Potential Tax Shelter Disclosure Obligation Without Tax Planning

by Sarah-Jane Morin

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In this article, Morin examines instances in which tax advisers may have a reporting obligation for loss transactions.

Treasury, the IRS, and the courts have several ways to catch transactions that they view as abusive: There is the codification of the economic substance doctrine under section 7701(o); there are tax regulations requiring disclosure of uncertain tax positions; there are SEC disclosure requirements for UTPs; and there are judicial antiabuse doctrines, such as substance over form and business purpose, available to challenge perceived abusive transactions. Ultimately, it seems logical and appropriate that the goal and outcome of these various methods is to help catch tax cheats within a reasonable margin of error. But what if there were a method that penalized taxpayers and their advisers for transactions that involved little or no affirmative tax planning and no abusive component?

There is such a method. Under the reportable transaction regulations of section 6011, it is feasible for a taxpayer, as well as its adviser, to be subject to tax shelter reporting rules simply because the taxpayer suffered a loss.[1] The loss may have been planned from a tax perspective to help shelter income in an abusive manner. But more often, the loss was probably unplanned from a tax perspective or at least wasn't planned to accomplish a nefarious tax shelter result.

Being subject to the reporting rules does not necessarily mean that the taxpayer or its adviser did anything improper from an abusive tax perspective. However, taxpayers and their advisers should be aware of their potential reporting obligation. Failure to comply with this reporting regime can result in significant penalties.

Background

The reportable transaction regulations were implemented to curb abusive tax shelter transactions. The transactions at issue are in some cases listed with specificity by the IRS and published for review. Others are identified by their similarity to listed transactions or by potentially abusive factors, such as transactions carried out under confidential terms or transactions in which the adviser receives a fee above a threshold amount in exchange for the tax planning. In theory, these categories generally make sense because they identify a set of transactions that might necessitate heightened review to determine if they are abusive.

But one category arguably makes less sense in that respect. This category encompasses transactions that generate a section 165 loss above a threshold amount. The threshold loss amounts vary by taxpayer:

- $10 million in a single year, or $20 million in any combination of years, for corporations and for partnerships that have only corporate partners;

[1] Reg. section 1.6011-4(b)(5).

- $2 million in any single year, or $4 million in any combination of years, for all other partnerships and for individuals, S corporations, and trusts; and
- $50,000 in any single year for individuals or trusts if the loss arises from a section 988 transaction (specific foreign currency transactions).[2]

Trap for the Unwary?

Presumably, the theory behind this loss category is that a tax shelter transaction often involves the generation of a loss, and that loss in turn may be used to shelter income in an abusive manner. Of course, the (gaping) hole in this theory is that many taxpayers find themselves with a loss transaction over the course of operating their business or otherwise — a loss that was unplanned or unexpected and reflects a true economic hit (that is, it was not an abusive tax planning loss, and it had real economic effect for the taxpayer). Nevertheless, assuming that relevant loss thresholds are met, this type of loss transaction may be subject to reporting by both the taxpayer and any of its advisers involved in the loss-generating transaction.

Consider an example.[3] A partnership taxpayer uses an alternative investment strategy in which it routinely invests in hedge funds in an attempt to bet against the market.[4] This is a typical hedging strategy. The taxpayer assumes that it will generate losses at times because the market may go up whereas the taxpayer is hedged against the market. In fact, the taxpayer decides to trigger a loss by withdrawing from a particular hedge fund. The taxpayer has no abusive tax motive in doing so — it is simply following its investment strategy. Yet this taxpayer is now subject to the reportable transaction regulations, assuming it triggered a loss exceeding the statutory threshold.

Now assume that before withdrawing from the hedge fund, the taxpayer consulted its attorney to discuss any potential unexpected tax consequences. Perhaps the taxpayer wanted to double-check on hot asset issues or similar issues. The attorney never asked about the magnitude of the loss that would be triggered. Even though the attorney wasn't engaged primarily to advise on the creation of a loss, she (as well as the taxpayer) may be subject to the reportable transaction regulations.

Note that an adviser's obligation to report a transaction may depend on the type of taxpayer being represented. If, for example, the loss transaction involves a corporate client, the reporting loss threshold is $10 million for any tax year or $20 million in any combination of years. Compare that with the respective $2 million and $4 million thresholds for partnerships that do not have only corporations as partners. Thus, a $5 million loss might trigger a disclosure obligation for the adviser if the client is a partnership but not if it is a corporation.

