OTPA

New York State Department of Taxation and Finance

Office of Tax Policy Analysis

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New York State Tax Shelter Voluntary Compliance Initiative

October 1, 2005 through March 1, 2006

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Executive Summary

Pursuant to legislation enacted in support of the 2005-06 Executive Budget, the Department of Taxation and Finance conducted a Voluntary Compliance Initiative (VCI) beginning October 1, 2005 and ending March 1, 2006. This report fulfills a requirement of the legislation.

The program was developed as part of New York State's response to the increased marketing of abusive tax shelter strategies. Targeted to wealthy individuals and businesses, these schemes typically create artificial losses to offset real income. Federal estimates indicate that abusive tax shelters contribute significantly to the "tax gap" – the difference between actual liability and taxes voluntarily paid. Despite continuing focus by the Internal Revenue Service (IRS) shelter activity continues. The U.S. Senate Committee on Homeland Security and Governmental Affairs held hearings on August 1, 2006 that highlighted the ongoing problem.

By the end of the last decade, the Internal Revenue Service had recognized the significant growth of abusive tax shelters and transactions and took steps to address the problem. The IRS formed the Office of Tax Shelter Analysis to co-ordinate its efforts to combat abusive transactions. Since 2000, the IRS has regularly published guidance on listed abusive transactions, and has promulgated several new regulations in efforts to increase disclosure by tax shelter participants and promoters. The IRS has also sought to foster resolution of tax shelter cases and increase future compliance by offering new settlement initiatives to taxpayers. Congress reacted to the rapid escalation of abusive tax shelter transactions by including a number of measures in the American Jobs Creation Act of 2004 designed to combat tax shelters.

New York also realized the impact of abusive tax shelters in increasing the tax gap. In August of 2002, the Department set up a separate Tax Shelter Unit to address the growing number of tax shelter cases that were being identified. This unit maintains the New York State Multi-State Tax Shelter database with the participation of 39 other states and taxing authorities. The unit also administered the Offshore Voluntary Compliance Initiative in April of 2003 and the Department's Son of BOSS program in May of 2004. These programs were moderately successful, but New York penalties for under-reporting income were low. Because abusive tax shelters are marketed to high income taxpayers, the VCI, unlike New York's prior amnesty programs, was made available to large corporate taxpayers.

The public was informed of the program through postings on the Department Web site, more than thirty presentations to tax practitioners and other interested groups, and direct contact by traditional and electronic mail to approximately 25,000 taxpayers and tax practitioners.

During the program, 119 taxpayers filed 342 amended returns reporting a total increased liability of approximately $350 million. Included in the preceding amounts are nearly $17 million in New York City personal income taxes, and $25 million in surcharge amounts from business taxpayers doing business within the Metropolitan Commuter Transportation District.

The distribution by tax type was different than expected with nearly $200 million of the increased liability coming from the Bank Franchise Tax. These taxpayers reported participation in a variety of shelter activities. Personal income taxpayers accounted for more than $75 million, with the other business franchise taxes totaling almost $80 million in increased liabilities.

Table A: Results of the VCI Program

Tax Type	Number of Taxpayers	Number of Returns	Gross Program Revenues (Total Liability)
Personal Income Taxes	55	92	$76,461,115
Business Taxes	64	250	272,864,005
Total	**119**	**342**	**$349,325,120**

As anticipated, much of the reported shelter activity took place during the economic boom years of the late 1990s with impacts on the tax liability years from 1999 to 2001. More than half of the increased liability was for abusive tax shelter activity during those years. This period also produced nearly half of the total amended returns. However, the second largest group of amended returns was from the most recent eligible tax years, the 2002 to 2004 liability years.

VCI participants disclosed their participation in 15 types of federal listed transactions, as well as reportable tax shelters with no direct federal counterpart. Increased liability associated with such "New York only" shelter activity was over $100 million. These involved questionable combinations of corporations in the New York combined group. Pursuant to the legislation, the Department is in the process of promulgating procedural regulations clarifying the requirements for defining New York reportable transactions and requiring their disclosure.

The success of the VCI, the number of amended returns from liability periods through 2004 (the last eligible period), and the continued issuance by the Internal Revenue Service through 2005 of revenue rulings and notices defining additional types of listed transactions, demonstrate the critical need to continue receiving disclosures of participation in such abusive tax shelter activities. However, the authority for the Department to require the reporting and disclosure of Federal and New York reportable and listed transactions expires on July 1, 2007.

Introduction

The voluntary compliance initiative (VCI) was included in the 2005-06 Executive Budget legislation as part of a comprehensive tax shelter bill. This initiative allowed taxpayers to avoid substantial new penalties by voluntarily disclosing participation in abusive tax shelters and filing amended returns for the liability periods affected. The bill also provided the Department of Taxation and Finance the tools to address the increasing use of abusive tax shelters by requiring disclosure of information relating to transactions that present the potential for tax avoidance. Substantial penalties were imposed for nondisclosure and the underpayment of taxes due to the participation in such transactions, and the statute of limitations for assessments relating to these transactions was extended. However, these provisions are scheduled to sunset on July 1, 2007.

