to a reassessment beyond the usual three-year assessment period if they fail to comply with the disclosure rules. They may be subject to a notice of reassessment up to the expiry of a one-year period beginning on the day following that on which they fulfil their obligations.

The tax administration has observed that this extended assessment period led to an increase in the number of disclosures filed by taxpayers. According to an Internal Revenue Service officer, 35 taxpayers filed 74 disclosure filings in respect of reportable transactions that they had not previously disclosed.[122]

The extended reassessment period may nonetheless prove to be too short to allow the tax administration to complete an audit of a taxpayer's affairs and issue a notice of reassessment because of the complexity of the transactions and a shortage of auditors. In the case of the listed transaction called "Son of Boss", the average period required for auditors to audit a taxpayer's affairs stands at roughly two and a half years. The tax administration is examining the need to further lengthen the extended period for reassessments.[123]

4.9 Concerns of taxpayers and advisers about the penalties applicable, in particular those pertaining to listed transactions

In the opinion of professional organizations, the penalty for failing to file the list of clients seems considerable because of the uncertainty of the parameters that define reportable transactions and reporting advisers. From the advisers' standpoint, the tax administration should, for the sake of fairness, eliminate the penalty depending on the circumstances when the advisers display due diligence to comply with the disclosure rules. A penalty that applies solely in the

[122] See US, General Accountability Office, Report to the Committee on Finance (U.S. Senate), *Tax Administration: Additional Time Needed to Complete Offshore Tax Evasion* (GAO-07-237), Washington DC, United States Government Printing Office, March 2007, pages 23-24.

[123] TIGTA, *Settlement Initiative and Abusive Tax Shelters*, *supra* note 98, pages 6-10.

event of gross incompetence or intentional neglect equivalent to a percentage of the gross fees that the defaulting adviser obtains might prove to be fairer than the current penalty.[124]

For taxpayers, the specific penalty for under-stating tax payable in respect of reportable transactions is higher than the general penalty for under-stating tax payable. The specific penalty is more restrictive than the general penalty since it applies regardless of the amount of tax under-stated. Moreover, the specific penalty makes provision for a higher penalty rate and the impossibility for a taxpayer to submit a due diligence defence should he fail to comply with the disclosure rules.

Heavy penalties and the impossibility for a taxpayer to submit a defence should he fail to comply with the disclosure rules might broaden compliance with these rules and accelerate the tax administration's monitoring activities. However, the penalties for under-stating tax payable will only have a coercive effect inasmuch as the tax law and the jurisprudence establish a sufficiently clear distinction between legitimate transactions and abusive tax avoidance.[125]

For taxpayers and reporting advisers, uncertainty surrounding the characteristics of reportable transactions significantly affects their disclosure duties. Generally speaking, the tax administration must establish that the taxpayers or the advisers failed to properly file information. However, taxpayers and advisers assume the burden of establishing that, according to an objective assessment of the facts by a reasonable person, they properly filed information in their return in a way that allows the tax administration to pinpoint factors that present risks of avoidance. If need be, the tax administration can conduct audits in respect of such factors. In the realm of aggressive tax planning schemes, disputes will inevitably arise concerning the degree of transparency in the disclosure of the relevant tax consequences by the taxpayers in order to ascertain whether the anti-avoidance rules or the economic substance doctrine apply to a given transaction.[126]

---

124 See NYSBA, *Report on Disclosure (Material Advisors) (2005)*, *supra* note 11, page 23.

125 See Treasury, *Corporate Tax Shelters (1999)*, *supra* note 2, page 86.

126 In the US context, the appropriateness of the disclosure of the relevant information in an income tax return affects the reassessment period applicable to the taxpayer. If the taxpayer fails to properly file the relevant information, the reassessment period applicable to the taxpayer rises from three years to six years. In the context of aggressive tax planning schemes, the Chair is of the opinion that the US tax administration may allege that a taxpayer has not properly filed the information in order to be able to issue a notice of reassessment beyond the usual period of three

Given the higher risk of avoidance that the tax administration perceives in reportable transactions, the tax administration will likely demand of taxpayers and advisers a higher level of diligence as compared with any other planning scheme. The courts might differ in opinion concerning a planning scheme's compliance with the tax law according to the balance of probabilities. This situation might arise when the facts are complex and, above all, when the distinction established by the tax rules and the economic substance doctrine between legitimate transactions and transactions carried out for tax avoidance purposes is nebulous.[127]

Taxpayers and advisers may take advantage of procedures established by the tax administration in case of uncertainty about their disclosure obligations. Pursuant to these procedures, taxpayers and advisers may either file a request to determine whether they must file an information return or file one as a precaution.[128] These procedures offer taxpayers and advisers the possibility of avoiding the application of penalties.

However, all of these procedures encumber the management of the disclosure system both for the government and for taxpayers.[129] The tax administration has observed that information returns that taxpayers and advisers filed as a precaution did not necessarily contain all of the information prescribed by the disclosure rules.[130] It has also noted that tax advisers have not

---

years. For a brief explanation of questions that are related to the extension of the tax assessment period in the US context, see Sheryl Stratton, "With Six-Year Statute, IRS Pulls Out All Assessment Stops for Shelters" (May 1, 2006) 111 Tax Notes 536.

127 We refer the reader to Instalment 6 of Part II of this study, entitled "Proposed Economic Substance Doctrine Codification," which highlights the difficulties inherent in the application of the tax rules and this doctrine.

128 See 26 C.F.R. § 1.6011-4(f). Under the US tax administration's transitional regulations, the tax administration will deem a taxpayer or an adviser to have complied with the disclosure rules if he files a request for clarification and submits all of the information prescribed for the purposes of the disclosure rules: see US, Department of Treasury (Internal Revenue Service), Final and Temporary Regulations, RIN 1545-BF98, TD 9295, *ACJA Modifications to the Section 6011, 6111 and 6112 Regulations* (November 2, 2006); Treasury, *Proposed ACJA Modifications to Regulations 6011* (November 2, 2006), *supra* note 43 under the point *E. Protective Disclosures*.

129 Uncertainty also persists concerning the tax administration's use of information submitted as a precaution by taxpayers and advisers: see Todd Simmens, "IRS Treats Protective Disclosure Inconsistently," (2006) 37:7 Tax Adviser 426.

130 See Treasury, *Proposed ACJA Modifications to Regulations 6111 (November 2, 2006)*, *supra* note 71, page 6; Treasury, *Proposed ACJA Modifications to Regulations 6011 (November 2, 2006)*, *supra* note 43, page 7.

always filed a list of clients establishing the relevant information in an appropriate form.[131] Furthermore, the tax administration has deemed it necessary to clarify the scope of a listed transaction in light of a large volume of returns filed as a precaution because, in particular, of the uncertainty surrounding the transactions that might be substantially similar to the description of the listed transaction.[132]

To our knowledge, the tax administration has still not levied the penalties stipulated by the disclosure rules. In 2004, it evaluated that the measures pertaining to the disclosure rules (mainly the penalties) would enable it to recover roughly $1.4 billion between 2005 and 2014.[133] Figure 4.3 breaks down this amount for each year in question.

In 2006, the tax administration proposed settlement offers to 36 advisers who were possibly subject to the disclosure rules. The reporting advisers had to pay the full amount of the penalty for failing to disclose a targeted transaction. On the other hand, the tax administration did not levy the penalty for failure to maintain a register of participants in the transactions and did not launch any criminal proceedings.[134] Through such offers, the tax administration is probably likely to obtain more extensive information on reportable transactions pursuant to the disclosure rules and on the participants in such transactions. The participating advisers avoided the most stringent penalties.

---

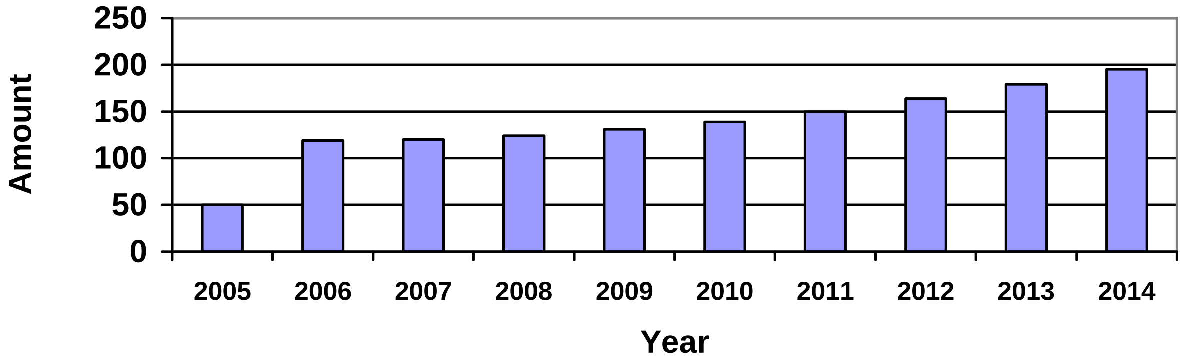
131 See Treasury, *Proposed ACJA Modifications to 6112 (November 2, 2006)*, *supra* note 73, pages 5-6. Prior to these modifications, the American tax administration issued interim directives: see IRS, "6111 and 6112 Temporary Regulations (2004)," supra note 69.

132 For an illustration of this problem, see US, Department of the Treasury (Internal Revenue Service), Notice 2006-16 "Tax Avoidance Using Notional Principal Contracts" (February 13, 2006).

133 US, Joint Committee on Taxation, *Estimated Budget Effects of the Conference Agreement for H.R. 4250, the American Jobs Creation Act of 2004* (JCX-69-04), October 7, 2004.

134 US, Government Accountability Office, Report to the Secretary of the Treasury, *Financial Audit IRS's Fiscal Years 2006 and 2005 Financial Statements* (GAO-07-136), November 2006, pages 20-21.

FIGURE 4.3
US TAX ADMINISTRATION'S ESTIMATES OF ANNUAL REVENUE STEMMING FROM THE MEASURES IMPLEMENTED IN 2004 CONCERNING THE DISCLOSURE RULES, IN MILLIONS OF US DOLLARS



Source: Figure elaborated by the authors based on data published by the Joint Committee on Taxation, JCX-69-04 (2004).

4.10 The courts must reconcile the tax administration's audit powers and the taxpayers' privilege of confidential communication

As we noted in subsection 3.3.5, advisers must maintain a register that lists their clients, describes the reportable transaction that the clients have carried out and in which the advisers have participated, and the tax opinions pertaining to the realization of the transaction. As we noted in subsection 3.2.2, taxpayers must file with their income tax returns an information form that reports the details of the reportable transaction and the contact information of other participants in the transaction.

A taxpayer will obtain a detailed opinion from his advisers insofar as he communicates to them all of the relevant information. The tax administration is of the opinion that information that the advisers must file pursuant to the disclosure rules is not usually protected by the taxpayers' privilege of confidential communication. In principle, advisers must file all of the information necessary for the tax administration to grasp the structure of a planning scheme and the nature of the tax benefits stemming from it, as well as information about their clients who have carried out a reportable transaction. According to the tax administration, only documents comparable to a tax opinion issued by an adviser to a client or other documents concerning the structure of a transaction and the tax benefits stemming from it might, under exceptional circumstances, be protected by a privilege of confidential communication:

> In the final regulations, the IRS and Treasury Department have clarified that the procedures for asserting a privilege claim apply to information required to be maintained in §301.6112-1(e)(3)(i)(I) that might be privileged. This change reflects the IRS and Treasury Department's belief that the other information covered by these regulations is not privileged. These procedures neither expand nor contract the scope of items that may be privileged.[135]
>
> [our extracts]

The documents to which this passage refers are mainly the tax opinions focusing on reportable transactions for the purposes of the disclosure rules:

> Copies of any additional written materials, including tax analyses or opinions, relating to each transaction that are material to an understanding of the purported tax treatment or tax structure of the transaction that have been shown or provided to any person who acquired or may acquire an interest in the transactions, or to their representatives, tax advisors, or agents, by the material advisor or any related party or agent of the material advisor. However, a material advisor is not required to retain earlier drafts of a document provided the material advisor retains a copy of the final document (or, if there is no final document, the most recent draft of the document) and the final document (or most recent draft) contains all the information in the earlier drafts of such document that is material to an understanding of the purported tax treatment or the tax structure of the transaction.[136]
>
> [our extracts]

When they elaborate a planning scheme, the taxpayer’s advisers will draft accounting documents in order to calculate the taxpayer’s tax reserve to prepare his financial statements and file his income tax return. In both cases, advisers must prepare documents containing their assessment of the likelihood that the tax administration will wholly or partially rescind the tax benefits attributable to the planning scheme (*Tax Accrual Workpapers*). The taxpayers’ auditors draft these documents to prepare their financial statements and income tax returns and to reconcile the income declared for accounting and tax purposes. Pursuant to generally accepted accounting principles, the advisers must identify the items on their clients’ income tax returns

---

135 See US, Department of the Treasury (Internal Revenue Service), Final Regulations TD9046, RIN 1545-AX81; 1545-BB49; 1545-BB50; 1545-BB48; 1545-BB53; 1545-BB51; 1545-BB52; 1545-AW26; 1545-AX79, *Tax Shelter Regulations*, (March 4, 2003, as modified on April 2, 2003), pages 11-12. On November 2, 2006, the US tax administration modified the disclosure rules applicable to tax advisers and abrogated the procedure that the advisers had to follow until then to assert the application of a privilege of confidential communication: see Treasury, *Proposed ACJA Modifications to 6112 (November 2, 2006)*, *supra* note 73, pages 6 and 7. See 26 C.F.R. § 1.6112-1(e)(2).

136 *Ibid*.

whose tax treatment is uncertain, calculate a reserve for tax in respect of these items, and properly disclose the uncertain items in the income tax return.

To prepare accounting documents, the advisers rely on an interpretation of the tax rules and the economic substance doctrine. Generally speaking, taxpayers and their advisers must file accounting documents to support the taxpayers' income tax returns. However, they might refuse to file information by invoking the privilege of confidential communication.[137] These privileges can be divided into two categories:

- the attorney-client privilege (the US *Internal Revenue Code* extends this privilege to all advisers accredited by the tax administration);[138]
- the work product doctrine, which applies when two parties are involved in a litigation.

During the course of its audits, the tax administration has concluded agreements with tax advisers who have undertaken to fulfil their obligations pursuant to the disclosure rules.[139] However, certain advisers have not filed information on the pretext of their clients' privilege of confidential communication. The tax administration has had to take legal action to enjoin advisers and taxpayers to comply with the disclosure rules. Nevertheless, the taxpayers and their advisers could always allege that their communications are protected by either of the privileges of confidential communication.

