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IRS Settlement Initiatives Relating to Tax Shelters

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There has been substantial publicity recently regarding IRS efforts to combat various tax shelter transactions that have been promoted by the large accounting firms and others. To attempt to resolve, without protracted litigation, tax deficiencies asserted or likely to be asserted against taxpayers that have engaged in such transactions, the IRS announced on October 4 settlement offers and procedures relating to two types of tax shelter transactions, and the termination later this year of settlement offers previously made relating to a third tax shelter.

Corporate-Owned Life Insurance (COLI)

Tax-oriented COLI transactions typically involved the purchase by a corporation of whole life insurance policies with respect to a large pool of employees. Under some such arrangements, premiums for the policies were paid through borrowings against the value of the policies. The corporation would seek to deduct the interest expense, while benefiting from the anticipated "inside build-up" in the value of the policies without any current tax on the increases in value.

The possible tax benefits from COLI transactions have been severely reduced over the years by changes to the Internal Revenue Code, and the IRS has successfully litigated several cases in which tax benefits expected to be derived from COLI transactions were denied. The IRS has offered settlement terms to other taxpayers that engaged in COLI transactions pursuant to an initiative that, as described by the Chief Counsel to the IRS in a recent speech, generally required taxpayers to concede 80% of the interest deductions relating to the COLI plans.

Announcement 2002-96 (2002-43 I.R.B. 756) states that taxpayers identified as having COLI plans have been notified by letter of the imminent termination of the settlement initiative. A taxpayer wishing to participate in the settlement offer relating to COLI (on terms described below) must mail to the IRS an offer to settle within 45 days after being notified by the IRS by letter of the termination of the settlement initiative, or in any event by November 18, 2002, if the taxpayer does not receive a letter from the IRS by October 18.

The written offer to settle must include the taxpayer's offer to concede 80% of the claimed interest deductions related to COLI, and the taxpayer must agree to sign a closing agreement providing that the amounts disallowed as interest deductions will not be allowable as deductions under any other provision of the Code for any year or as adjustments to basis.

Basis-Shifting Transactions

A second initiative relates to a category of basis-shifting transactions, previously described in IRS Notice 2001-45 (2001-33 I.R.B. 129), that are referred to in Announcement 2002-97 (2002-43 I.R.B. 757) as "section 302/318 basis-shifting transactions."

These transactions typically involved the redemption of stock in a foreign corporation (often a bank) owned by an entity that was not subject to U.S. tax or was otherwise indifferent to U.S. tax consequences. The entity owning the stock that was redeemed was in some way related to, or affiliated with, a U.S. taxpayer that also acquired stock in the same foreign issuer.

By means of options or other techniques taking advantage of the "constructive ownership" rules under Code section 318, the related entity would be viewed for U.S. tax purposes as receiving the proceeds of the stock redemption as a dividend, rather than in connection with a disposition of stock. However, because of its tax status, the related entity, which generally was not subject to U.S. taxation on its dividend income, would not be disadvantaged by this characterization.

Meanwhile, the U.S. taxpayer would allegedly be entitled, pursuant to regulations under Code section 302, to increase the basis of its stock in the foreign issuer by an amount equal to all or part of the redeemed shareholder's basis. The taxpayer would then dispose of its stock and other interests in the foreign corporation and claim a loss computed by reference not only to its own investment, but also that of the related entity.

Taxpayers that have engaged in basis-shifting transactions that are the same as, or substantially similar to, those described above and that meet the eligibility requirements of Announcement 2002-97 will be allowed to resolve issues relating to such transactions on the terms described in the Announcement. A taxpayer that already has a docketed court case relating to a basis-shifting transaction, however, is not eligible.

The settlement terms include: (i) that any gain or loss from the taxpayer's purchase and sale of shares will be reported in accordance with the terms of those transactions, but without regard to the claimed basis shift or transaction costs (as defined below); (ii) that 80% of the claimed basis shift will be conceded, with any loss resulting from the remaining 20% of the basis shift being apparently allowed; and (iii) that 80% of transaction costs will be conceded and 20% will be treated as a capital loss.

For purposes of the settlement initiative, actual transaction costs relating to the basis-shift transaction are disregarded (and agreed to be nondeductible). Instead, transaction costs are deemed to equal 8% of the sum of the amount of the basis shift and the cost to the taxpayer of options or warrants that it held in the related tax-indifferent entity that was a party to the basis-shift transaction.

The accuracy-related penalties will not apply to basis-shift transactions settled under this initiative that were previously disclosed pursuant to Announcement 2002-2 (2002-2 I.R.B. 304), which provided for relief from penalties with respect to certain tax shelters and other transactions disclosed by April 23, 2002. Other transactions may be subject to penalties "based on the merits of the case, including whether the transaction was otherwise voluntarily disclosed."