This report, as required by the legislation, describes how the Department conducted the VCI and presents the results of the program. The report contains:

- issues raised by the abusive tax shelter legislation.
- discussion of federal efforts to combat losses from abusive tax shelters;
- discussion of tax shelter actions in other states;
- the VCI as it relates to New York amnesties and other compliance measures;
- description of the New York legislation;
- revenue effects of New York's VCI;
- participation in New York's VCI;
- discussion of the types of shelters disclosed during the VCI.

Issues Raised by Abusive Tax Shelter Disclosures During New York's VCI

Voluntary Compliance Initiative

Compared to the Department's expectations based upon the experience of other states, the program's results were in some ways unanticipated. As expected, most reported tax shelter participation occurred between 1999-2001 following the economic boom years; however, the second largest number of amended returns with shelter disclosures received were for the most recent eligible period, 2002-2004.

The IRS offered an initiative in October 2005, ending in January 2006, for 21 different types of shelters. Taxpayers that also had a New York presence were thus encouraged, under the State's new legislation, to simultaneously disclose and amend their returns, during the VCI. The IRS added the Distressed Asset shelter to their initiative in December 2005, ending in February 2006. This resulted in several VCI filings by taxpayers that had participated in this type of shelter activity.

Based on the experience of other large states that had conducted similar programs, it was expected that personal income taxpayers would have the largest reported liability increases, after amending their affected returns. However, less than one-quarter of the revenues received were for personal income taxes. A number of bank franchise taxpayers disclosed their participation in a variety of tax shelters, resulting in aggregate additional amended liabilities of approximately $200 million.

More than $100 million in increased liabilities from filings during the program were for tax shelter activities that have no Federal Listed Transaction counterpart. That is, the taxpayers perceived these activities as constituting New York reportable transactions. Further, most of this amount was received with taxpayer filings that chose to waive appeal rights.

New York Reportable Transactions

Pursuant to the authority given by the comprehensive tax shelter bill passed in April 2005, the Department is promulgating regulations to clarify what constitutes New York reportable transactions. Proposed new regulations[1] provide that a "New York reportable transaction" is a transaction that has the potential to be a tax avoidance transaction, and establishes three categories of New York reportable transactions: New York listed transactions; New York confidential transactions; and New York transactions with contractual protection. These categories, and their definitions, following, are modeled after their federal counterparts.

New York Listed Transactions

The proposed regulation also defines a "New York listed transaction" as a transaction that is the same as or substantially similar to one of the types of transactions that the Commissioner has determined to be a tax avoidance transaction and identified by notice or other form of published guidance as a New York listed transaction. For purposes of identifying a "New York listed transaction," the determination that a type of transaction is a tax avoidance transaction shall be based upon a finding by the Commissioner that (1) the transaction is not done for a valid business purpose, that is, one or more business purposes, other than obtaining tax benefits, that alone or in combination constitute the primary motivation for the transaction; (2) the transaction does not have economic substance apart from its tax benefits; or (3) the tax treatment of the transaction is based upon an elevation of form over substance.

New York Confidential Transactions

A "New York confidential transaction" is a transaction that is offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a fee. A transaction is considered to be offered to a taxpayer under conditions of confidentiality if the advisor who is paid the fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies. A transaction is treated as confidential even if the conditions of confidentiality are not legally binding on the taxpayer.

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[1]Part 2500 of the Procedural Regulations, of Chapter IX of the regulations of the Department of Taxation and Finance, of Title 20 of the Official Compilation of Codes, Rules and Regulations of the State of New York

New York Transactions with Contractual Protection

A “New York transaction with contractual protection” is a transaction for which the taxpayer or a related party has the right to a full or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained. A transaction with contractual protection also is a transaction for which fees are contingent on the taxpayer's realization of tax benefits from the transaction. The proposed regulation also provides guidance on filing and paperwork retention requirements.

Disclosure Sunset

The higher than expected VCI participation from taxpayers acknowledging participation in abusive tax shelters, together with the ongoing Federal discovery of new shelter schemes, shows a clear need to continue requiring disclosure by New York taxpayers of such participation. However, the authority to do so is no longer available under current statute after July 1, 2007.

Ongoing Federal Efforts to Combat Abusive Tax Shelters

Historically, the Federal government and state revenue departments dealt with tax sheltering activity on a case-by-case basis through the audit process and in court proceedings. As the complexity of the sheltering transactions evolved over time, however, enforcement efforts turned to legislative remedies. Congress took the first significant action with the Tax Reform Act of 1976, which enacted "at-risk" rules. These rules limited deductions from losses stemming from investments in which individuals had minimal economic risk. These rules were subsequently broadened in 1978 and 1981. The Deficit Reduction Act of 1984 was the first legislation that substantively dealt with tax shelters themselves, requiring registration of tax shelters and maintenance of investor lists. These laws, combined with the Tax Reform Act of 1986, which enacted "passive loss" rules, reduced tax shelter opportunities for individuals, but moved sheltering activity to the corporate arena.