Over the years, the courts' decisions on the privileges of confidential communication in tax matters have provided possible answers to the reconciliation of the disclosures rules and the privilege of confidential communication. However, they do not entirely dispel uncertainty surrounding the concomitant application of these rules and privileges.[140] There will very likely be an increasing number of disputes over the tax administration's requests for information about aggressive tax planning schemes. Disputes focusing on the tax administration's requests to

---

137 Committee on Homeland Security, *Role of Professional Firms*, *supra* note 3, pages 59-60.

138 26 U.S.C. § 7525.

139 Everson, *Senate Hearing on Abusive Tax* Shelters, *supra* note 83.

140 See *United States* v. *Arthur Andersen, LLP*, 2003 U.S. Dist. LEXIS NEXIS 14228 (N.D Illinois 2003).

obtain information from taxpayers and advisers rose from sixth to third place among the 10 principal categories of disputes between 2004 and 2006.[141]

The courts must therefore reconcile the principle of transparency concerning the taxpayers' income tax returns and the protection of their privilege of confidential communication. The courts can only reconcile them at the conclusion of a perilous, complex analysis of all the facts and circumstances surrounding the preparation of an income tax return, where the taxpayers make business decisions based on professional opinions. This passage from a decision of the United States Court of Claims illustrates these questions and difficulties:

> Balancing the interpenetrating factors involved in the assertion of privileges in our federal judicial system is a subtle and complicated process. The necessity for judicial accommodation between the intersecting pursuit of truth and the protection of confidences, though often expressed in terms of rules of certainty and simplicity, is often applied in a fashion that is neither certain nor simple. Frequently, striking that balance requires a court to make close, factually-intensive distinctions, particularly in the area of federal income taxation, in which business planning, tax return preparation and legal advice tend to coalesce.[142]
>
> [our extracts]

Central to these disputes is the application of the privilege of confidential communication to:

- the identity of the taxpayers who have participated in a transaction that is reportable for the purposes of the disclosure rules and the facts and circumstances pertaining to the transaction, on the one hand; and
- the advisers' opinion on the application of the tax law and the jurisprudence, on the other hand.

---

141 See US, Internal Revenue Service (National Taxpayer Advocate Division), *2005 Annual Report to Congress* and *2006 Annual Report to Congress*, online on the IRS Website: <http://www.irs.gov/advocate/article/0,,id=97404,00.html>. Between June 1, 2004 and May 31, 2005, this division of the Internal Revenue Service inventoried 44 legal decisions handed down on the execution of requests to file information. Briefly, the advisers or the taxpayers must convince the courts that the tax administration's requests were illegal. In only two of the 44 cases inventoried previously did the courts wholly or partly rescind the requests. In one of the cases, the advisers did not have to submit any or substantially any of the tax opinions demanded pursuant to the privilege of confidential communication. In at least nine of the decisions, the requests were made to tax advisers who, in the tax administration's opinion, were promoting aggressive tax planning schemes.

142 *Evergreen Trading, LLC* v. *United States*, No. 06-123 (U.S. Ct. Clms, December 21, 2007) [Evergreen].

The jurisprudence is voluminous and must be read in light of the facts of each case. It must also be read bearing in mind the context of each case, since it does not always focus on the reconciliation of the privilege of confidential communication and the disclosure rules. In light of recent case law, the scope of the privilege of confidential communication in a litigation context appears to be potentially more extensive than the attorney-client privilege in the context of aggressive tax planning schemes. The dividing line between the documents prepared for the purposes of filing income tax returns and the tax opinions protected by the privilege of confidential communication remains nebulous.[143]

For the purposes of this section, we will only select certain US courts decisions that crystallize the viewpoint of each group of stakeholders in the current climate surrounding aggressive tax planning schemes, in particular the courts' decision in three cases to which we refer below.

4.10.1 Attorney-client privilege

4.10.1.1 Rationale of the attorney-client privilege

The attorney-client privilege is intended to ensure full and frank discussion between an attorney and his client by guaranteeing the confidentiality of such communication. This extract from the ruling of the District Court in the *Textron* case summarizes that rationale:

> The purpose of the attorney-client and tax practitioner privileges is to encourage the full and frank discussion necessary for providing the client with sound advice. That purpose is achieved by guaranteeing that confidential communications between the client and the advisor will remain confidential.[144] …
>
> [our extracts]

---

143 See Linda M. Beale, "Tax Advice Before the Return: The Case For Raising Standards and Denying Evidentiary Privileges," (2006) 25:3 Virginia Tax Review 583 [Beale, "Tax Advice and Evidentiary Privilege"], pages 651-654.

144 See *United States* v. *Textron*, CA 06-198T, August 28, 2007 (D. R. I.) [*Textron* (D.R.I)], page 27. The American tax administration appealed this ruling before the United States Court of Appeals for the First Circuit. This court handed down a majority decision on January 21, 2009 partly upholding and partly rescinding the decision of the court of first instance (*United States* v. *Textron*, 07-2631, January 21, 2009 (First Circuit 2009)), but decided on March 25, 2009 to overrule the latter decision and to hear the case in banc: *United States* v. *Textron*, 06-2631, March 25, 2009 (First Circuit 2009). The Court of Appeal focused, in particular, on the possibility that the taxpayer implicitly relinquished the privilege of confidential communication with respect to disputes.

However, that privilege is not absolute. As we will see later, the tax administration has adopted exceptions to this privilege. Moreover, according to the jurisprudence, this privilege does not apply in respect of fraud.

4.10.1.2 The disclosure rules take precedence over this privilege as regards the disclosure by tax advisers of the identity of their clients but not with respect to the contents of tax opinions

The courts concluded that the disclosure rules took precedence over the attorney-client privilege regarding the identity of taxpayers who have carried out transactions that are reportable under those rules.[145] In the *BDO Seidman* case, the US Court of Appeals for the Seventh Circuit concluded that the advisers covered by a tax administration's request to file information should reveal the identity of their clients who participated in a transaction similar to the reportable transaction described in the request.

In this case, the tax administration had asked the advisers to file documents that identified their clients who had carried out one of the planning schemes indicated in the request, the date on which the planning scheme was carried out, registration forms about the planning scheme, and the list of clients who carried it out. The tax administration wished to ascertain whether the advisers had fulfilled their obligations under the disclosure rules. The advisers did not comply with the request, alleging, among other things, that the requested information was confidential pursuant to the attorney-client privilege or the work product doctrine.

The tax administration filed a request with a District Court to enjoin the advisers to submit the requested information. The court enjoined the advisers to submit the documents for judicial inspection to determine whether they were protected by a privilege of confidential communication. After the advisers had notified their clients that they were going to comply with the court order, certain clients intervened to prevent the filing of the documents. The court dismissed the clients' motion for an interlocutory injunction. The clients lodged an appeal before the US Court of Appeals for the Seventh Circuit, which upheld the District Court's ruling.

---

145 See Brian R. Ford, "Helter Shelter: Protecting Taxpayers' Identities in Tax-Shelter Cases" (2005) 18:3 Geo. J. Legal Ethics 723.

The US Court of Appeals for the Seventh Circuit opined that the taxpayers' identity is not information that is covered by the attorney-client privilege. The disclosure rules compel advisers to maintain a list of their clients who have participated in aggressive tax planning schemes and to submit it upon request to the tax administration. The taxpayers may not, therefore, claim any privilege of confidential communication concerning their identity and their participation in a transaction that is reportable under the disclosure rules:

> More fundamentally, the [Roes'] participation in potentially abusive tax shelters is information ordinarily subject to full disclosure under the federal tax law. *See* 26 U.S.C. §§ 6111, 6112. Congress has determined that tax shelters are subject to special scrutiny, and anyone who organizes or sells an interest in tax shelters is required, pursuant to I.R.C. § 6112, to maintain a list identifying each person to whom such an interest was sold. This list-keeping provision precludes the [Roes] from establishing an *expectation of confidentiality* in their communications with BDO, an essential element of the attorney-client privilege and, by extension, the § 7525 privilege. At the time that the [Roes] communicated their interest in participating in tax shelters that BDO organized or sold, the [Roes] should have known that BDO was obligated to disclose the identity of clients engaging in such financial transactions. Because the [Roes] cannot credibly argue that they expected that their participation in such transactions would not be disclosed, they cannot now establish that the documents responsive to the summonses, which do not contain any tax advice, reveal a *confidential* communication.
>
> BDO's affirmative duty to disclose its clients' participation in potentially abusive tax shelters renders the [Roes'] situation easily distinguishable from the limited circumstances in which we have determined that a client's identity was information subject to the attorney-client privilege.[146]
>
> [our extracts]

Thus, the tax administration may consult the clients register maintained by an adviser in order to identify those who have carried out a reportable transaction. However, it may not consult the register if the disclosure of the taxpayers' identity would allow it to establish a link between the taxpayers and the contents of communications protected by the privilege of confidential communication. The taxpayers and their advisers must then convince the courts that this possibility obtains in their situations. In the *BDO Seidman* case, the taxpayers were unable to establish such a possibility:

> The [Roes] have not established that a confidential communication will be disclosed if their identities are revealed in response to the summonses. Disclosure of the identities of the [Roes] will disclose to the IRS that the [Roes] participated in one of the 20 types of tax shelters described in its summonses. It is less than clear, however, as to what motive, or other confidential communication of tax advice, can be inferred from that information alone. Compared to the situations in the *Tillotson* and *Cherney* cases, where the Government

---

[146] See *BDO Seidman, LLP* v. *United States* (July 23, 2003), 337 F.3d 802 (7th Cir. 2003) [*BDO Seidman* (2003)].

> already knew much about the substance of the communications between the attorney and his unidentified client, in this case the IRS knows relatively little about the interactions between BDO and the [Roes], the nature of their relationship, or the substance of their conversations. Moreover, the [Roes] concede that the documents that BDO intends to produce in response to the summonses are not subject to any other independent claim of privilege beyond the [Roes'] assertion of privilege as to identity.
>
> [our extracts]

In the *Doe* case,[147] the advisers also had to disclose the identity of their clients who carried out a listed transaction. In this case, a District Court in Texas to which the taxpayers filed a motion for an interlocutory injunction concluded that their advisers had to disclose their identity to the tax administration pursuant to the disclosure rules. The taxpayers had carried out several planning schemes, one of them called Son of Boss, which the tax administration categorized as a listed transaction in 2000. The tax administration had asked the advisers to disclose the identity of their clients who had carried out these planning schemes, and to file documents in support of the schemes.

The court dismissed the taxpayers' request, following the ruling of the US Court of Appeals for the Seventh Circuit in the *BDO Seidman* case. In its opinion, the taxpayers may not expect their identity to be confidential because of the obligations that are expressly stipulated in the disclosure rules. The following extracts from the judgment largely canvass the court's reasoning:

> […] Plaintiffs did not have a reasonable expectation that their identities or their participation in the tax shelter described in Notice 2000-44 would be confidential. The attorney-client privilege, and therefore, the privilege created under § 7525, "do not protect communications between a tax practitioner and a client simply for the preparation of a tax return". …
>
> *Additionally, Plaintiffs had no reasonable expectation of confidentiality as to their participation in the Notice 2000-44 tax shelter because of the provisions in I.R.C. §§ 6111 and 6112*. Section 6111 requires organizers and sellers of tax shelters to maintain lists of investors in tax shelters. The Seventh Circuit has held that these provisions prevent taxpayers from establishing an expectation of confidentiality in their communications regarding participation in a tax shelter. … *Even if Plaintiffs thought KPMG would not be required to disclose their identities pursuant to a list maintenance requirements of § 6112, Plaintiffs themselves were required to disclose to the IRS their participation in the event of an audit because they included those losses on their year 2000 tax returns. If Plaintiffs' tax returns were audited, Plaintiffs would be required to explain how the losses resulted. Plaintiffs could not have reasonably believed their participation in the tax shelter was confidential.* Also, the Court notes that Plaintiffs did not address whether the tax shelter they participated in was subject to registration requirements of § 6111. *The Court, therefore,*

147 *Doe.* v. *KPMG, L.L.C.*, 325 F. Supp. 2d 746 (N.D. Tex. 2004), 2004 U.S. Dist. LEXIS 6191.

> *adopts the Seventh Circuit's conclusion that §§ 6111 and 6112 destroy any reasonable expectation of confidentiality as to participation in a tax shelter.*[148]
>
> [our extracts and italics]

4.10.1.3 The privilege does not apply if the client or his legal adviser communicates the information to a third party, including the client's auditor

The rationale for the attorney-client privilege is to enable taxpayers to freely communicate all of the information necessary to allow their advisers to formulate an opinion on which they can rely. As we noted earlier, the tax administration seems to acknowledge that the attorney-client privilege might exceptionally apply to communications relating to advisers' tax opinions, despite the disclosure rules.[149] Depending on the circumstances, the courts concluded that the attorney-client privilege could prevent advisers from disclosing opinions put forward to their clients during the elaboration of an aggressive tax planning scheme if the opinion concerns the application of the tax law and the jurisprudence.[150] However, the disclosure to a third party of a document, including the taxpayer's auditors, automatically entails the client's relinquishment of this privilege. If need be, the tax administration could request the submission of the opinions in question.

The *Textron* case[151] clearly illustrates this situation. In this case, the Internal Revenue Service took legal action before a District Court to enjoin a taxpayer to file documents concerning taxation years from 1998 up to and including 2001, as previously requested by the tax administration. It formulated this request after it learned that this taxpayer had carried out a sale-in, lease-out planning scheme, which the tax administration subsequently declared to be an aggressive tax planning scheme (listed transaction) on February 11, 2005.[152]

The tax administration wished to obtain accounting documents prepared by the taxpayer's taxation department. These documents contained the department's assessment of the likelihood

---

148 *Ibid*.

149 See Treasury, *Proposed ACJA Modifications to 6112 (November 2, 2006)*, *supra* note 73, pages 6-7.

150 *United States* v. *BDO Seidman, LLP*, 2004 U.S. Dist. LEXIS 12145 (N.D. Ill. June 28, 2004); *United States* v. *BDO Seidman, LLP*, 2005 U.S. Dist. LEXIS 5555 (N.D. Ill. March 30, 2005) [*BDO Seidman* (March 30, 2005)].

151 See *Textron* (D.R.I), *supra* note 144.

152 We refer the reader to Table 4.1 in subsection 3.1.1 of this instalment.

that the tax administration would disagree with certain items in the taxpayer's income tax return and the calculation of the reserve for taxes. The taxpayer had submitted these documents to his attorneys so that they could review them and assess the likelihood of the taxpayer's winning his case before the courts. The taxpayer's auditors also possessed these documents to determine the accuracy of the tax reserves and to measure their impact on the financial statements.