A taxpayer seeking to resolve a basis-shift case pursuant to the terms of Announcement 2002-97 must contact the IRS by December 3, 2002. If a taxpayer is already under examination for the years with respect to which benefits from the basis-shifting transaction were claimed, the taxpayer must notify the examining agent. Otherwise, the taxpayer must send a letter to the IRS Office of Tax Shelter Analysis with information specified in the Announcement.

Contingent Liability Transactions

The contingent liability transactions addressed by Rev. Proc. 2002-67 (2002-43 I.R.B. 733), which are the same as or similar to transactions previously described in Notice 2001-17 (2001-1 C.B. 730), generally involved a transfer of assets with a substantial value and tax basis by a corporation to a controlled corporation in a transaction allegedly within the scope of Code section 351, in exchange for stock and the transferee's assumption of a liability of the transferor that had not yet been taken into account for tax purposes.

The transferor would then sell the stock so received and claim a capital loss, on the premise that its basis in the stock of the transferee was equal to the bases of the assets transferred without reduction for the liability assumed. Separately, the transferee would claim the tax benefits associated with the liability at the time the liability was taken into account for tax purposes.

To elect to resolve issues in dispute relating to such contingent liability transactions, a taxpayer must file an application, in the form of the agreement appended as an exhibit to Rev. Proc. 2002-67, by January 2, 2003. The application must be accompanied by a statement with specified information regarding the transaction.

The transaction must also meet certain eligibility criteria set forth in the Revenue Procedure, including (i) that the contingent liability must have been assumed on or before October 18, 1999, and (ii) that the transaction must not be in litigation in the form of a docketed case. (Assumptions of liabilities after October 18, 1999, are subject to Code section 358(h), which was adopted to preclude tax benefits from transactions such as those described above.)

The Revenue Procedure gives certain taxpayers a choice between two settlement procedures, referred to as the "Fixed Concession Procedure" and the "Fast Track Dispute Resolution Procedure."

Under the Fixed Concession Procedure, the taxpayer is permitted a capital loss deduction equal to 25% of the capital loss reported on the sale of the stock, but, to prevent a duplication of tax benefits, an amount equal to the capital loss must be included in the taxpayer's income ratably over a period of 15 years beginning with the 2003 taxable year (or in a different manner that achieves the same economic result, based on a specified discount rate).

Any tax benefits associated with the assumed contingent liability, as and when taken into account by the corporation entitled to those tax benefits, are not affected by the settlement, and no adjustment is made to deductions for transaction costs. Further, no penalties under Code section 6662 will be imposed with respect to settlements under the Fixed Concession Procedure.

The Fast Track Dispute Resolution Procedure describes a more complicated process under which (i) there is an initial period for the exchange of information and legal argument between the taxpayer and the IRS and for settlement negotiations, and (ii) if settlement negotiations are not successful, the parties must take part in a binding "baseball arbitration" procedure to determine the most appropriate settlement figure, based on the hazards of litigation. The arbitrator's decision must result in disallowance of between 50% and 90% of the capital loss reported on the sale of the stock, "depending on the merits of the case."

Under the Fast Track procedure, the parties may negotiate or arbitrate the identity of the corporation entitled to the tax benefits associated with the deduction of the assumed liability, the manner and timing of the reduction in tax benefits associated with the overall transaction, and the application of any penalty proposed under Code section 6662. Penalties under section 6662 will not apply if the transaction was previously disclosed in accordance with Announcement 2002-2.

Observations

The settlement initiatives described above appear to reflect consideration by the IRS of the relative merit or lack of merit of the taxpayers' positions in each of these three types of transactions and of the hazards and costs of litigation, with the settlement terms for the COLI transactions (where the IRS has had a strong record in litigation) and the Section 302/318 basis-shift transactions being apparently stingier than those being offered with respect to the contingent liability transactions.

Whether these settlement offers represent good tax policy is unclear. There is an obvious benefit to affected taxpayers, the IRS, and the judicial system generally in avoiding the costs and delays associated with extended tax shelter litigation. Conversely, however, the announced willingness of the IRS to settle these cases for less than "100 cents on the dollar" rather than to litigate them may cause more corporations and individual taxpayers to view the reasonably likely potential downside of marketed tax-motivated transactions that are arguably abusive, including the potential for interest charges (not abated under any of the above programs), additions to tax and penalties, as being less onerous than they might have previously feared.

With respect to taxpayers that are potentially within the scope of the settlement initiatives described above, the Announcements and Revenue Procedure obviously merit close scrutiny, bearing in mind that relatively quick action will be necessary to take advantage of these programs.

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