From 1986 onward, several factors combined to spur the growth of shelter activity. Unprecedented economic growth led to large capital and income gains, particularly in the mid-to-late 1990s. A sophisticated system of tax planning arose to assist businesses and individuals to reduce their tax burden, often through questionable financial structures and transactions. Furthermore, with penalties not commensurate with the potential tax savings, shelter promoters were emboldened to market increasingly aggressive shelter schemes.

Strategic Goals

By the end of the 1990s, the IRS had formulated a comprehensive strategy to combat abusive tax shelters and transactions on the federal level. These efforts have focused on four clear goals. The first goal is to identify the promoters of such transactions through increased audit, enforcement, and litigation activities. The IRS also publishes a variety of guidance and examples of abusive transactions in order to keep the public and the practitioner community well informed. Another goal had been greater disclosure by the promoters and participants in these transactions.

Finally, the IRS has worked on developing alternative methods to resolve cases involving abusive transactions claimed by taxpayers.

The Office of Tax Shelter Analysis within the Internal Revenue Service

A key part of the efforts to combat abusive tax shelters and transactions was the formation of the Office of Tax Shelter Analysis (OTSA). This office is part of the Large & Mid-Size Business Division (LMSB) of the IRS. The OTSA collects and analyzes information on abusive tax shelters and transactions, and also coordinates the LMSB's activities relating to tax shelter planning and operations. As part of the ongoing efforts to promote increased disclosure of abusive transactions, the OTSA also maintains a toll-free Tax Shelter Hotline that can be used to provide information on shelter activity, anonymously if necessary.

Listed Abusive Tax Shelters and Transactions

The IRS, in conjunction with the Treasury Department's Office of Chief Counsel, also publishes guidance on listed abusive tax shelters and transactions. These are tax avoidance transactions that the IRS has determined to be abusive in nature. They are identified by notice, regulation, revenue ruling, or other form of published guidance. Taxpayers who participate in listed transactions or transactions similar in nature are required to disclose such activities to the IRS. This initiative was first begun in early 2000 with the issuance of ten listed transactions. As the IRS has gathered more information on abusive tax shelters, the number of listed transactions has grown to thirty.

Regulations on Abusive Tax Shelters and Transactions

Since 2000, the IRS has promulgated numerous different regulations to require increased disclosure of abusive tax shelters and transactions. These include regulations requiring promoters of certain transactions that were deemed to be potentially abusive to maintain lists of investors in these shelters. New regulations also identified several types of transactions that corporate taxpayers are required to disclose their participation in to the IRS. The regulations were later amended to extend these reporting requirements to individuals and flow-through entities.

These transactions include not only listed transactions which have been officially identified by the IRS as abusive, but five other general types of transactions which present the potential for tax avoidance. These are confidential transactions, transactions with contractual protection, loss transactions, transactions with a significant book-tax difference, and transactions with a brief asset holding period. The IRS has also issued additional regulations which specifically address disclosure and registration issues involving confidential transactions.

Public Outreach and Education

The IRS has published a great deal of material on the nature of abusive tax shelters. This includes fact sheets, news releases, tax fraud alerts, information on IRS and Department of Justice criminal investigations, and other general information on common tax scams. The intent of these efforts is to keep the public, as well as the practitioner community, well-informed and up-to-date on the constantly evolving issues surrounding tax shelters. The IRS believes that greater education and outreach can help curb the use of questionable tax transactions. Although these efforts will likely not help in combating highly aggressive tax planning, it is hoped that taxpayers that otherwise might be taken in by tax scams or may be engaging in less aggressive or more common methods of tax planning will be deterred from participating in abusive shelters.

Tax Accrual Workpapers

In 2002, the IRS changed its policy regarding tax accrual workpapers. These are documents developed by a taxpayer to evaluate deferred or contingent tax liabilities in connection with the taxpayer's disclosure to third parties of its financial condition. The IRS has the power to summon these tax accrual workpapers because they are not generated in connection with legal or tax advice and are not privileged communications. For returns filed after July 1, 2002, the IRS announced it will seek these documents whenever a taxpayer claims a benefit from a listed transaction. A new section setting out this requirement was added to the Internal Revenue Manual in 2005 to assist auditors in the process of requesting and examining tax accrual workpapers.

American Jobs Creation Act

Congress reacted to the rapid escalation of abusive tax shelter transactions in 2004 by including a number of anti-tax shelter measures in the American Jobs Creation Act. The provisions sought to expand the scope of tax shelter regulations, increase penalties for noncompliance, and add new restrictions on tax shelters.

Pre-Act shelter registration rules were replaced with a new set of requirements for "material advisors," generally persons providing assistance with, promoting, selling, or administering a reportable transaction in return for payment of over $50,000 from individuals or $250,000 from businesses. Material advisors are now required to provide informational returns identifying and describing the transaction and any potential tax benefits and maintain investor lists. Failure to comply results in significant penalties ranging from $50,000 to $200,000 or more. Failure to keep an investor list or to comply with an IRS request to provide the list results in a $10,000 per day penalty. Tax shelter promoters also face a penalty equal to 50 percent of the gross income derived from the shelter transaction. Finally, the confidentiality privilege between taxpayers and practitioners is rendered inapplicable with respect to tax shelter communications.