The taxpayer alleged that the requested documents were protected either by the attorney-client privilege or by the work product doctrine. In the court's opinion, the documents would have been protected by the attorney-client privilege had they not been communicated to the auditors. Since the auditors are outside the relationship that the taxpayer maintains with his attorney, the communication of documents to the auditors entails the relinquishment of professional privilege. This extract from the court's decision summarizes this principle:

> It is well established that "voluntary disclosure to a third party waives the attorney-client privilege even if the third party agrees not to disclose the communications to anyone else."… That principle has been applied specifically to disclosures made to independent auditors.
>
> …
>
> Since the tax practitioner privilege created by § 7525 mirrors the attorney-client privilege, it, too, may be waived by disclosure to a third party. …
>
> … Textron argues that, because it occasionally revises its reserves based on the opinions of the independent auditor, the auditor's review of Textron's workpapers should be viewed as performed in connection with providing "tax advice" to Textron and, therefore, it is privileged under § 7525. That argument is creative but not persuasive because it ignores reality to describe an independent auditor responsible for reporting to the investing public whether a company's financial statements fairly and accurately reflect its financial condition, as providing "tax advice" to the company when the auditor seeks to determine the adequacy of amounts reserved by the company for contingent tax liabilities.
>
> In short, any attorney-client privilege or tax practitioner privilege that attached under § 7525 was waived when Textron provided its workpapers to E&Y.
>
> The purpose of the attorney-client and tax practitioner privileges is to encourage the full and frank discussion necessary for providing the client with sound advice. That purpose is achieved by guaranteeing that confidential communications between the client and the advisor will remain confidential. Since disclosure to a third party is inconsistent with a claim of confidentiality, such disclosure waives the privilege.[153]
>
> [our extracts]

However, the District Court concluded that the work product privilege applied to the documents sought by the tax administration. Consequently, the taxpayer did not have to submit them to the tax administration. On August 28, 2007, the tax administration lodged an appeal to the US Court

153 *Textron* (D.R.I.), *supra* note 144, pages 25 to 27.

of Appeals for the First Circuit. The Court of Appeals initially upheld the ruling of the court of first instance but referred the case back to that court so that it could determine whether the taxpayer had implicitly relinquished the application of the work product doctrine, which applies in the context of litigation.[154] Subsection 4.10.2 will focus on the application of this privilege of confidential communication.

4.10.1.4 The privilege does not apply in the case of solicitations

The tax administration has made provision for an exception to the attorney-client privilege. According to the US *Internal Revenue Code,* this privilege does not apply to written communications pertaining to solicitations by advisers of taxpayers for the use of an entity or any transaction one of whose significant purposes is tax avoidance.[155] The general scope of the expression "significant purpose" could compel the taxpayers and the advisers to disclose the tax opinions put forward in the vast majority of planning schemes that are subject to promotion by advisers.[156] In the context of solicitation activities, the tax administration is in a better position to obtain all of the relevant information to apply, as need be, the anti-avoidance rules and the economic substance doctrine in order to rescind the tax benefits stemming from abusive tax planning schemes.

4.10.1.5 The privilege does not apply to fraudulent cases

In conjunction with an audit, the tax administration must consult all of the documents necessary to determine whether it must rescind the tax benefits claimed by the taxpayers and assess a penalty. While tax opinions may, in principle, be protected by the attorney-client privilege, the tax administration may nonetheless consult these opinions if the taxpayer pursues a purpose akin to fraud.

---

154 The appeal was heard on September 5, 2008: see *Textron*, *supra* note 144.

155 26 C.F.R. § 7525.

156 See NYSBA, *Report on Disclosure (Material Advisors) (2005)*, *supra* note 11, page 21. The courts have generally concluded that the standardized tax opinions put forward by advisers in conjunction with the promotion of aggressive tax planning schemes are not protected by the attorney-client privilege. See *United States* v. *KPMG LLP*, 316 F. Supp. 2d 30; 2004 U.S. Dist. LEXIS 8106 (D. D. C.).

According to the jurisprudence, this possibility only applies under exceptional circumstances in the realm of aggressive tax planning schemes.[157] To determine whether a tax planning scheme is abusive to the point of being comparable to fraud, the courts must complete a thorough analysis of a transaction's compliance with complex tax rules to resolve contentious issues. The courts believe that it is usually premature to grant the tax administration the right to consult communications during the auditing of an income tax return based on mere allegations of fraud.

The *BDO Seidman* case illustrates the courts' approach to the application of this exception in the realm of aggressive tax planning schemes.[158] In this case, the tax administration had initiated an audit of the affairs of this consulting firm. It believed that the company had solicited taxpayers. The tax administration submitted a request to a District Court in Illinois to order the consulting firm in question to file over one thousand documents.

The consulting firm refused to file several documents on the grounds that they were protected by the attorney-client privilege or by the work product doctrine. The District Court had concluded that the attorney-client privilege did not prevent the consulting firm from revealing the identity of its clients. It also concluded that some of the documents were protected by either form of privilege of confidential communication. However, it had to ascertain whether the tax administration could consult 267 documents on the grounds that the taxpayers concerned were pursuing a purpose comparable to fraud. After it had examined each of these documents, the court concluded that the exception applied solely to one of them.

While it acknowledged that a taxpayer may make decisions for commercial and fiscal reasons, the court may rescind the attorney-client privilege if the taxpayers and their advisers attempt to conceal that the sole objective pursued by the taxpayers in a planning scheme was of a tax nature.[159] To determine whether a transaction can be likened to fraud, the court assesses all of the circumstances according to various indicators, including:

- the promotion of standardized fiscal transactions that advisers;
- the formulating of starndardized tax opinions by advisers;

---

157 See James M. Lynch, "War of the [Tax] Worlds: Privilege Versus Transparency" (2004), 82:3 Taxes 89 [Lynch, "Privilege Versus Transparency"].

158 See *BDO Seidman* (March 30, 2005), *supra* note 150.

159 *United States* v. *BDO Seidman LLP*, 2005 U.S. Dist. 12363 (N.D. Ill. May 17, 2005) [*BDO Seidman* (May 17, 2005)].

- communications between taxpayers and advisers to carry out a standardized transaction solely for the purpose of reducing the tax payable;
- the concealment by the taxpayers and the advisers of the genuine purposes of the planning scheme;
- the advisers' knowledge that their clients have no legitimate business purposes.[160]

Below is an extract from the ruling of the District Court that summarizes certain indicators on which the courts will rely to ascertain whether the tax administration has established *prima facie* evidence of fraud:

> In summary, the court has considered the following to be potential indicators of fraud when it performed the *in camera* review of the submitted documents to determine whether there is sufficient evidence to support a *prima facie* showing of fraud: (1) the marketing of pre-packaged transactions by BDO; (2) the communication by the Intervenors to BDO with the purpose of engaging in a pre-arranged transaction developed by BDO or third party with the sole purpose of reducing taxable income; (3) BDO and/or the Intervenors attempting to conceal the true nature of the transaction; (4) knowledge by BDO, or a situation where BDO should have known, that the Intervenors lacked a legitimate business purpose for entering into the transaction; (5) vaguely worded consulting agreements; (6) failure by BDO to provide services under the consulting agreement yet receipt of payment; (7) mention of the COBRA transaction; and (8) use of boiler-plate documents. *The court does not limit itself to the indicators in determining whether a prima facie case for the application of the crime-fraud exception. Instead, this court looks to the "totality of the circumstances,"… surrounding each document in order to determine whether there is "something to give colour to the charge . . . so as to require the [Intervenors], the one[s] with superior access to the evidence and in the best position to explain things, to come forward with that explanation.* … Furthermore, its important note that an indication of potential fraud does not mean that fraud exists sufficient for a *prima facie* finding. These factors are merely guideposts to assist this court in its *in camera* evaluation.[161]
>
> [our extracts and italics]

According to the court, the courts may not conclude that the exception for fraud applies solely by relying on the tax administration's allegations that the advisers have engaged in solicitations concerning planning schemes that it considers to be abusive:

> This court rejected the IRS' broad assertion that BDO and the Intervenors were denied the right to assert privilege under the crime-fraud exception when this court considered the 110 BDO documents in June 2004 … The blanket application of the crime-fraud exception would be inappropriate because this court characterized much of the IRS' arguments as being based on "speculation and innuendo."… The fact that the IRS has characterized a transaction as abusive and unlawful does not mean that the characterization is proper as a matter of law when considering whether to apply the crime-fraud exception. … *Furthermore,*

---

160 See *BDO Seidman* (March 30, 2005), *supra* note 150.

161 *Ibid*.

> *in light of the complexity and uncertainties of the IRS code, the fact that determining whether the involved transactions are in fact unlawful is one of the ultimate questions of this litigation, and the lack of evidence presented by the IRS to that point in the litigation, this court's March 30,2005 opinion held that "[a] determination by this court that BDO and the Intervenors engaged in fraudulent and criminal activity . . . would be premature and would place the proverbial 'Cart before the Horse."'* …
>
> As this court stated in its March 30, 2005 opinion, "[under the crime-fraud exception, communications that would otherwise be protected by the attorney-client privilege, [as well as the tax practitioner privilege], lose their protected status if they were 'made for the purpose of getting advice for the commission of a fraud or crime.'"… *"'The crime-fraud exception applies where the party attempting to circumvent the privilege, [in the present case the IRS,] can meet the following test: (1) a prima facie showing of [a crime or] fraud, and (2) the communications in question are in furtherance of the misconduct.* …
>
> [our extracts and italics]

When the tax administration demonstrates the appearance of fraud, the burden falls on the taxpayers to prove that their activities could not be considered fraudulent. The courts have compelled the taxpayers to establish this evidence since they are in the best position to provide the appropriate explanations concerning the nature of the document and the activities in which they have engaged. This additional passage from the *BDO Seidman* ruling summarizes the taxpayer's burden of proof:

> The Intervenors's present position is that document A-40 is not communication in furtherance of a crime or fraud, but was part of the common financial planning activity of selling off investments towards the end of a year in order to take advantage of tax savings. According to the Intervenors' April 14, 2005 memorandum, Intervenors including Intervenor Cullio, invested in a portfolio of emerging market distressed debt and then sought to sell that debt at the end of a year to lessen their tax liability. (Dkt. No. 181 at pg .2-3). According to the Intervenors' brief, there is no fraud or crime in this behavior, but instead this is a common financial planning activity performed by "every stock broker, financial planner, tax advisor and investor in America" at the end of every year. …
>
> The government counters that document A-40 is not part of legitimate year-end tax planning, but instead is part of the overall abusive sham tax shelter transaction perpetrated by BDO and invested in by Intervenor Cullio and others. The government provides the Fifth Supplemental Declaration from IRS Revenue Agent Sandra Alevlo ("Alevlo"), in support of its position and the Alevlo's declaration in turn is supported by a variety of documents previously obtained by the IRS from BDO and the Intervenors related to the distress debt transaction. …
>
> Upon review of the parties' submissions, this court holds that the Intervenors have failed to meet their burden of providing a satisfactory explanation as to why document A-40 should not be disclosed under the crime-fraud exception. *The Intervenors, the party "with superior access to the evidence and in the best position to come forward" with an explanation that rebuts the finding of the prima facie case for the application of the crime-fraud exception, have failed to meet their burden of providing a sufficient explanation to rebut this court's March 30, 2005 finding for a prima facie case for the application of the crime-fraud exception for document A-40.* …
>
> The court wishes to be clear that this memorandum opinion and order is limited to the question of whether the crime-fraud exception eviscerates the Intervenors' privilege claim on

> document A-40. … The larger issue of whether the overall activities of BDO and the Intervenors are lawful or unlawful remain for investigation by the IRS and potential future litigation between the parties[162].
>
> [our extracts]

The court acknowledges that taxpayers may organize their affairs to minimize their tax payable and that doing so is not usually likened to fraud. However, the taxpayers must refute the tax administration's allegations that the transactions carried out do not comply with the US *Internal Revenue Code*. They can hardly refute such allegations if the documents reveal that the sole purpose pursued was of a tax nature when they claim instead that their purpose was to make a profit:

> The Intervenors' position does not prevail here for several reasons. First, the Intervenors present the position that Intervenor Cullio was merely selling off assets in which he had previously invested in order to take advantage of the loss for tax purposes. However, this position would require Intervenor Cullio to have previously invested in the assets, presumably hoping to turn a profit thereon, the investment had not provided for a profit and that Intervenor Cullio was merely trying to salvage a tax advantage from his failed investment.
>
> However, based on the information provided through Revenue Agent Alvelo's declaration and supporting materials, it appears that the immediate activity in transaction was for Cullio to obtain a loss. The initial investment in the distressed debt appears to have occurred in late 2001, the same period in which Cullio was looking to receive the loss. This contradicts other materials previously provided by the Intervenors in which they claim that their primary purpose for investing in these transactions was the hope of making a profit.
>
> …
>
> The court must acknowledge, of course, that investing in a debt security for the potential tax advantages is not by itself a crime or fraud. The Intervenors are correct in their assertion that it is a normal practice for individuals to liquidate their investments to take advantage of losses for tax purposes. *The problem in this case, however, is that the Intervenors have failed to provide any explanation in their briefs or supporting documentation to overcome the government's position that this particular transaction is in violation of the Internal Revenue Code.*[163]
>
> [our extracts and italics]

4.10.2 The work product doctrine

4.10.2.1 Rationale of this privilege

US civil procedure rules contain a rule based on this doctrine. Briefly, a party with a conflicting interest with another party may not discover documents prepared by the latter or its

---

162 See *BDO Seidman* (May 17, 2005), *supra* note 159.

163 *Ibid*.

representative. Under exceptional circumstances, it may discover such documents if it demonstrates to the court that it must absolutely obtain them to back up its arguments and that it cannot obtain them otherwise without sustaining undue hardship:

> Rule 26. Duty to Disclose; General Provisions Governing Discovery
>
> …
>
> (3) *Trial Preparation: Materials.*
>
> (A) *Documents and Tangible Things.* Ordinarily, a party may not discover documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent). But, subject to Rule 26(b)(4), those materials may be discovered if:
>
> (i) they are otherwise discoverable under Rule 26(b)(1); and
>
> (ii) the party shows that it has substantial need for the materials to prepare its case and cannot, without undue hardship, obtain their substantial equivalent by other means.
>
> (B) *Protection Against Disclosure.* If the court orders discovery of those materials, it must protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of a party's attorney or other representative concerning the litigation[164]. …
>
> [our extracts]

Through this rule, parties with potentially conflicting interests can manage their respective risks in the event of litigation without gaining an undue advantage by accessing the other party's documents.[165] This extract from the ruling of the District Court in the *Textron* case cited earlier outlines this principle:

> […] the purpose of the work product privilege is to prevent a potential adversary from gaining an unfair advantage over a party by obtaining documents prepared by the party or its counsel in anticipation of litigation which may reveal the party's strategy or the party's own assessment of the strengths and weaknesses of its case[166].
>
> [our extracts]

Taxpayers and their advisers seemingly do not have to disclose the opinions formulated by the latter during the elaboration phase of aggressive tax planning schemes when such opinions are drafted in anticipation of litigation with the tax administration.[167] The possibility of this privilege's applying to any communication of this nature between the taxpayers and their advisers might

164 Rule 26(b)(3) of the *Federal Rules of Civil Procedure* (U.S. Government Printing Office: Washington, DC, December 1, 2007). The US Supreme Court is empowered to adopt rules of civil procedure: 28 U.S.C. § 2072.