Exception for Qualifying Basis Loss Transactions

The IRS has, through a series of revenue procedures, tried to limit the loss transactions that must be reported.[5] In that guidance, the IRS takes the position that a loss is not reportable if it involves assets that have a qualifying basis. Qualifying basis is essentially basis attributable to a taxpayer's original cash investment.[6]

As some have pointed out, this exception arguably almost swallows the rule because often taxpayers will have qualifying basis and therefore not have a reportable loss.[7] Unfortunately, this carveout for qualifying basis loss transactions doesn't apply to losses generated by assets that are interests in a passthrough entity, other than regular interests in a real estate mortgage investment conduit.[8] Thus, we are brought back to our example of the seemingly innocuous hedge fund withdrawal that may trigger a reporting obligation under the reportable transaction rules.

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[2] Reg. section 1.6011-4(b)(5)(i).

[3] For a similar example, see Megan L. Brackney, "Reporting Loss Transactions: Too Much of a Good Thing," 59 *N.Y.L. Rev.* 37 (2014).

[4] Note that the reportable transaction rules consider a partnership a taxpayer for these purposes. Reg. section 1.6011-4(c)(1) (referencing section 7701(a)(1)).

[5] *E.g.*, Rev. Proc. 2003-24, 2003-1 C.B. 599; Rev. Proc. 2004-66, 2004-2 C.B. 966; Rev. Rul. 2009-9, 2009-14 IRB 735; and Rev. Proc. 2013-11, 2013-2 IRB 269.

[6] Rev. Proc. 2013-11.

[7] Jasper L. Cummings, Jr., "Why Are Losses So Troublesome?" *Tax Notes*, Feb. 11, 2019, p. 617.

[8] Rev. Proc. 2013-11.

Advice for Advisers

How do you know if you advised the taxpayer in a manner that triggers a reporting obligation for purposes of these rules? The regulations provide that, among other requirements, an adviser is subject to the regulations if she made a "tax statement" to a taxpayer regarding the transaction at issue (and assuming, of course, that the transaction otherwise falls within a reportable transaction category).

A tax statement is any oral or written statement that relates to a tax aspect of a transaction that causes the transaction to be reportable.[9] A statement relates to a tax aspect if it concerns an item that gives rise to a loss as described in the reportable transaction regulations.[10] Well, that's pretty broad.

Using the earlier hypothetical, does this mean that drafting a disclosure to the hedge fund's investors about their exit from the underlying investment triggers a reporting obligation? Maybe. What about a call with one of the fund's principals about the reasons they are exiting the investment and how it may affect the different tax profiles of investors? Again, maybe. Advisers will want to be cognizant of these potential triggers.

Failing to comply with a reporting obligation results in penalties, and those penalties do not depend on whether the transaction is inherently abusive. In other words, an adviser cannot avoid penalties just because the IRS reviews the transaction and determines that it is not an abusive tax shelter or because the adviser believes the transaction is not abusive (even if the IRS agrees with the adviser). This is effectively a strict liability standard. Given that penalties are at stake, advisers are themselves well advised to review transactions in light of the reportable transaction regulations.

If you encounter a situation in which you think you might have a reporting obligation as an adviser, you might consider a protective filing to avoid potential penalties. Protective disclosures are allowable under the reportable transaction regulations,[11] and they can be the "better safe than sorry" route in many cases. The problem with this route, of course, is that you are bringing the transaction to the IRS's attention on the equivalent of a silver platter, allowing the agency to review the losses in detail for potential abuse. And that's something the client might understandably object to.

A delicate balance between the interests of the adviser and client must be undertaken. At a minimum, it would be best practice to ensure your client is in the loop before you make a protective disclosure. The client may want to review the disclosure with sufficient time to provide input. And in many cases, this all happens because you advised — perhaps incidentally, in your view — on a nonabusive loss transaction. ■

[9] Reg. section 301.6111-3(b)(2)(ii)(A).

[10] Reg. section 301.6111-3(b)(2)(ii)(D).

[11] Reg. section 1.6011-4(f)(2).