Taxpayers failing to disclose reportable transactions also face stringent new penalties. Individuals are subject to a $10,000 penalty, with the amount increasing to $100,000 for listed transactions. All other taxpayers are subject to a $50,000 penalty, rising to $200,000 for listed transactions. Prior to the Act, no such penalties existed. A new penalty is also imposed on taxpayers who have an understated liability due to participation in listed and reportable transactions. The penalty is 20 percent of the understatement, but is increased to 30 percent if the transaction was not disclosed.

Taxpayers with foreign financial accounts who fail to comply with reporting requirements are subject to a new $10,000 penalty, which increases to the greater of $100,000 or 50 percent of the amount of the transaction for a willful violation. The Act also sought to curb tax-exempt entity leasing arrangements, such as sale in-lease out, or SILO, transactions by limiting the depreciation and amortization periods for leased intangibles and deductions arising from property used by such entities.

Settlement Initiatives

Despite increased efforts to combat abusive tax shelters and transactions, the impact of sheltering activity continued to grow. The IRS estimated that in the first nine months of 2003, the number of abusive transactions grew by 42 percent, with the corresponding revenue loss growing by $11 billion, to $85 billion in total revenue. The new regulations that required the maintenance and disclosure of investor lists for tax shelters had led the IRS to identify a large number of abusive transactions claimed by taxpayers. This led the IRS to offer settlement initiatives on certain listed transactions in order to foster resolution of these issues and increase future compliance.

The most widely publicized settlement initiative involved the so-called "Son of BOSS" transaction. This type of transaction was aggressively marketed to corporations and wealthy individuals in the late 1990s and early years of this decade. The transaction typically involved the use of an inflated partnership basis to generate improper tax losses. It was identified as a listed transaction in Notice 2000-44, published in August 2000. The settlement initiative was announced May 5, 2004 and ran until June 21st of that year.

Taxpayers were required to concede the entire claimed tax loss and pay the related interest. Participants in the initiative were allowed to treat fees incurred via their utilization of the shelter as a loss. Taxpayers who had previously disclosed their transaction were not subject to a penalty. For other taxpayers, the penalty was ten percent if the "Son of BOSS" transaction was their first and only abusive tax shelter and twenty percent for participants in multiple abusive shelters. Taxpayers who chose to forgo the initiative were not allowed to deduct fees and costs associated with the shelter, faced the maximum penalties allowed, and were prohibited from using the administrative appeals process.

The IRS considered the results of the settlement initiative a great success. Over 1,500 taxpayers elected to participate in the initiative, comprising approximately 85 percent of those known to the IRS as having used "Son of BOSS" transactions. Furthermore, over 300 previously unknown taxpayers came forward under the initiative. Ultimately, the revenue collected from the more than 1,200 qualified participants was approximately $4 billion.

Another noted settlement initiative targeted taxpayers involved in contingent liability transactions under IRC §351. The initiative was announced in October 2002 and ran until March of 2003. It also covered certain other transactions involving basis shifting and corporate owned life insurance (COLI). The IRS also announced a settlement initiative in February of 2005 that ran until May of that year targeting abusive transactions involving the transfer of stock options to related parties.

The most recent major settlement initiative was announced in October 2005 and ran until January 23, 2006. It covered sixteen listed transactions and five other transactions, including many dealing with employee plans. Taxpayers were required to concede 100 percent of the transaction's tax benefits in return for reduced penalties and the ability to treat the full transaction costs as an ordinary loss. The IRS had targeted 4,000 taxpayers involved in these transactions, and expected to uncover many more participants through the initiative.

State Efforts Addressing Abusive Tax Shelters

Actions in California

Meanwhile, California took the first steps at the state level in addressing abusive tax shelters. As the state recognized a tenfold increase in tax shelter cases between 2001 and 2003, and as the statute of limitations on existing audit cases was approaching, they decided they could no longer wait for federal action.

In October of 2003, the state enacted its own abusive tax shelter legislation which included increased penalties for promotion and participation in abusive shelters and reporting, registration, and record-keeping requirements. The centerpiece of the legislation, however, was its voluntary compliance initiative (VCI).

The VCI program ran from January 1 through April 15, 2004 and was available to corporate and individual taxpayers who participated in an abusive tax shelter before 2003. Taxpayers were allowed to file amended tax returns and pay the liability and interest attributable to the tax shelter in exchange for a waiver of penalties and immunity from criminal prosecution. Taxpayers were allowed to choose between two options. The first required them to waive their appeal rights to receive a full penalty waiver. The second allowed them to retain the right to appeal, but they remained subject to one penalty. Approximately 40 percent of participants ultimately chose the first option.

The gross amount collected vastly exceeded the projected $230 million revenue gain. VCI brought in over $1.4 billion, 77 percent of which came from the 1999 through 2001 tax years. After accounting for the results of pending appeals, further government action, and accelerated revenue, California estimated that the net revenue gain from VCI was $700 million.