165 Lynch, "Privilege Versus Transparency," supra note 157, page 112.

166 *Textron* (D.R.I.), *supra* note 144, page 28.

167 During this phase, the taxpayers and the advisers usually assess the likelihood that the tax administration will reject the tax benefits claimed, especially if they are substantial.

prevent the tax administration from having in hand the relevant information to determine whether the anti-avoidance rules and the economic substance doctrine apply to a planning scheme.[168]

The US courts have elaborated two criteria to determine whether the documents have been elaborated in anticipation of litigation with the tax administration:

- some courts opine that this privilege applies solely if the possibility of litigation with the tax administration is the main reason why taxpayers and their advisers elaborated the documents;
- other courts have concluded that the privilege applies the moment that the taxpayers and their advisers have prepared the documents because, in their opinion, of the possibility that litigation with the tax administration will arise.

The second approach is advantageous for taxpayers and their advisers. Under this approach, a document may be covered by this privilege of confidential communication despite its having been prepared mainly for non-tax purposes. Such would be the case when an adviser elaborates a document to enable a taxpayer to make a commercial decision while assessing the likelihood that the tax administration will challenge the tax benefits stemming from it.[169] In the *Textron* case, the District Court adopted this approach, in keeping with the stance that prevailed in the First Circuit. This extract from the ruling presents the two approaches applied in the jurisprudence and the District Court's choice:

> Courts have applied two different tests in determining whether a document was prepared "in anticipation of litigation." Under the "primary purpose" test, documents are held to be prepared in anticipation of litigation "as long as the primary motivating purpose behind the creation of a document was to aid in possible future litigation." El Paso, 682 F.2d at 542. Under the more inclusive "because of" test, the relevant inquiry is whether the document was prepared or obtained "because of" the prospect of litigation. United States v. Adlman, 134 F.3d 1194 (2nd Cir. 1998). In Adlman, after making a detailed analysis of the two tests, the Second Circuit found the "because of" test "more consistent with both the literal terms and the purposes of [Rule 26(b)(3)]"…

---

168 See Lynch, "Privilege Versus Transparency," supra note 157, pages 112-121; Beale, "Tax Advice and Denying Evidentiary Privileges," supra note 143, pages 665-666; Lee A. Sheppard, "News Analysis: Textron Case Expands Work Product Privilege" (September 10, 2007), 116 Tax Notes 917, 2007 TNT 176-6 [Sheppard, "Textron"].

169 *United States* v. *Adlman*, 134 F.3d 1194; 1998 U.S. App. LEXIS 2633 (2nd Cir. 1998). See Lynch, "Privilege Versus Transparency," supra note 157, pages 114 to 117.

> The First Circuit has adopted the "because of" test articulated in Adlman. Maine v. Dept. of the Interior, 298 F.3d 60, 68 (1st Cir. 2002).[170]
>
> [our extracts]

4.10.2.2. Subjective and objective anticipation of litigation

The application of either of the approaches described earlier depends on the taxpayers' perception of the possibility that litigation with the tax administration will arise. The main difficulty consists in determining the time when the taxpayers can reasonably expect to be involved in such litigation.[171] To answer this question, the courts will attempt to ascertain whether an individual placed in the same circumstances as the taxpayer could objectively and reasonably anticipate litigation. This extract from the ruling of the US Court of Appeals for the Sixth Circuit in the *Roxworthy* case illustrates this approach:

> We have yet to define "in anticipation of litigation." Other circuits have adopted the standard first articulated in Wright and Miller's Federal Practice and Procedures, asking whether a document was "prepared or obtained *because of* the prospect of litigation."… We have articulated and applied the "because of" standard in our unpublished cases … and district courts from our circuit have also applied this test …. Today, we join our sister circuits and adopt the "because of" test as the standard for determining whether documents were prepared "in anticipation of litigation."
>
> Adopting this standard prompts the further question of when documents can be said to have been created because of the prospect of litigation. It is clear that documents prepared in the ordinary course of business, or pursuant to public requirements unrelated to litigation, or for other nonlitigation purposes, are not covered by the work product privilege. … Thus, a document will not be protected if it would have been prepared in substantially the same manner irrespective of the anticipated litigation. … Furthermore, courts applying the "because of" test have typically recognized both a subjective and objective element to the inquiry; that is, a party must "have had a subjective belief that litigation was a real possibility, and that belief must have been objectively reasonable."… We therefore embrace the test used by a number of the district courts in our circuit, including the district court in this case, which asks (1) whether a document was created because of a party's subjective anticipation of litigation, as contrasted with an ordinary business purpose, and (2) whether that subjective anticipation of litigation was objectively reasonable.[172] …
>
> [our extracts and italics]

As the Court of Appeals of the Seventh Circuit noted in the *Frederick* case, the audit stage in respect of an income tax return can lead to the issuing by the tax administration of a notice of

---

170 *Textron*, *supra* note 144 pages 21 and 22 of the Court's ruling. The facts of this case are described in subsection 4.10.2.3. See also *United States* v. *Roxworthy*, 457 F. 3d 590 (6th Cir. 2006), ruling of the Court of Appeals for the Sixth Circuit No. 05-5776 (August 10, 2006) [*Roxworthy*].

171 Lynch, "Privilege Versus Transparency," supra note 157, pages 114 and 115.

172 *Roxworthy*, *supra* note 170, page 3 of the ruling published by the court.

reassessment. To this effect, the audit stage can be likened to an antechamber to the litigation stage. Consequently, groups of stakeholders will differ in opinion on the application of the work product doctrine according to the facts and circumstances pertaining to an audit. Below is an extract from the ruling of the Court of Appeals in this case summarizing these principles:

> The most difficult question presented by this appeal, and one on which we cannot find any precedent, relates to documents, numerical and otherwise, prepared in connection with audits of the taxpayers' returns. An example is a memo from Frederick to a paralegal asking her for the amount that Mr. Lenz and his corporation had paid Frederick for legal services rendered personally to Lenz in 1992. The memo was prepared to help Frederick respond to questions raised in an audit of the Lenzes' and the corporation's tax returns. *An audit is both a stage in the determination of tax liability, often leading to the submission of revised tax returns, and a possible antechamber to litigation. When a revenue agent is merely verifying the accuracy of a return, often with the assistance of the taxpayer's accountant, this is accountants' work and it remains such even if the person rendering the assistance is a lawyer rather than an accountant.* Throwing the cloak of privilege over this type of audit-related work of the taxpayer's representative would create an accountant's privilege usable only by lawyers. *If, however, the taxpayer is accompanied to the audit by a lawyer who is there to deal with issues of statutory interpretation or case law that the revenue agent may have raised in connection with his examination of the taxpayer's return, the lawyer is doing lawyer's work and the attorney-client privilege may attach.* But the documents in issue do not, so far as we are able to determine, relate to such representation.[173]
>
> [our extracts and italics]

As this passage from the ruling of the Court of Appeals of the Sixth Circuit in the *Roxworthy* case illustrates, the dividing line between the audit stage and the litigation stage for the purposes of the application of the work product doctrine is nebulous and depends on the facts and circumstances in which the taxpayer finds himself:

> Yum further argues that the magistrate judge erred in concluding that anticipation of an audit does not constitute anticipation of litigation under Rule 26(b)(3). *See* J.A. 43 (Report and Recommendation at 13). The magistrate judge's observation that mere anticipation of an audit does not suffice, however, was made in the context of concluding that the submitted affidavits and KPMG memoranda did not evidence a subjective anticipation of litigation. Because we reverse the district court's determination that Yum has not adequately demonstrated subjective anticipation of litigation, we need not decide when, if ever, subjective anticipation of an audit may suffice to constitute subjective anticipation of litigation.[174]
>
> [our extracts]

To determine whether the taxpayers could reasonably anticipate litigation with the tax administration, the courts must decide whether a reasonable person placed in the same circumstances would objectively reach this conclusion. The courts have adopted various

---

173 *United States* v. *Frederick*, 182 F.3d 496; U.S. App. LEXIS 7420 (7th Cir. 1999) [*Frederick*].

174 *Roxworthy*, *supra* note 170, page 8 of the ruling published by the Court of Appeals.

approaches to ascertain the point at which a taxpayer may reasonably and objectively anticipate litigation with the tax administration. The courts opine that documents prepared in anticipation of an "administrative dispute" that arises during the auditing of an income tax return might be protected by the work product doctrine:

> Courts have articulated various tests for determining when anticipation of litigation is too speculative to be objectively reasonable. The DC Circuit has required the objecting party to prove that a document was "prepared with a specific claim supported by concrete facts which would likely lead to litigation in mind,"… but has also found the privilege to apply in the absence of a specific claim where an attorney "rendered legal advice in order to protect the client from future litigation about a particular transaction,"… The Fourth Circuit has stated that the protection only applies when the "preparer faces an actual claim or a potential claim following an actual event or series of events that reasonably could result in litigation."… *Although not every audit is potentially the subject of litigation, … a document prepared "in anticipation of 'dealing with the IRS' … may well have been prepared in anticipation of an administrative dispute and this may constitute 'litigation' within the meaning of Rule 26,"*…[175]
>
> [our extracts and italics]

In the *Roxworthy* case, the Court of Appeals concluded that, from an objective standpoint, the taxpayer could reasonably anticipate litigation with the tax administration. It took into account the significant discrepancy between the income calculated for accounting purposes and that calculated for tax purposes, uncertainty surrounding the application of the law to the transaction carried out by the taxpayer, and the tax administration's specifically targeting this type of transaction. Based on other courts' rulings in similar cases, the Court of Appeals concluded that the risk of litigation arising between the taxpayer and the tax administration was far from negligible, although no specific factor suggested that it would arise:

> … Yum argues that it anticipated litigation because a yearly IRS audit of Yum was a certainty due to the company's size, the transaction at issue involved a $112 million discrepancy between tax loss and book loss, and the company had been advised by KPMG that the area of law was unsettled and that the IRS had recently targeted this type of transaction. Yum points to a case with analogous facts in which a district court upheld the work product privilege. …
>
> Likewise, in *United States v. Adlman*, 68 F.3d 1495, 1496 (2nd Cir. 1995) (*Adlman I*), an accounting firm prepared documents evaluating the tax consequences and likely IRS challenges to a company's proposed reorganization in which the company would claim a capital loss of $290 million. The Second Circuit held that the district court erred in concluding that the prospect of litigation was too remote for work product privilege to apply, observing that "[i]n many instances, the expected litigation is quite concrete, notwithstanding that the events giving rise to it have not yet occurred." *Id.* at 1501. The court remanded the matter for the district court to apply the proper standard.
>
> We find these factually analogous cases persuasive. As contemplated by *Adlman I*, *Yum has demonstrated that the "expected litigation" here is "quite concrete" despite the absence of*

175 *Ibid*.

> *any overt indication from the IRS that it intends to pursue litigation against Yum.* Yum has identified a specific transaction that could precipitate litigation, the specific legal controversy that would be at issue in the litigation, the opposing party's opportunity to discover the facts that would give rise to the litigation, and the opposing party's general inclination to pursue this sort of litigation. *We believe that Yum has established that the memoranda at issue sought to protect Yum "from future litigation about a particular transaction,"… that Yum has also established that KPMG and Yum had in mind a "specific claim supported by concrete facts which would likely lead to litigation,"… and that Yum has established that it "face[d] an actual or a potential claim following an actual event or series of events that reasonably could result in litigation,"*… Because we believe that Yum's circumstances clearly constitute objectively reasonable anticipation of litigation under any of the tests we have seen employed by our sister circuits, we need not decide which of these articulations is most useful.
>
> *We therefore conclude that the district court committed an error of law in determining that Yum's anticipation of litigation was too remote to constitute a reasonable anticipation of litigation.*[176]
>
> [our extracts and italics]

4.10.2.3 Possibility that the courts maintain the privilege in the presence of complex tax rules and substantial amounts of tax, in particular in the case of listed transactions

The courts could conclude that a document is protected by this privilege on the grounds that the document contains an analysis by the advisers of ambiguous tax rules, which is usually the case for transactions that are reportable under the disclosure rules. The courts might also conclude that the taxpayers can reasonably expect to be involved in litigation with the tax administration when the latter publicly announces that it will deploy all of its resources in order to rescind tax benefits stemming from a type of planning scheme, as it does in respect of listed transactions. Moreover, the courts might conclude that the documents used to calculate a tax reserve to deal with a potential litigation with the tax administration are protected when the taxpayers are periodically subject to an audit or when the tax reserve is substantial.

According to the United States Court of Appeals for the Seventh Circuit in the *Frederick* case, documents prepared by an attorney or an accountant in anticipation of an audit of the accuracy of the income tax returns of their clients are not protected by the work product doctrine. However, this privilege may attach to the documents that the attorney drafts if they contain an interpretation of the tax law in support of the income tax return.[177]

---

[176] *Ibid*.

[177] See *Frederick*, *supra* note 173.

The District Court's ruling in the *Textron* case[178] illustrates the potentially broad scope of the work product doctrine when taxpayers engage in aggressive tax planning schemes and are systematically subject to audits. In this case, the District Court concluded that the tax administration could not obtain the taxpayer's tax accrual workpapers since they were covered by the work product privilege. The tax administration had asked the taxpayer to file these documents to determine whether the taxpayer had carried out aggressive tax planning schemes for the purposes of the disclosure rules. These documents contained information concerning items in the income tax returns likely to be subject to a notice of reassessment and the weighting of the taxpayer's chances of success in the event of litigation with the tax administration.

The taxpayer in the *Textron* case was of the opinion that the attorney-client privilege and the work product privilege applied to the accounting documents requested, since the taxpayer's advisers had prepared them in anticipation of litigation with the tax administration about the interpretation of the tax law. The tax administration opined that these documents were elaborated solely for the purposes of filing the taxpayer's income tax return and were covered by neither of the privileges claimed by the taxpayers.

The District Court concluded that attorney-client privilege applied to the documents demanded by the tax administration but that the taxpayer had relinquished this privilege by communicating the documents to its external auditors. However, the court concluded that the work product privilege applied and that the taxpayer had not relinquished this privilege. In this latter instance, the communication by the attorneys of the documents to the taxpayer's external auditors does not lead to the taxpayer's relinquishment of this privilege, since the external auditors represented the taxpayer's interests and not those of the adverse party:

> … the purpose of the work product privilege is to prevent a potential adversary from gaining an unfair advantage over a party by obtaining documents prepared by the party or its counsel in anticipation of litigation which may reveal the party's strategy or the party's own assessment of the strengths and weaknesses of its case. Accordingly, only disclosures that are inconsistent with keeping the information from an adversary constitute a waiver of the work product privilege. …
>
> Most courts considering the question have held that disclosure of information to an independent auditor does not waive the work product privilege because it does not substantially increase the opportunity for potential adversaries to obtain the information. …

[178] *Textron* (D.R.I.), *supra* note 144.

> In this case, too, the disclosure of Textron's tax accrual workpapers to E&Y did not substantially increase the IRS's opportunity to obtain the information contained in them. Under AICPA Code of Professional Conduct Section 301 *Confidential Client Information,* E&Y had a professional obligation "not [to] disclos[e] any confidential client information without the specific consent of the client." Furthermore, E&Y expressly agreed not to provide the information to any other party, and confirms that it has adhered to its promise. … Even if the AICPA Code coupled with E&Y's promise did not establish an absolute guarantee of confidentiality, they made it very unlikely that E&Y would provide Textron's "tax accrual workpapers" to the IRS and they negate any inference that Textron waived the work product privilege.
>
> … in this case, E&Y was a truly independent auditor that had no obligation to the IRS to determine whether Textron's tax return was correct and no authority to challenge the return. In this instance, E&Y was seeking, only, to determine whether the reserve established by Textron to cover the corporation's contingent tax liabilities satisfied the requirements of GAAP. Since E&Y was not a potential Textron adversary or acting on behalf of a potential adversary, and, since E&Y agreed to treat the workpapers as confidential, disclosure to E&Y did not substantially increase the likelihood that the workpapers would be disclosed to the IRS or other potential Textron adversaries[179]. …
>
> [our extracts]

The District Court was of the opinion that the documents must remain confidential since the taxpayers anticipated litigation with the tax administration. According to the court, this anticipation stemmed from the fact that the taxpayers had engaged in planning schemes in respect of which the tax rules and the jurisprudence were complex and ambiguous and they had been subject to a tax audit in seven of the eight previous taxation years:

> As the IRS correctly observes, the work product privilege does not apply to "'documents that are prepared in the ordinary course of business or that would have been created in essentially similar form irrespective of the litigation.'" Maine, 298 F.3d at 70 (quoting Adlman, 134 F.3d at 1202). However, it is clear that the opinions of Textron's counsel and accountants regarding items that might be challenged by the IRS, their estimated hazards of litigation percentages and their calculation of tax reserve amounts would not have been prepared at all "but for" the fact that Textron anticipated the possibility of litigation with the IRS. If Textron had not anticipated a dispute with the IRS, there would have been no reason for it to establish any reserve or to prepare the workpapers used to calculate the reserve. Thus, while it may be accurate to say that the workpapers helped Textron determine what amount should be reserved to cover any potential tax liabilities and that the workpapers were useful in obtaining a "clean" opinion from E&Y regarding the adequacy of the reserve amount, *there would have been no need to create a reserve in the first place, if Textron had not anticipated a dispute with the IRS that was likely to result in litigation or some other adversarial proceeding.*
>
> *Nor can there be any doubt that Textron's belief in the likelihood of litigation with the IRS was well founded. As already noted, the matters identified in the workpapers dealt with issues on which the law was unclear. Moreover, in seven of Textron's eight previous audit cycles, "unagreed" issues had been appealed to the IRS Appeals Board, and three of those issues were litigated in federal court.*

---

179 *Textron* (D.R.I.), *supra* note 144, pages 27 to 32.

> Moreover, even if the workpapers were needed to satisfy E&Y that Textron's reserves complied with GAAP, that would not alter the fact that the workpapers were prepared "because of" anticipated litigation with the IRS.[180]
>
> [our extracts and italics]

Under exceptional circumstances, the tax administration may demand the filing of documents despite the work product doctrine. According to the rules of procedure, it may demand the filing of privileged documents if they are essential to allow the tax administration to determine the taxpayer's tax payable and it cannot otherwise obtain such information without sustaining undue hardship. The tax administration must assume a burden of proof greater than the balance of probabilities. This passage from the ruling of the District Court in the *Textron* case summarizes the requirements linked to this exception principle:

> As already noted, the work product doctrine creates only a qualified privilege that may be overcome by a showing of (1) "substantial need" for the protected documents, and (2) an inability to otherwise obtain the information contained therein or its substantial equivalent without "undue hardship." Fed. R. Civ. P. 26 (b) (3).
>
> While establishing that protected documents relate to a legitimate IRS investigation may satisfy the "relevancy" requirement of § 7602, it is insufficient to establish the "substantial need" showing necessary to overcome the work product privilege. … That is especially true in the case of opinion work product, which consists of the "mental impressions, conclusions, opinions or legal theories" of attorneys, where the party seeking the materials must meet a heightened burden.[181]
>
> [our extracts]

In the *Textron* case, the tax administration was unable to demonstrate that the exception principle applied. The court opined that the taxpayer would find itself in an unduly inequitable situation in relation to the tax administration in the case of litigation if it had to disclose these documents to the tax administration, just as it would be inequitable for the tax administration to disclose to the taxpayer the legal opinions of its advisers:

> Here, the IRS has failed to carry the burden of demonstrating a "substantial need" for ordinary work product, let alone the heightened burden applicable to Textron's tax accrual workpapers, which constitute opinion work product. *While the opinions and conclusions of Textron's counsel and tax advisers might provide the IRS with insight into Textron's negotiating position and/or litigation strategy, they have little bearing on the determination of Textron's tax liability. The determination of any tax owed by Textron must be based on factual information, none of which is contained in the workpapers and all of which is readily available to the IRS through the issuance of IDRs and by other means.* The opinions of Textron's counsel, either favorable or unfavorable, would have little to do with that determination, and *forced disclosure of those opinions would put Textron at an unfair*

---

180 *Ibid., page*s 20 to 22.

181 *Ibid.,* page 32.

> *disadvantage in any dispute that might arise with the IRS, just as requiring the IRS to disclose the opinions of its counsel regarding areas of uncertainty in the law or the likely outcome of any litigation with Textron would place the IRS at an unfair disadvantage.*[182]
>
> [our extracts and italics]

4.10.3 The tax administration has a policy of minimizing requests for accounting documents, except in the case of listed transactions

Opinions will, in all likelihood, differ among groups of stakeholders concerning the possibility for the tax administration of consulting accounting documents elaborated by a taxpayer's advisers for the purposes of the taxpayer's income tax return. More specifically, the advisers must determine, according to the balance of probabilities, if the taxpayer may claim a tax benefit in a manner that complies with the tax rules and the jurisprudence. To this end, the advisers must assess the likelihood that the tax administration will rescind the tax benefits claimed and that the courts will confirm the tax administration's application of the tax law and the jurisprudence.

Briefly, the courts have decided that privileges of confidential communication do not apply to accounting documents if they have been prepared for the purposes of filing income tax returns or if they do not contain an interpretation of the law.[183] Consequently, the tax administration could demand that the taxpayers file a substantial volume of documents.

The tax administration has adopted a reserve policy in respect of these documents. It will only demand that they be filed in exceptional cases and only if it cannot otherwise obtain the information sought. However, since 2002, it has not applied this reserve policy in the case of listed transactions. In such instances, the tax administration usually asks taxpayers who have carried out these transactions to file the accounting documents. While some taxpayers have filed the documents requested by the tax administration, others have refused to do so, following the example of *Textron*. The conclusions in the *Textron* case therefore have significant repercussions on the tax administration's powers to demand that taxpayers and their advisers file accounting documents.[184]

---

182 *Ibid.,* pages 33 and 34.

183 See *Frederick*, *supra* note 173.

184 See Sheppard, "Textron," supra note 168.

Below are extracts from the statement of the US tax administration announcing its intention to request the filing of such documents concerning listed transactions:

> The Internal Revenue Service is revising its policy concerning when it will request and, if necessary, summon tax accrual and other financial audit workpapers relating to the tax reserve for deferred tax liabilities and to footnotes disclosing contingent tax liabilities ("Tax Accrual Workpapers") appearing on audited financial statements. *This limited expansion of the circumstances in which the Service will seek Tax Accrual Workpapers is necessary to allow the Service to fulfill its obligation to the public to curb abusive tax avoidance transactions and to ensure that taxpayers are in compliance with the tax laws. In all other respects, the Service's current policy regarding requests for Tax Accrual Workpapers will continue to apply.*
>
> The Service may request Tax Accrual Workpapers in the course of examining any return filed on or after July 1, 2002, that claims any tax benefit arising out of a transaction that the Service has determined to be a listed transaction at the time of the request … If the Listed Transaction was disclosed under Temp. Treas. Reg. § 1.6011–4T, the Service will routinely request the Tax Accrual Workpapers pertaining only to the Listed Transaction. If the Listed Transaction was not disclosed, the Service will routinely request all Tax Accrual Workpapers. In addition, if the Service determines that tax benefits from multiple investments in Listed Transactions are claimed on a return, regardless of whether the Listed Transactions were disclosed, the Service, as a discretionary matter, will request all Tax Accrual Workpapers. Similarly, if, in connection with the examination of a return claiming tax benefits from a Listed Transaction that was disclosed, there are reported financial accounting irregularities, such as those requiring restatement of earnings, the Service, as a discretionary matter, will request all Tax Accrual Workpapers.
>
> …
>
> Despite the broad scope of authority recognized by the Supreme Court, the Service has historically acted with restraint, declining to request Tax Accrual Workpapers as a standard examination technique. …
>
> The Service will continue its current policy of requesting Tax Accrual Workpapers only in unusual circumstances (1) for any returns filed prior to July 1, 2002, other than those that claim any tax benefit arising out of a Listed Transaction that has not been disclosed as mentioned above, and (2) for any returns filed on or after July 1, 2002, other than those that claim any tax benefit arising out of a Listed Transaction as described above.[185]
>
> [our extracts and italics]

4.10.4 The application of the penalty for under-stating tax payable may encourage taxpayers to relinquish their privilege of confidential communication

The US tax administration has adopted a penalty for under-stating tax payable, which is intended to heighten financial risks for aggressive taxpayers.[186] Generally speaking, the penalty

[185] US, Internal Revenue Service, Announcement 2002-63, "Request for Tax Accrual and Other Financial Audit Workpapers" 2002-27 I.R.B. 72 (July 8, 2002).

[186] Treasury, *Corporate Tax Shelters (1999)*, *supra* note 2, pages 64-66.

is equivalent to 20% of the amount of tax under-stated.[187] The taxpayers are liable to this penalty if the difference between the amount of tax that they should have paid and the amount of tax that they estimated exceeds a pre-established monetary threshold. Different thresholds apply to individuals and to corporations.

It is usually possible for taxpayers to avoid the penalty if they display due diligence in the application of the tax law and the jurisprudence. The degree of diligence required depends on the complexity of the planning scheme, the value of the tax benefits at stake and the taxpayers' expertise in tax matters. They could avoid the penalty if the weight of the recognized legal and administrative sources that support the tax benefits claimed is substantial compared with those supporting the tax administration's stance. Briefly stated:

- such weight will usually be deemed to be substantial if there is a roughly 40% likelihood that the courts will subscribe to it;
- if the taxpayers have properly disclosed in their income tax returns or the prescribed form the facts supporting the tax treatment claimed, the courts should be able to adhere to the taxpayer's position if there is at least a 20% likelihood that legal sources support this position.

However, the taxpayers' degree of diligence is higher when they carry out aggressive tax planning schemes.

When the under-statement of tax payable stems from a transaction one of whose significant purposes[188] is the obtaining of a tax benefit, the taxpayer may avoid part or all of the penalty if he demonstrates his good faith and the existence of reasonable and probable cause. However, he must establish that he had reasonable grounds to believe that the tax treatment claimed in respect of this transaction complied with the tax law and the jurisprudence according to the balance of probabilities, i.e. over 50%:

---

187 The taxpayers must pay this penalty over and above the interest that they had to pay on the amount of tax under-stated. Instalment 6 of Part II of this study examines in greater detail the penalty for under-stating tax payable.

188 Until the modification adopted in 1997, the penalty for under-stating tax payable applied to a transaction whose main purpose fell within the province of tax avoidance. For the purposes of this penalty, the tax administration adopted the "one of the main purposes" criterion in 1997, since the criterion of the main purpose in a transaction was harder to establish (a significant purpose would imply less weight than that attributable to the main purpose of a transaction).

- the courts will assess the degree of diligence that a taxpayer demonstrates by taking into consideration all of the facts and circumstances;
- the taxpayer may avoid the penalty even if he has not properly disclosed his tax position in his income tax return. Failure to properly disclosure this fiscal status might nonetheless be considered a lack of good faith on the taxpayer's part and lead to the application of the penalty.[189]

If the taxpayer has carried out a transaction that is reportable under the disclosure rules, he must have fulfilled his obligations pursuant to these rules for it to be possible to avoid the specific penalty for under-stating tax payable. Otherwise, the tax administration could levy a penalty equivalent to 30% of the amount of tax under-stated and the taxpayer would not be able to avoid it.[190]

To minimize the risks of being subject to a penalty for under-stating tax payable, taxpayers may seek the opinion of tax advisers. When faced with a grey area in the tax law and the jurisprudence, the taxpayers could rely on the opinion of a tax adviser who has concluded that obtaining the tax benefits complied with the tax law in force when they were claimed, according to the balance of probabilities and the weight of each of the recognized legal or administrative interpretation sources.[191]

The withdrawal of the tax benefits and the concomitant application by the tax administration of a penalty for under-stating tax payable thus puts pressure on the taxpayer and encourages the latter to disclose to the tax administration the contents of his advisers' opinions. Following the example of the economic substance doctrine, the penalty centres on the presence of a tax purpose in a planning scheme. To support the application of the economic substance doctrine and the penalty for under-stating tax payable, the tax administration will attempt to collect

---

189 In the case of individuals, see 26 U.S.C. § 6662(d)(2)(C) and 26 C.F.R. § 1.6662-4(g). In the case of corporations, see 26 U.S.C. § 6664(c) and 26 C.F.R. §1-6662-4(g)(1)(iv) and §1-6664(f). Instalment 6 of this study examines in greater detail the penalty for under-stating tax payable.