Action in Other States

California and other states also benefited from the federal Son of BOSS settlement initiative. Taxpayers who participated in the federal initiative amended their state tax returns resulting in an ancillary revenue gain for state coffers. The IRS also worked closely with the states, sharing information on the taxpayers and abusive transactions, allowing states to take independent action.

New York State, for example, conducted a concurrent Son of BOSS initiative, but extended the deadline to June 30, 2004.

After observing the success of California's VCI, several states immediately followed with VCI programs of their own. Some paired their VCI programs with corresponding tax shelter legislation, while others simply offered a VCI based on participation in federal listed transactions. One state, Connecticut, first offered VCI in June of 2004, enacted tax shelter legislation in 2005, and then offered a subsequent VCI three months later.

Illinois enacted comprehensive tax shelter legislation on July 30, 2004, comprised of increased penalties and disclosure requirements and a VCI which ran from October 15, 2004 to January 31, 2005. Like California, the program offered taxpayers two participation options - waiving or retaining appeal rights. Also like California, the program exceeded its estimate, resulting in $135 million, $35 million more than projected.

Minnesota's VCI was also coupled with enhanced disclosure, registration, and enforcement legislation. The VCI began on August 1, 2005 and concluded on January 31, 2006. As of this writing, results were not available, but the state expected the program to generate $57 million in additional revenue in 2006-07.

New Jersey, South Carolina, North Carolina, and Arizona all conducted administrative VCI programs that did not include companion tax shelter legislation. New Jersey's approach focused on participants in federally listed shelter transactions, especially BOSS and Son of BOSS. Taxpayers had until September 15, 2004 to provide information on the entities and promoters used and pay the tax due plus interest while still retaining appeal rights. Participation would allow them to avoid a 50 percent post-VCI civil fraud penalty. South Carolina also piggybacked on the federal Son of BOSS initiative and gave taxpayers until September 1, 2004 to participate in a VCI. The terms were generally similar to those offered in New Jersey.

North Carolina's VCI applied to taxpayers who had underreported income due to the utilization of tax sheltering strategies. Taxpayers who had been assessed for such activity had until January 31, 2005 to pay all tax and interest due in order to receive a waiver of penalties. Generally, they were also required to waive their rights to a refund. Taxpayers under audit or those not assessed were given two options and allowed until April 15, 2005 to pay all tax and interest due. Under the first option, taxpayers had to file returns and remit payment, but had to waive rights to a refund and remained subject to further audit. Under the second option, a taxpayer had to complete a managed audit, file returns, and remit payment. The state received approximately $255 million from almost 400 participants, with 329 corporations accounting for slightly over $200 million of the total.

On February 14, 2006, North Carolina announced its second VCI program in two years. Taxpayers who engaged in certain specified transactions had until June 15, 2006 to elect to participate, and until December 15, 2006 to agree to waive rights to appeal or refund and pay all tax, interest, and reduced penalties. In exchange, the Department of Revenue agreed to waive a portion of the civil penalty and agree not to pursue criminal action. There were three classes of transactions covered by VCI. The first was IRS listed transactions subject to a 50 percent penalty waiver. The second was IRS listed or other transactions that were not identified by the prior VCI. These were subject to a 90 percent penalty waiver. The final group was state-only transactions, also subject to a 90 percent penalty waiver. These include transactions such as the use of real estate investment trusts, regulated investment companies, management companies, certain intellectual property companies, and other intercompany transactions. The Department stated that these transactions were included as an attempt to avoid protracted audits and litigation.

Arizona's program ran from February 14 to April 1, 2005, although that deadline was subsequently extended to April 22. The state followed the example of the first Connecticut VCI, focusing on taxpayers who participated in federally listed and substantially similar transactions. Penalties were waived if taxpayers paid tax and interest due on 100 percent of the loss, deduction, or gain sheltered due to the abusive transaction. To encourage participation, Arizona also offered to waive a portion of the interest due and allow some deductions that might not have been allowed under an audit. Seventy-one taxpayers participated in the VCI, resulting in a total revenue gain of $29 million and $18 million for fiscal years 2005 and 2006, respectively.

New York State Amnesty History and Other Compliance Measures

General Amnesties

New York State has offered three general amnesties: 1985-86, 1996-97, and 2002-03. The 1985-86 amnesty strengthened various penalty provisions, increased fines, elevated several tax evasion crimes to felony status, and authorized new compliance capabilities for the Tax Department. In exchange for full payment of tax and interest due, amnesty participants received a waiver of penalty for tax periods covered under amnesty and immunity from future civil, administrative, and criminal actions. The 1996-97 amnesty offered the same benefits, but imposed an additional five percent penalty surcharge on any penalty due on a tax amnesty-eligible liability for taxpayers who failed to participate in the program. The 2002-03 amnesty offered an additional incentive: a two percent interest rate reduction. The 2002-03 program did not contain the 5 percent surcharge, but added two percent to the future interest rate for outstanding assessments and unpaid liabilities. These amnesties excluded large businesses and banks because those taxpayers are subject to routine audits.