190 Subsection 3.2.5 of this instalment focuses on the specific penalty for under-stating tax payable in respect of the reportable transactions specified by the tax administration for the purposes of the disclosure rules.

191 26 U.S.C. § 6662 and 26 C.F.R § 1.6662; 26 U.S.C. § 6664 and 26 C.F.R. § 1.6664. Instalment 6 of this study examines in greater detail the penalty for under-stating tax payable.

information on the taxpayer's subjective intentions in a planning scheme, in particular based on opinions or other communications between the taxpayer and his advisers.[192] In light of this information, the tax administration will be in a better position to establish the items required to support, *prima facie,* the penalty, as required by the US rules (burden of production).[193] Obviously, the tax administration can only apply the penalty insofar as it determines that the taxpayer has under-stated the tax payable because the planning scheme carried out lacked economic substance.

The taxpayer could allege that the work product doctrine protects all of the opinions if they were obtained in anticipation of the possibility of the tax administration's rescinding the tax benefits and levying a penalty on the taxpayer. The taxpayer would then have the possibility of filing only the opinions that allow him to avoid the penalty. If this privilege applies, the tax administration may not obtain all of the documents that it is seeking at the audit stage in order to support, *prima facie*, a penalty for under-stating tax payable.

As the *Roxworthy* case illustrates, the approach advocated by the courts in the application of the work product doctrine affects the taxpayer's obligation to disclose the tax opinions prepared so that he can avoid a possible penalty. If the courts are of the opinion that this privilege applies to any document prepared in anticipation of a tax dispute, even though it has been used for other purposes, the taxpayers may then file only those documents that afford them the best chance of avoiding the penalty.

In the *Roxworthy* case, the Internal Revenue Service had asked the taxpayer to file two tax opinions from his advisers during an audit concerning certain taxation years. These opinions contained an analysis of the tax consequences of certain transactions, including the arguments that the tax administration might raise to rescind the tax treatment claimed by the taxpayer and

---

192 By way of illustration, see the ruling of the North Carolina District Court (West District) in *Howa Trading LLC et al.* v. *United States of America* (June 2, 2008), Charlotte 3:07CV324-R (W.D. N.C.).

193 26 U.S.C. § 7491(c). Taken literally, this appears to apply only if the penalty is levied on an individual. However, for whatever purpose it may serve, the tax administration must expect to demonstrate to the courts that a penalty is applicable in all cases. We refer the reader to the *Long Term Capital Holdings* (D. Conn.) case, *supra* note 4, for an analysis of the abovementioned article and the burden of proof concerning the application of a penalty for under-stating tax payable. We refer the reader to Instalment 6 of this study for a more detailed examination of the penalty for under-stating tax payable.

the rebuttal arguments that the taxpayer could invoke. The taxpayer refused to file the opinions on the grounds that they were protected by the privilege of confidential communication, i.e. the work product doctrine.

The tax administration filed a motion for an injunction with the District Court, which ordered the taxpayer to file his advisers' tax opinions. In the opinion of the court, these documents were not confidential pursuant to the work product doctrine since they had been produced to help the taxpayer prepare his income tax returns and auditing of them by the tax administration in the normal course of its operations and not in anticipation of litigation with the tax administration.

The taxpayer launched an appeal before the US Court of Appeals for the Sixth Circuit. The taxpayer maintained that the documents' contents show that they were prepared in anticipation of litigation with the tax administration:

> Yum argues that the documents themselves are the best evidence that they were created in anticipation of litigation. Indeed, apart from eleven pages of background facts regarding Tricon's creation of a captive insurance company and subsequent transfer of stock, both of which occurred prior to the memoranda's completion, the memoranda contain dense legal analysis of current tax law, including arguments and counter-arguments in certain areas of law that the memoranda argue are unsettled. The "Conclusions" portion of each memo states that "it is more likely than not ... that the following federal tax consequences (among others) will result from the transactions described herein and that such consequences will be supported by 'substantial authority' within the meaning of Treas. Reg. § 1.6662-4(d)."The "Conclusions" that follow include statements about the tax treatment of the "Premium Payment" and "Loss Payment," calculation of the basis of Tricon's stock, and the proper recognition of taxable income and capital loss resulting from the transaction. The "Discussion" section of each memo sets forth "the rationale for [KPMG's] conclusions and some of the more likely theories that could be asserted by the IRS in challenging [KPMG's] conclusions." The Discussion section in each of the memoranda expresses legal conclusions throughout, using language such as the following: "[W]e believe that it is likely that a court would agree with ..."; "it would seem that unless [certain events occur], this issue ... may not be contested"; "we believe that it is more likely than not that a court would agree that ..."; "it appears reasonable to rely on ..."; "[a]lthough not free from doubt, we believe that [the hypothetical argument] would be rejected by a court"; and "[i]t is possible that the application of [certain tax rules] could be raised ...."[194]
>
> [our extracts]

The Court of Appeals for the Sixth Circuit quashed the District Court's order. In the opinion of this Court of Appeals, the documents had to remain confidential even if they were prepared to enable the taxpayer to avoid the penalty for under-stating tax payable. This Court of Appeals

[194] *Roxworthy*, *supra* note 170, page 4 of the ruling of the Court of Appeals for the Sixth Circuit.

opined that the courts must determine whether the documents have been prepared in anticipation of litigation even though they may have served other purposes. These extracts from the Court of Appeals for the Sixth Circuit's ruling indicate the court's reasoning:

> We find no evidence in the record to controvert the affidavits supplied by Yum. ... Although Yum's supplemental affidavits do not clarify why the memoranda were not submitted until after the transactions were complete, we find error in the magistrate judge's speculation that the timing decreases the likelihood that the memoranda were completed in anticipation of litigation. The company's decision to obtain a legal opinion only after it had completed a series of transactions could easily lead to the conclusion that the opinion was *more* likely to be in anticipation of litigation as opposed to being used for ordinary business purposes. Yum's uncontroverted assertions that it anticipated litigation because of the uncertainty surrounding the area of tax law at issue are also corroborated by the memoranda's highly detailed discussions of hypothetical legal arguments. Finally, the additional specifics regarding why Yum anticipated litigation, particularly its explanation that it planned to claim a $112 million tax loss with no corresponding book loss, that KPMG had advised the company that the law surrounding captive insurance companies was unsettled, and that the IRS had demonstrated an inclination to litigate in that area, provide more than bare self-serving conclusions. Thus, Yum's unambiguous sworn affidavits and deposition testimony satisfy its burden of demonstrating that the memoranda were prepared due to Yum's subjective anticipation of litigation and not in the ordinary course of business.
>
> Yum focuses on the magistrate judge's discussion of the possible use of the KPMG memoranda in Yum's audit process, and argues that the magistrate judge erroneously assumed that use of the memoranda for such a purpose precludes assertion of a work product privilege. As the magistrate judge's report and recommendation and the IRS's brief both note, the tax code imposes a twenty percent penalty on substantial understatements of income tax. I.R.C. §§ 6662(a)–(b). This penalty typically does not apply, however, to an item that was adequately disclosed on one's tax return if substantial authority supports the chosen tax treatment. *Id.* § 6662(d)(2)(B); Treas. Reg. § 1.6662-4(d)(2). Thus, the KPMG memoranda's references to "substantial authority" and citation to Treasury Regulation 1.6662-4(d)(2) suggest that the arguments supplied were expected to be used by Yum in articulating its tax-treatment rationale to the IRS during an audit in order to avoid a penalty.
>
> *We are persuaded by Yum's argument that even if the KPMG memoranda were prepared in part to assist Yum in avoiding underpayment penalties during an audit, the documents do not lose their work product privilege "merely because [they were] created in order to assist with a business decision," unless the documents "would have been created in essentially similar form irrespective of the litigation."*… As other courts have noted, a document can be created for both use in the ordinary course of business and in anticipation of litigation without losing its work product privilege. To the extent that the magistrate judge's findings turned on a requirement that the primary or sole purpose of the KPMG memoranda be in preparation of litigation, we conclude that the magistrate judge relied upon an incorrect interpretation of the law.[195]
>
> [our extracts and italics]

[195] See *Roxworthy*, *supra* note 170, page 7 of the ruling published by the Court of Appeals for the Sixth Circuit. For an analysis of the scope of this ruling, see Burgess J.W. Raby and Willam L. Raby, "Penalty Protection Tax Opinions and Work Product Privilege" (October 23, 2006) 113 Tax Notes 321.

The tax administration could issue a notice of reassessment to the taxpayer in which, based on the information at hand, it applies the economic substance doctrine and the penalty for under-stating tax payable. In such a case, the taxpayer should then allege that in his advisers' opinion, the planning scheme carried out complied with the economic substance doctrine according to the balance of probabilities. He would implicitly relinquish his privilege of confidential communication and should file his advisers' opinions.[196] Consequently, the tax administration could consult the opinions during the objection stage both to justify the application of the economic substance doctrine and the penalty.

The *G-I Holdings* case[197] illustrates the dilemma that a taxpayer faces when the tax administration applies the penalty for under-stating tax payable in a notice of reassessment. In this case, the tax administration had issued a notice of reassessment to the taxpayer in which it rescinded the tax benefits that the taxpayer had obtained by recharacterizing the transactions that supported the benefits. It also applied the penalty for under-stating tax payable. In its notice of objection, the taxpayer alleged that if the tax benefits were rejected, the taxpayer must not be subject to a penalty since it had relied on the opinion of its advisers concerning the transactions' compliance with the tax law.

The taxpayer took legal action before a District Court to have the litigation concerning the determination of any under-statement of tax payable dealt with before the litigation focusing on the application of the penalty. The taxpayer thus had the advantage of not having to immediately file with the tax administration all of its advisers' opinions. The tax administration would then have to debate the under-statement by the taxpayer of tax payable without having access to the entire array of documents on which the taxpayer relied to obtain the tax benefits. The following extracts from the court's ruling summarize the taxpayer's position on the disclosure of its advisers' opinions when the taxpayer is facing a penalty for under-stating tax payable:

---

196 See Lynch, "Privilege Versus Transparency," supra note 157, page 121. For an illustration of issues pertaining to the use by the taxpayer of a tax opinion to attempt to avoid a penalty for under-stating tax payable, see the *Long Term Capital Holdings* case (D. Conn.), *supra* note 4. We refer the reader to Instalment 6 of Part II of this study, which examines the application details of this penalty.

197 *In re: G-I Holdings Inc.*, DC N.J., 218 F.R.D. 428; 2003 U.S. Dist. LEXIS 13901 (D. N.J. 2003) [*G-I Holdings*].

> Debtors seek to avoid the "prejudice" of premature waiver of the attorney-client privilege. They argue that in defending against the Government's penalty claims, they might assert a "reasonable cause" affirmative defense. … The affirmative defense provides that no penalty shall be imposed with respect to any portion of underpayment if the taxpayer acted in good faith and there was reasonable cause for such underpayment. 26 U.S.C. § 6664(c)(1) (2003). A taxpayer can demonstrate "reasonable cause" by showing that the taxpayer reasonably relied on professional advice. 26 C.F.R 1.6664-4(b) (2003).
>
> Debtors ask the Court to bifurcate this litigation into substantive tax and penalty phases so that they can delay disclosure of confidential communications with their legal counsel until a penalty phase. Debtors argue that they could then limit their waiver of the attorney-client privilege to the penalty phase only and protect their privileged communications in a substantive tax phase.[198]
>
> [our extracts]

However, the court concluded that the taxpayer had to file the information with the tax administration and, based on the jurisprudence, that the taxpayer had relinquished his privilege of confidential communication in respect of the litigation overall and not solely for the purposes of the penalty for under-stating tax payable. The court noted that the simultaneous filing of all of the documents reduces legal costs and shortens waiting time, which ensures the sound administration of justice both for the parties concerned and the court. The following extracts from the ruling summarize the essential points of the court's reasoning:

> When a party cites legal representation as an affirmative defense to a claim, however, the party puts that advice "at issue" and waives the attorney-client privilege. ...
>
> ...
>
> Debtors argue that they are currently in a position to decide whether to waive their attorney-client privilege. The Court finds, however, that Debtors have already waived the attorney-client privilege with respect to the 1990 Transaction and Subsequent Events. The "reasonable cause" affirmative defense, set forth in Debtors' Response to Government Interrogatory No. 3 of the Government's First Set of Interrogatories, amounts to a "reliance on counsel" defense.
>
> Debtors aim to protect themselves from waiver in General Objection No. 1, where they object to all of the interrogatories to the extent that they seek information subject "to the attorney-client privilege, attorney work product doctrine, or any other applicable privilege."... Debtors, however, destroyed any previously asserted privilege by voluntarily placing the advice of their counsel at issue ... Had Debtors sought to preserve the attorney-client privilege, they should have refrained from raising the advice of counsel altogether.
>
> ...
>
> Debtors argue that the Court could bifurcate this litigation on efficiency grounds, as permitted by Rule 42(b). They claim that the penalties issue will not ripen unless the Government first prevails on the substantive tax claims and that the Court could truncate discovery by excluding potentially unnecessary discovery of penalty issues.
>
> ...

198 *Ibid.,* page 431.

> Debtors' efficiency arguments fails because of this Court's finding that Debtors have already waived the attorney-client privilege with regard to the 1990 Transaction and Subsequent Events. Contrary to Debtors' arguments, the subject matter waiver applies to the entire 1990 Transaction and Subsequent Events and is not limited to the issue of penalties. Even though Debtors waived in response to a penalty-related Interrogatory, established authority supports waiver for the subject matter addressed.
>
> Since there is now subject matter waiver allowing the Government to access relevant communications for tax and penalty phases of litigation, there is no need to bifurcate the trial to limit the waiver to the penalty phase. It is also in the best interest of the Court and the parties to maintain a single discovery phase so that discoverable information with regard to the 1990 Transaction and Subsequent Events need only be produced once. A single trial would lessen the delay, expense, and inconvenience to all parties.[199]
>
> [our extracts]

[199] *Ibid.,* pages 431 to 434.

5

Conclusion

In Canada, the disclosure rules pertaining to aggressive tax planning scheme apply in light of solicitation by promoters. The United States deemed it necessary to broaden the field of application of their disclosure rules in order to collect information both on transactions subject to solicitation and transactions elaborated on an *ad hoc* basis by taxpayers and their advisers.

The approach that the US tax administration advocates concomitantly enhances its detection capacity. It is then able to match the information filed by tax advisers and taxpayers with the taxpayers' income tax returns in order to rescind tax benefits. In the long run, this approach allows the US tax administration to reduce its tax gap. The amounts of tax in question in respect of transactions that are reportable under the disclosure rules appear considerable according to the data published by the US tax administration. No data allows us to reliably determine the tax administration's success rate in collecting these amounts. This rate might be measured according to the amounts of tax and penalties collected in relation to the number of information returns filed.

The Chair is of the opinion that the US approach is likely to attract the attention of all tax administrations, although it believes that no tax administration should blindly copy the US disclosure rules, which are specifically geared to the US tax system. They fit into the other spheres of intervention of the US tax administration and centre, by and large, on the application by the courts of the economic substance doctrine to rescind tax benefits stemming from aggressive tax planning schemes and the risk for taxpayers of having to pay a penalty for under-stating tax payable. The rules also centre, to a large extent, on the US tax administration's resources to process the information filed and audit each taxpayer who has possibly engaged in aggressive tax planning schemes. The Chair believes that neither Canada nor its other trading partners have at their disposal tools that are in every respect identical to those of the US tax administration.

Among the specific features of the US tax administration is the application by the courts of the economic substance doctrine and the parameters of the penalty for under-stating tax payable stipulated by the US *Internal Revenue Code.*

Despite the disclosure rules, the most aggressive taxpayers and advisers could take advantage of grey areas in the law and the jurisprudence and take the risk of carrying out a reportable transaction.[200] The effectiveness of the disclosure rules then depends on the application of the economic substance doctrine, just like the penalty for under-stating tax payable. The following passage from a study conducted by the tax administration focusing on aggressive tax planning schemes illustrates the relationship between these three tools:

> As discussed in Part V.A. with respect to disclosure, in order to assess a penalty, the IRS must discover the questionable transaction. Thus, issues of disclosure and penalties are interrelated. In addition, even if the taxpayer believes the IRS were to discover a questionable transaction, the section 6662 penalty is an effective deterrent only if it can be applied to a substantial understatement. If there is a defect in the underlying substantive law such that the claimed tax benefits are not disallowed and concomitantly no understatement is created, the penalty alone will not be an effective deterrent.[201]
>
> [our extracts]

At the centre of the disclosure rules are what the US tax administration are listed transactions. Since 2000, it has thus designated over 30 transactions based, by and large, on the economic substance doctrine. In this way, the disclosure rules are set out in a manner that focuses more on the impact of the planning scheme on the taxpayer's tax attributes, e.g. the adjusted cost base of an asset, than on the form of the transaction that the taxpayer carries out. The multiplicity of the tax administration's *ad hoc* interventions and uncertainty surrounding the degree of similarity of a transaction to a listed transaction encumbers the compliance duties of taxpayers and advisers overall.

Because of the uncertainty surrounding the parameters of this doctrine, taxpayers might file a substantial volume of information in which the relevant data are buried without the tax administration's being able to identify them in a reasonable manner. In this instance, the Chair

---

200 By way of illustration, see the differences of opinion expressed by the advisers involved in the aggressive tax planning schemes examined by the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs in Committee on Homeland Security, *Role of Professional Firms*, *supra* note 3.

201 Treasury, *Corporate Tax Shelters (1999)*, *supra* note 2, page 86.

believes that the tax administration will have difficulty detecting within a reasonable length of time taxpayers' income tax returns that present a risk of abusive tax avoidance.

On the other hand, taxpayers might refuse to file some information on the grounds that their transactions are not similar to those described in the tax administration's declarations because of the uncertainty surrounding the parameters of the economic substance doctrine. In this case, the Chair is of the opinion that it is virtually impossible for the tax administration to detect within a reasonable length of time taxpayers' income tax returns that present a risk of abusive tax avoidance.

Moreover, taxpayers could refuse to file certain information because of their privilege of confidential communication.

The disclosure rules require the taxpayers to file information concerning listed transactions that they have carried out, while recognizing the taxpayers' privileges of confidential communication may apply to certain documents such as their advisers' opinions. In our view, uncertainty persists on the reconciliation of the disclosure rules and the privilege of confidential communication.

More specifically, the Chair believes that litigation will inevitably arise over the taxpayers' and their advisers' obligation to disclose tax opinions containing information on the taxpayers' purposes. Inasmuch as the essential purpose pursued by the taxpayer in a transaction is central to the application of the economic substance doctrine and the penalty for under-stating tax payable, the tax administration might strategically apply a penalty for under-stating tax payable to taxpayers so that they file the tax opinions of their advisers with a view to avoiding the penalty. Faced with the risk of paying a penalty for under-stating tax payable, the taxpayer might feel compelled to file information that might otherwise be protected by the privilege of confidential communication.

Paradoxically, the tax administration's having declared a transaction to be aggressive for the purposes of the disclosure rules could lead the courts to conclude that the work product doctrine applies to documents elaborated by the taxpayer and his advisers in order to carry out a transaction that may be similar to a listed transaction. In its declarations, the tax administration publicly asserts its intention to rescind the tax benefits by applying the doctrine and imposing the penalty on transactions that are identical or similar to the listed transaction. The work product doctrine may apply to documents in which the taxpayer and his advisers have assessed the likelihood of the courts' supporting the application by the tax administration of the economic substance doctrine and the penalty for under-stating tax payable to the transaction carried out by the taxpayer.

The privacy principle in litigation matters risks preventing the tax administration from completing the audit of the most aggressive taxpayers' income tax returns, especially in respect of listed transactions. Insofar as the courts interpret in a restrictive manner the disclosure rules, the most aggressive taxpayers paradoxically benefit from a broad privilege of confidential communication when they are obtaining tax benefits in a potentially abusive manner.

The Chair is of the opinion that the filing of information that allows for the detection of aggressive tax planning schemes from income tax returns represents a simple way to reconcile the tax administration's and the taxpayers' interests. It should be emphasized that the US tax administration has ultimately adopted this approach in respect of transactions whose accounting and tax treatments display significant disparities.

Under a self-assessment tax system, the Chair believes that taxpayers have the responsibility to state their tax payable according to the application of the tax law and the jurisprudence to the facts underlying their situation, including the jurisprudence pertaining to the economic substance doctrine. The taxpayers and their advisers must file detailed information concerning the facts and details of planning scheme and the nature of the tax benefits claimed in an income tax return, along with the necessary explanations on their interpretation of the tax law and the jurisprudence in support of the benefits claimed.

In a current context where the US tax administration and the taxpayers appear to hold conflicting positions in respect of aggressive tax planning schemes, the privilege of confidential communication in anticipation of litigation is at the centre of debate between these parties concerning the documents that must be filed with the tax administration. The US courts opine that the audit stage can be likened to an antechamber to the litigation stage: documents prepared in anticipation of an “administrative dispute” that arises during the auditing of an income tax return might be protected by this privilege.

Under a self-assessment tax system, taxpayers immediately obtain the tax benefits claimed in their income tax returns. On the other hand, they should then be able to justify these benefits if ever the tax administration detects a risk of avoidance during an administrative audit. The taxpayers should then file the final documents on which they relied to claim the tax benefits, including the weighting of risks related to the withdrawal of the tax benefits and the possible application of a penalty for under-stating tax payable. The simultaneous filing of all of the documents to determine whether the economic substance doctrine and the penalty for under-stating tax payable apply would ensure the sound administration of justice for all of the parties concerned.

Under a self-assessment tax system, litigation risks arising only if the tax administration issues a notice of reassessment that withdraws the tax benefits pursuant to the tax rules or the economic substance doctrine: the documents that the taxpayers and their advisers prepare from that point on could be protected by the privilege of confidential communication.

In order to reconcile the principles of fairness and simplicity in the management of the tax system, the Chair advocates greater transparency in income tax returns so that the tax administration can properly pinpoint the relevant information in order to analyse a transaction’s impact on the tax attributes of the taxpayers who carried it out. According to the Chair, the filing of precise, detailed information on the taxpayers’ tax attributes might enhance the efficacy of the disclosure rules by mitigating differences of opinion on the nature of the information to be disclosed. The information should focus on attributes such as the adjusted cost base of an asset, paid-up share capital, the holding period of assets, the identity of the purchasers and investors, and the financing methods used in the course of the taxpayers’ activities.

In our opinion, such an approach optimizes the work of the auditors by enabling them to focus solely on the income tax returns that present the highest risk of tax avoidance. This may be especially beneficial for a tax administration that does not have the financial resources to increase its staff. The tax administration should nonetheless endeavour to minimize the compliance burden for all taxpayers carrying out routine commercial transactions.

Beyond the nature of the information and the manner in which taxpayers and their advisers must file it with the tax administration, the efficacy of the disclosure rules depends, on the one hand, on compliance by taxpayers and their advisers with the rules and, on the other hand, on the tax administration's resources to act in a timely manner based on the information filed.

The possibility of the taxpayers' being subject to the specific penalty for under-stating tax payable may encourage them to comply with the disclosure rules. Compared with the general penalty, the specific penalty broadens the possibility for the tax administration of collecting information from taxpayers and their advisers concerning aggressive tax planning schemes. Moreover, the application of a penalty for under-stating tax payable without the possibility for taxpayers of avoiding it when they do not fulfil their duties of disclosure strikes us as being fairer than the strict penalty proposed by the economic substance doctrine codification, which obtains once the tax administration and the courts apply this doctrine.

The penalties stipulated for advisers for failure to comply with the disclosure rules should encourage them to maintain a register of reportable transactions. The application by the tax administration of these penalties would allow for broader compliance by taxpayers and their advisers with the disclosure rules. The tax administration could collect more extensive relevant information. Uncertainty persists on the application of the penalty in light of the law and the regulations in force, at least until the tax administration communicates information on their application.[202]

As the US experience shows, the efficacy of the disclosure rules ultimately depends on the possibility for a tax administration to promptly and more readily pinpoint avoidance factors in income tax returns and information returns.

- The listed transactions present the highest risk of abusive tax avoidance. Since the US tax administration has listed over 30 transactions, it should first have at its disposal the appropriate tools and necessary resources to pinpoint these transactions before declaring them to be listed transactions.

---

202 The American tax administration had published temporary statutory regulations with the intention of publishing the final regulations in late 2006: US, Treasury Inspector General for Tax Administration, *The Internal Revenue Service Provided Interim Guidance and Plans to Take Additional Actions to Implement New Tax Shelter Penalty Provisions*, (2006-30-058), March 2006.

- The US tax administration is seeking to obtain additional staff to audit the income tax return of every taxpayer who has disclosed his participation in a reportable transaction. An extended reassessment period must allow the tax administration reasonable time to complete the audit of a taxpayer's affairs. However, the US tax administration was of the opinion that the extended reassessment period now called for under the US *Internal Revenue Code* might seem too brief because of a shortage of auditors to handle complex transactions.

To adequately protect the integrity of the tax system, any tax administration must have at its disposal sufficient auditors to target aggressive tax planning schemes. This is especially important when, following the example of the US tax administration, a tax administration relies on the disclosure rules to first identify taxpayers who have carried out aggressive tax planning schemes in order to rescind the tax benefits stemming therefrom according to a general rule or a legal doctrine instead of adopting specific rules to counter each scheme.

By way of indication, the US tax administration has reached out-of-court settlements with aggressive taxpayers after proposing settlement offers to those identified through the disclosure rules. It was thus able to collect roughly $4.7 billion in 2005, i.e. a portion of the amounts of tax otherwise avoided.[203] This might be explained by the fact that the tax administration intends to apply the economic substance doctrine to rescind the tax benefits stemming from reportable transactions, in particular listed transactions, and a penalty for under-stating tax payable depending on the circumstances. In the US context, settlement offers complement the other tools adopted by the tax administration distributed in its other spheres of intervention. Instalment 9 of Part II of this study by the Chair on aggressive tax planning schemes examines US settlement offers.

[203] Instalment 9 of this study examines settlement offers.

Bibliography

Legislation and regulations

United States statutes

American Jobs Creation Act of 2004, Pub. L. No. 108-357 (October 22, 2004).

Small Business and Work Opportunity Tax Act of 2007, Pub. L. 110–28 (May 25, 2007).

Internal Revenue Code, 26 U.S.C.

United States regulations, including draft regulations and other documents of a statutory nature

Code of Federal Regulations, 26 and 31 C.F.R.

Federal Rules of Civil Procedure (U.S. Government Printing Office: Washington, DC, December 1, 2007).

US, Department of the Treasury (Internal Revenue Service). Notice 2008-99, "Transaction of Interest – Potential for Avoidance of Tax Through Sale of Charitable Remainder Trust Interest" (October 31, 2008), to be published in 2008-47 I.R.B. (November 24, 2008).

US, Department of the Treasury (Internal Revenue Service). Rev. Proc. 2008-20, 2008-20 I.R.B. 980 (May 19, 2008).

US, Department of Treasury (Internal Revenue Service). "Patented Transactions: Hearing," REG-1299916-07, RIN 1545-BG76 (January 10, 2008), 73:7 FR 1851.

US, Department of Treasury (Internal Revenue Service). "Patented Transactions," REG-129916-07, RIN 1545-BG76 (September 26, 2007), 72:186 FR 54615.

US, Department of the Treasury (Internal Revenue Service). Notice 2007-72, "Transaction of Interest – Contribution of Successor Member Interest" (August 14, 2007), 2007-36 I.R.B. 544 (September 4, 2007).

US, Department of the Treasury (Internal Revenue Service), Notice 2007-73, "Transaction of Interest – Toggling Grantor Trust" (August 14, 2007), 2007-36 I.R.B. 545 (September 4, 2007).

US, Department of the Treasury (Internal Revenue Service), Final Regulations RIN 1545-BE24, TD 9350, *ACJA Modifications to the Section 6011 Regulations* (August 3, 2007), 72:149 F.R 43146.

US, Department of the Treasury (Internal Revenue Service). Final Regulations RIN-1545-BE26, TD 9351, *AJCA Modifications to the Section 6111 Regulations* (August 3, 2007).

US, Department of the Treasury (Internal Revenue Service). *ACJA Modifications to the Section 6011 Regulations,* RIN 1545-BE24, TD 9350 (August 3, 2007), 72:149 FR 43146.

US, Department of the Treasury (Internal Revenue Service). Rev. Proc. 2007-21, 2007-9 I.R.B. 613 (February 26, 2007).

US, Department of the Treasury (Internal Revenue Service). Rev. Proc. 2007-20, 2007-7 I.R.B. 517 (February 12, 2007).

US, Department of Treasury (Internal Revenue Service). Final and Temporary Regulations, RIN 1545-BF98, TD 9295, *ACJA Modifications to the Section 6011, 6111 and 6112 Regulations* (November 2, 2006).