1994 Targeted Amnesty

The 1994 amnesty program targeted three specific groups of taxpayers. The income tax component targeted nonresidents of New York, the business tax component targeted out-of-state taxpayers, and the compensating use tax component targeted resident individuals and small businesses. Amnesty required eligible taxpayers to pay any taxes owed plus interest. Eligible taxpayers were also protected from any related criminal prosecution or administrative penalty. Unlike the general amnesties, the 1994 program was not coupled with stronger enforcement provisions.

Tax Shelter Unit

In August of 2002, the Department set up a separate Tax Shelter Unit to address the growing number of tax shelter cases that were being identified. This unit maintains the New York State Multi-State Tax Shelter database with the participation of 39 other states and taxing authorities. The unit also administered the Offshore Voluntary Compliance Initiative in April of 2003 and the Department's Son of BOSS program in May of 2004. Tax Shelter Unit staff identify tax shelter transactions, develop search procedures and databases, facilitate information exchanges with other jurisdictions, and develop, work, and close tax shelter cases.

Offshore Voluntary Compliance Initiative

In April of 2003, the Department announced its Offshore Voluntary Compliance Initiative (OVCI) to bring taxpayers who had used credit cards issued by offshore accounts, or other offshore financial arrangements to hide income into compliance. The program was designed to coincide with the federal OVCI program.

Information Sharing With Other Jurisdictions

In August of 2003, the Department signed a Memorandum of Understanding with the Internal Revenue Service (IRS) to facilitate information sharing between the IRS and the Department regarding abusive tax avoidance transactions. In March of 2004, New York State, along with 37 other states and taxing authorities, signed a Memorandum of Agreement to exchange information about abusive shelters, as well as the names of participants and promoters. In August 2004, New York and California sponsored an education and information session with eight other states. Subsequently, the Eastern States Working Group was formed. Representatives from 18 states attend quarterly meetings to compare strategies for combating abusive tax shelters.

Son of BOSS Program

In May 2004, the Department announced its Son of BOSS program, allowing people who were involved in "Son of BOSS" or other types of abusive tax shelters to come into compliance. This program was also intended to leverage the IRS's focus and efforts in resolving the tax abuse consequences of these shelter activities. Through 2004, the Department also continued receiving information from the IRS on their OVCI cases. The resolution of tax shelter cases resulted in collections of more than $20 million in State Fiscal Year 2004-05.

Description of New York's Legislation

Part N of Chapter 61, as amended by Part A of Chapter 63, of the Laws of 2005 created New York State's Voluntary Compliance Initiative (VCI) which ran from October 1, 2005 through March 1, 2006. This initiative allowed taxpayers to avoid substantial new penalties by voluntarily disclosing participation in abusive tax shelters and filing amended returns for the liability periods affected. Voluntary disclosure was available for all tax years prior to January 1, 2005. The VCI was available for tax liabilities under Articles 9, 9-A, 22, 30, 30-A, 30-B, 32, and 33. Notably, this VCI program, unlike recent amnesty programs, allowed large corporate taxpayers to report and pay past underreported tax liabilities and interest.

The VCI was part of a comprehensive tax shelter bill passed with the 2005-06 Executive Budget, which provided the Department of Taxation and Finance the tools to address the increasing use of abusive tax shelters by requiring disclosure of information relating to transactions that present the potential for tax avoidance, imposing penalties for nondisclosure and the underpayment of taxes due to the participation in such transactions, and extending the statute of limitations for assessments relating to these transactions. All of the new disclosure requirements, however, will sunset as of July 1, 2007.

The OVCI and "son of BOSS" initiatives conducted by the Department's Tax Shelter Unit were moderately successful because of increased inter-jurisdictional information sharing. The VCI legislation was necessary to provide a one-time acceleration of revenues into the target State fiscal year. Like other amnesty programs, the enhanced penalties encouraged participants in abusive tax shelters to report during the program period on their amended liabilities voluntarily to avoid larger penalties. Together with the new requirements to disclose with their New York tax returns any tax shelter disclosures required with their Federal returns, which make discovery of abusive tax strategies more likely, the new penalties add a significant financial risk to manipulations that under-report income or over-state losses.

The legislation required that the VCI be administered by the Department of Taxation and Finance. VCI allowed taxpayers to report and pay underreported tax liabilities and interest attributable to tax avoidance transactions. Taxpayers who participated in this initiative had the option to participate with a waiver of the right to appeal their liability for any taxes paid under the program, or to participate with the right to appeal. If a taxpayer chose to forgo the right to appeal, all applicable penalties were waived. Participation with appeal rights resulted in a waiver of all penalties except the negligence and substantial understatement penalties under the Tax Law. The election was made for each taxable year covered by the application, and a different option could be elected from one year to the next. However, once the election was made it was irrevocable.