US, Department of Treasury (Internal Revenue Service). Notice of Proposed Rulemaking REG-103038-05, RIN 1545-BE24, *AJCA Modifications to the Section 6011 Regulations* (November 2, 2006).

US, Department of Treasury (Internal Revenue Service). Proposed Regulations REG-103039-05, RIN 1545-BE26, “ACJA Modifications to the Section 6111 Regulations” (November 2, 2006).

US, Department of Treasury (Internal Revenue Service). Proposed Regulations REG-103043-05, RIN 1545-BE28, “ACJA Modifications to the Section 6112 Regulations” (November 2, 2006).

US, Department of Treasury (Internal Revenue Service). IR-2006-167, “Treasury, IRS Issue Regulations on Requirement for Disclosing Reportable Transactions and Maintaining Lists” (November 1, 2006).

US, Department of the Treasury (Internal Revenue Service). Notice 2006-16 “Tax Avoidance Using Notional Principal Contracts” (February 13, 2006).

US, Department of the Treasury (Internal Revenue Service). Notice 2006-6, “Notification of Removal of the Transaction with a Significant Book-Tax Difference Category of Reportable Transactions under 1.6011-4” (January 6, 2006).

US, Department of the Treasury (Internal Revenue Service). Notice 2005-11, “New Penalty Section 6707A and Rescission Penalty,” 2005-7 I.R.B 493 (February 14, 2005).

US, Department of the Treasury (Internal Revenue Service). Notice 2004-80, “Temporary Rules Under Sections 6111 and 6112” (November 16, 2004).

US, Department of Treasury (Internal Revenue Service). IR 2004-138, “Treasury and IRS Issue Guidance on New Requirements for Disclosing Reportable Transactions” (November 16, 2004).

US, Department of the Treasury (Internal Revenue Service). Notice 2003-54, “Common Trust Fund Straddle Tax Shelter” (July 16, 2003), 2003-33 I.R.B. 363 (August 18, 2003).

US, Department of the Treasury (Internal Revenue Service). Final Regulations T.D. 9046, “Tax Shelter Regulations,” 2003-12 I.R.B. 614 (March 24, 2003).

US, Department of the Treasury (Internal Revenue Service). Final Regulations TD9046, RIN 1545-AX81, 1545-BB49; 1545-BB50; 1545-BB48; 1545-BB51; 1545-BB52, 1545-AW26; 1545-AX79, *Tax Shelter Regulations*, (March 4, 2003, as amended on April 2, 2003).

US, Department of the Treasury (Internal Revenue Service). Notice 2002-65, "Passthrough Entity Straddle Shelter" (September 25, 2002), 2002-41 I.R.B. 690 (October 15, 2002).

US, Department of the Treasury (Internal Revenue Service). Notice 2002-50, "Partnership Straddle Tax Shelters" (June 25, 2002), 2002-28 I.R.B. 98 (July 15, 2002).

US, Department of the Treasury (Internal Revenue Service). Notice 2000-15, "Listed Transactions," 2000-12 I.R.B. 826 (March 20, 2000).

US, Department of the Treasury (Internal Revenue Service). Announcement 2000-12 "Disclosure Requirements for Corporate Tax Shelters," 2000-12 I.R.B. 835 (March 20, 2000).

US, Department of the Treasury (Internal Revenue Service). Temporary Regulations T.D. 8877, "Tax Shelter Disclosure Requirements," 2000-11 I.R.B. 747 (March 13, 2000).

US, Department of the Treasury (Internal Revenue Service). Temporary Regulations T.D. 8876, "Corporate Tax Shelter Registration," 2000-11 I.R.B. 753 (March 13, 2000).

US, Department of the Treasury (Internal Revenue Service). Notice of Proposed Rulemaking and Notice of Public Hearing REG-110311-98, "Corporate Tax Shelter Registration," 2000-11 I.R.B. 767 (March 13, 2000).

Forms and guides

US, Department of the Treasury (Internal Revenue Service). *Form 13976: Itemized Statement Component of Advisee List* (April 2008).

US, Department of the Treasury (Internal Revenue Service). Form 8918, *Material Advisor Disclosure Statement* (Rev. October 2007).

US Department of the Treasury (Internal Revenue Service). Instructions 8918, *Instructions for Form 8918* (Rev. October 2007).

US, Department of the Treasury (Internal Revenue Service). *Form 8886 Reportable Transaction Disclosure Statement* (Rev. December 2005).

US, Department of the Treasury (Internal Revenue Service)*. Instructions for Form 8886* (Rev. December 2005).

Jurisprudence

BDO Seidman, LLP v. *United States* (July 23, 2003), 337 F.3d 802 (7th Cir. 2003).

Black & Decker Corp. v. *Commissioner*, 436 F.3d 431, 441 (4th Cir. 2006); No. 05-1015, CA-02-2070-WDQ (February 2, 2006).

Cultic Indus., Inc. v. *United States*, 454 F.3d 1340 (Fed. Cir. App. 2006), 2006 U.S. App. LEXIS 24771 (Fed. Cir. App. 2006), (July 12, 2006) U.S. Court of Appeals for the Federal Circuit, 05-5111, cert. denied by the United States Supreme Court: *Cultic Indus.* v. *United States*, 2007 U.S. LEXIS 2087 (U.S., 2007).

Doe. v. *KPMG, L.L.C.*, 325 F. Supp. 2d 746, 2004 U.S. Dist. LEXIS 6191 (N.D. Tex. 2004).

Evergreen Trading, LLC v. *United States*, No. 06-123 (U.S. Ct. Clms, December 21, 2007).

Howa Trading LLC et al. v. *United States of America* (June 2, 2008), Charlotte 3:07CV324-R (W.D. N.C.).

In re: G-I Holdings Inc., DC N.J., 218 F.R.D. 428; 2003 U.S. Dist. LEXIS 13901 (D. N.J. 2003).

Long Term Capital Holdings v. *United States*, 330 F. Supp. 2d.122, 2004 U.S. Dist. LEXIS 17159 (D. Conn. 2004), ruling upheld on appeal by 150 Fed. Appx. 40, U.S. App. LEXIS 20988 (2nd Cir. 2005).

United States v. *Adlman*, 134 F.3d 1194; 1998 U.S. App. LEXIS 2633 (2nd Cir. 1998).

United States v. *Arthur Andersen, LLP*, 2003 U.S. Dist. LEXIS NEXIS 14228 (N.D Illinois 2003).

United States v. *BDO Seidman, LLP*, 2004 U.S. Dist. LEXIS 12145 (N.D. Ill. June 28, 2004).

United States v. *BDO Seidman, LLP*, 2005 U.S. Dist. LEXIS 5555 (N.D. Ill. March 30, 2005).

United States v. *BDO Seidman LLP*, 2005 U.S. Dist. 12363 (N.D. Ill. May 17, 2005).

United States v. *Frederick*, 182 F.3d 496; U.S. App. LEXIS 7420 (7th Cir. 1999).

United States v. *KPMG LLP*, 316 F. Supp. 2d 30; 2004 U.S. Dist. LEXIS 8106 (D. DC).

United States of America v. *Roxworthy*, 457 F. 3d 590 (6th Cir. 2006).

United States v. *Textron*, CA 06-198T, August 28, 2007 (D. R. I.).

Doctrine

Government publications

United States

US, Department of the Treasury. *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* (July 1999).

US, General Accountability Office. Report to the Committee on Finance (US Senate). *Tax Administration: Additional Time Needed to Complete Offshore Tax Evasion* (GAO-07-237), Washington DC, United States Government Printing Office, March 2007.

US, Government Accountability Office. Report to the Secretary of Treasury, *Financial Audit: IRS's Fiscal Years 2005 and 2004 Financial Statements* (GAO-06-137), November 2005.

US, Government Accountability Office. *Tax Shelters: Services Provided by External Auditors Report to the Ranking Minority Member, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs (U.S. Senate)* (GAO-05-171), February 2005.

US, Government Accountability Office. Report to the Secretary of the Treasury, *Financial Audit IRS's Fiscal Years 2006 and 2005 Financial Statements,"* (GAO-07-136), November 2006.

US, Joint Committee on Taxation. *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05) Washington, DC, United States Government Printing Office, May 2005.

US, Joint Committee on Taxation. *Estimated Budget Effects of the Conference Agreement for H.R. 4250, the American Jobs Creation Act of 2004* (JCX-69-04), October 7, 2004.

US, Joint Committee on Taxation. *Background and Present Law Relating to Tax Shelters* (JCX-19-02), Washington, DC, United States Government Printing Office, March 19, 2002.

US, Internal Revenue Service. IR-2007-103, "Sidley & Austin LLP Pays IRS $39.4 Million Penalty" (May 23, 2007).

US, Internal Revenue Service. IR-2007-71, "Jenkens & Gilchrist Admits It Is Subject to $76 million IRS Penalty" (March 29, 2007).

US, Internal Revenue Service (National Taxpayer Advocate Division). *2006 Annual Report to Congress*.

US, Internal Revenue Service (National Taxpayer Advocate Division). *2005 Annual Report to Congress*.

US, Internal Revenue Service. Announcement 2002-63, "Request for Tax Accrual and Other Financial Audit Workpapers" 2002-27 I.R.B. 72 (July 8, 2002).

US, Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs (US Senate). *The Role Of Professional Firms In The U.S. Tax Shelter Industry* (S. Rep. No. 109–54) Washington, DC, United States Government Printing Office, April 13, 2005.

US, Treasury Inspector General for Tax Administration. *The Settlement Initiative for Investors in a Variety of Bond and Option Sales Strategies Was Successful and Surfaced Possible Next Steps for Curtailing Abusive Tax Shelters* (2006-30-065), March 2006.

US, Treasury Inspector General for Tax Administration. *The Internal Revenue Service Provided Interim Guidance and Plans to Take Additional Actions to Implement New Tax Shelter Penalty Provisions*, (2006-30-058), March 2006.

US, US House of Representatives. H.R. Rep. No. 148, 105th Cong., 1st Sess. 469 (1997).

US, US Senate. S. Rep. No. 33, 105th Cong., 1st Sess. 148 (1997).

Periodicals, congresses, symposia and reviews

Beale, Linda M. "Tax Advice Before the Return: The Case For Raising Standards and Denying Evidentiary Privileges" (2006) 25:3 Virginia Tax Review 583.

Ford, Brian R. "Helter Shelter: Protecting Taxpayers' Identities in Tax-Shelter Cases" (2005) 18:3 Geo. J. Legal Ethics 723.

Lynch, James M. "War of the [Tax] Worlds: Privilege Versus Transparency" (2004) 82:3 Taxes 89.

Raby, Burgess J.W. and Raby, Willam L. "Penalty Protection Tax Opinions and Work Product Privilege" (October 23, 2006) 113 Tax Notes 321.

Sheppard, Lee A. "News Analysis: Textron Case Expands Work Product Privilege" (September 10, 2007), 116 Tax Notes 917, 2007 TNT 176-6.

Simmens, Todd. "IRS Treats Protective Disclosure Inconsistently" (2006) 37:7 Tax Adviser 426.

Stratton, Sheryl. "With Six-Year Statute, IRS Pulls Out All Assessment Stops for Shelters" (May 1, 2006) 111 Tax Notes 536.

Walsh, Joe. "Circular 230 Sets Stringent Requirements for Written Advice" (2005) 75:4 Practical Tax Strategies 196.

Miscellaneous

American Bar Association (Section of Taxation). Letter to the Commissioner of Internal Revenue Service. Comments Concerning Notice 2004-80 (Interim Guidance under IRC 6111, 6112 and 6708), February 7, 2005. Online on the ABA Website: <http://www.abanet.org/tax/pubpolicy/2005/050207tstf.pdf>.

Brostek, Michael (Director, Internal Revenue Service). Testimony, "Challenges Remain in Combatting Abusive Tax Shelters," before the US Senate Committee on Finance (GAO-04-104T) October 21, 2003.

Everson, Mark (Commissioner of Internal Revenue Service). Testimony. "Prepared Testimony of Commissioner of Internal Revenue Mark W. Everson Before the Permanent Subcommittee on Investigations Committee on Governmental Affairs United States Senate Hearing on Abusive Tax Shelters" (November 20, 2003).

George, Hon. J. Russell (Treasury Inspector General for Tax Administration). "A Closer Look at the Size and Sources of the Tax Gas," hearing before the US Senate Committee on Finance Subcommittee on Taxation and IRS Oversight, Washington, DC, July 26, 2006. Online on the TIGTA Website: <http://www.treas.gov/tigta/congress/congress_07262006.pdf>.

New York State Bar Association (Tax Section). Letter to the Commissioner of Internal Revenue Service. Re: *Report on Reportable Transaction Disclosure and List Maintenance Regulations*, January 22, 2007.

New York State Bar Association (Tax Section). *Application of the IRC §§6111 and 6112 Material Advisor Rules to Law and Accounting Firms*, Report No. 1109 (May 5, 2006). Online on the NYSBA Website: <http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1109rpt.PDF>.

New York State Bar Association (Tax Section). *Report on Disclosure by Material Advisors*, Report No. 1080 (February 23, 2005). Online on the NYSBA Website: <http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1080rpt.pdf>.

Tax Executives Institute, Inc. Letter to the US Senate Committee on Finance, *S. 2020 - Tax Relief Act of 2005* (January 10, 2006). Online on the TEI Website: <http://www.tei.org/dman/Document.phx?documentId=zy01806153814028>.

Thomson, Samuel Jr. (Director, Law Center, University of California). Testimony, "Testimony Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means" given before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means" (May 9, 2006). Online on the House Committee on Ways and Means Website: <http://waysandmeans.house.gov/hearings.asp?formmode=view&id=4940>.

Walker, David M. (Comptroller General of the United States). Testimony before the US Senate Finance Committee. "Tax Compliance: Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting" (GAO-06-85IT) Washington, DC, United States Government Printing Office, June 13, 2006.

Websites

American Bar Association: <http://www.abanet.org/>.

Internal Revenue Service : <http://www.irs.gov>.

Joint Committee on Taxation: <http://www.jct.gov>.

New York State Bar Association (Tax Division): <http://www.nysba.org>.

United States House of Representatives: <http://www.house.gov>.

United States Senate: <http://www.senate.gov>.

United States Tax Court: <http://www.ustaxcourt.gov>.

U.S. Department of Treasury: <http://www.treas.gov/>.

U.S. General Accountability Office: <http://www.gao.gov>.

U.S. General Publishing Office: <http://www.gpoaccess.gov>.

U.S. Treasury Inspector of General Tax Administration: <http://www.ustreas.gov/tigta/>.

Tax Executive Institute: <http://www.tei.org>.