Participation in the program required completion of Form DTF-671, *Election to Participate in the Tax Shelter Voluntary Compliance Initiative.* The taxpayer also had to file New York State original or amended tax returns, which reflected the amount of tax due without regard to the tax avoidance transaction for each year which the taxpayer used any tax avoidance transaction, and remit full payment of tax and interest for each tax year attributable to the tax avoidance transaction. The significant elements of the two filing options were as follows:

Option 1 - Voluntary Compliance WITHOUT Appeal Rights

- File an original tax return or amended tax return to eliminate the tax avoidance transaction (tax shelter);
- pay the tax and interest due;
- penalties that apply to participation in the tax avoidance transaction are waived or abated;
- the Commissioner of Taxation and Finance will not bring or seek criminal, civil, or administrative action; and
- participant cannot file a claim for credit or refund for amounts paid under the VCI.

Option 2 - Voluntary Compliance WITH Appeal Rights

- File an original tax return or amended tax return to eliminate the tax avoidance transaction;
- pay the tax and interest due;
- penalties that apply to participation in the tax avoidance transaction are waived or abated, **except** the penalties imposed under Tax Law sections 685(b), 1085(b) (deficiency due to negligence), 685(p), and 1085(k) (substantial underpayment of tax liability);
- the Commissioner of Taxation and Finance will not bring or seek criminal, civil, or administrative action; and
- taxpayer reserves the right to file a claim for credit or refund for the amounts paid under the VCI, including certain penalties.

In addition, taxpayers were required to cooperate fully with inquiries made regarding the facts and circumstances related to the use of tax avoidance transactions to underreport their tax liabilities. Failure to fully cooperate with inquires made by the Department resulted in the taxpayer's removal from the VCI program and the application of all available penalties.

Finally, the VCI legislation authorized the Tax Department to impose an interest penalty equal to 100 percent of the interest payable on any deficiency assessment on any eligible taxpayer who did not participate in the VCI program.

Analysis of Voluntary Compliance Initiative Revenues and Participation

Total Revenues Received

Table 1 shows the total revenues received from program participants. The table also shows the number of taxpayers that participated in the program as well as the number of Voluntary Compliance Initiative (VCI) returns filed by these taxpayers. The terms taxpayer and participant are used interchangeably in the report. Because a single taxpayer may file VCI returns for several different tax years, the number of returns is greater than the number of taxpayers. The totals are presented by tax type. The category *Personal Income Taxes* includes both State and New York City taxes. The category *Other Business Taxes* includes the corporate franchise tax, and the capital stock tax on transmission and transportation corporations. However, nearly all the data presented in this category is due to the corporate franchise tax.

Table 1: Total Revenues Received

Tax Type	Number of Taxpayers	Number of Returns	Total Revenues Received
Personal Income Taxes	55	92	$75,881,739
Bank Franchise Tax	14	70	195,552,017
Other Business Taxes	50	180	66,176,595
Total	**119**	**342**	**$337,610,351**

A total of 119 taxpayers filed 342 returns under the VCI program. The average taxpayer filed more than three separate returns under the program, and six when considering only personal income taxes. The total amount of revenues received at the time of this report was approximately $337.6 million. Personal income taxes accounted for the most taxpayers, but the category *Other Business Taxes* produced more than half the total number of returns. Although the bank franchise tax accounted for the least number of taxpayers and returns, it represented about three-fifths of total revenues received.

Accelerated Revenues

Participants in the VCI program had a total additional liability of $349.3 million. As noted above, $337.6 million was received in payments at the time of this report. A portion of these returns and associated liability was due to the accelerated resolution of cases already under audit. These are cases involving taxpayers under audit for tax shelter transactions that the Tax Department was aware of before the VCI program. However, this does not include taxpayers who may have been under audit but who disclosed previously unknown tax shelter liabilities. Revenues from these taxpayers, along with those who disclosed transactions that were previously wholly unknown to the Department, are considered new revenues.

One hundred thirty-one of the total 342 VCI returns were filed due to accelerated cases, and these returns had an associated total liability of $82.3 million. Payment has already been received on virtually all of this liability. Some taxpayers who filed returns on accelerated cases also filed returns attributable to new revenues. Because of this, the number of taxpayers in either of these categories is not reportable.

Net Program Revenues

Table 2 gives an estimate of net revenues from the VCI program. Gross program revenues are equal to the total liability of program participants. To arrive at a figure for net program revenues, accelerated revenues, program costs, and requested refunds are subtracted from this number. Program costs represent the costs incurred by the Tax Department associated with the administration of the VCI program. These include costs due to printings, mailings, and staff time. The amount of requested refunds is due to overpayments on VCI returns that have been or will be refunded to taxpayers.

Table 2: Net Program Revenues

Gross Program Revenues (Total Liability)	$349,325,120
Accelerated Revenues	$82,251,884
Program Costs	93,126
Requested Refunds	6,829,229
Net Program Revenues	**$260,150,881**

As discussed above, accelerated revenues accounted for $82.3 million. Program costs totaled less than $100,000. The total amount of refunds requested was $6.8 million. After subtracting these amounts from gross program revenues, the total estimate of net program revenues is approximately $260.2 million.

Appeals Options

Table 3 shows how many taxpayers chose to waive appeals rights (option one), and how many chose to keep the ability to appeal (option two). It also shows the total libability attributable to each of these two categories of participants. As in the first table, the data is presented by tax type.

Table 3: Total Liability by Appeals Option

	Option One - No Appeal Rights		Option Two - With Appeal Rights	
Tax Type	**Number of Taxpayers**	**Total Liability**	**Number of Taxpayers**	**Total Liability**
Personal Income Taxes	33	$59,610,447	22	$16,850,668
Bank Franchise Tax	4	98,139,147	10	97,412,870
Other Business Taxes	25	12,786,578	25	64,525,410
Total	**62**	**$170,536,172**	**57**	**$178,788,948**

Slightly more than half of the participants in the VCI program chose to waive their appeals rights, although most of the total liability was due to taxpayers that kept appeal rights. Most personal income taxpayers chose option one, and these taxpayers accounted for about four-fifths of total liability for this tax type. Most participants under the bank franchise tax chose to keep appeals rights, although total liability for banks was about evenly split by option. The same number of taxpayers under the *Other Business Taxes* category chose option one as chose option two. However, those who chose to keep appeals rights accounted for more than five times as much in total liability.

Total Liability

Table 4 shows the composition of total VCI liability. The total amount paid with returns represents the tax, interest, and penalty paid by taxpayers due to their disclosure of participation in tax shelters. The category of additional assessments and offsets includes additional amounts assessed by the Tax Department after review of VCI returns, as well as offsets to requested refunds. These two categories comprise the total amount of revenues received from VCI participants at the time of this report. The table also shows the total amounts still outstanding on assessments that have not yet been paid, and total liability for VCI participants. The data in this table is also presented by tax type. However, for reasons of taxpayer confidentiality, all business taxes have been grouped together in a single category.

Table 4: Composition of Total Liability

Tax Type	Total Amount Paid with Returns	Additional Assessments and Offsets	Total Revenues Received	Amounts Still Outstanding on Assessments	Total Liability
Personal Income Taxes	$73,431,886	$2,449,853	$75,881,739	$579,376	$76,461,115
Business Taxes	$229,793,798	$31,934,814	$261,728,612	$11,135,393	$272,864,005
Total	**$303,225,684**	**$34,384,667**	**$337,610,351**	**$11,714,769**	**$349,325,120**

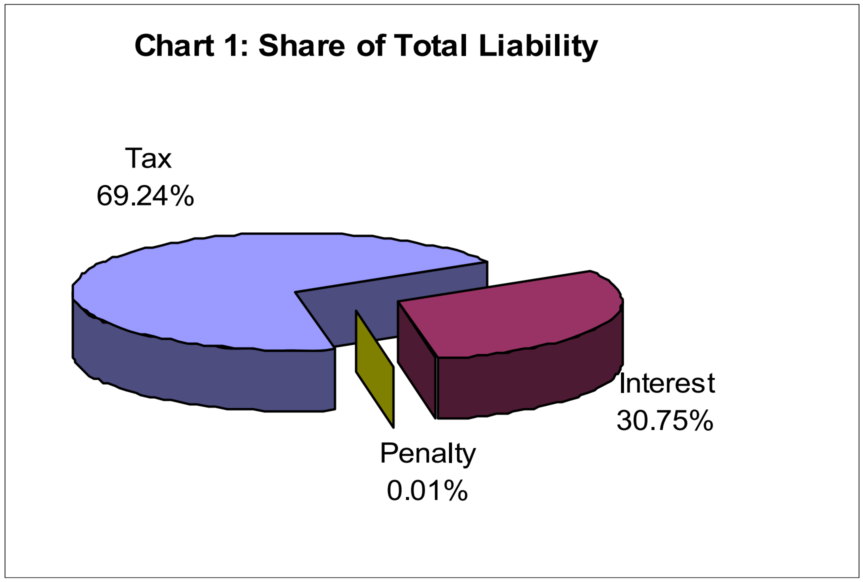
Participants in the VCI program paid approximately $303.2 million with their VCI returns, about three-quarters of which was due to business taxes. Of the amounts due to business taxes, almost $200 million was due to the bank franchise tax. Additional assessments and offsets have only contributed a relatively small amount toward total revenues received at the time of this report. Total revenues received equaled about $337.6 million.

Approximately $11.7 million in assessments from VCI participants are still outstanding and have not yet been paid. However, nearly all this amount is due to taxpayers that have entered into installment payment agreements (IPAs). An IPA is available under certain conditions if a taxpayer cannot pay the full amount of tax owed by the return due date. A taxpayer who enters into an IPA is required to make monthly installment payments, subject to interest and penalties, until the full balance is paid. Most of the VCI balance still outstanding is due to business taxes, and this is mostly attributable to the corporate franchise tax. The total liability for participants in the VCI program is approximately $349.3 million.

Certain business taxpayers filed returns under the VCI program and disclosed their participation in tax shelters, but did not incur any additional liability. The changes these taxpayers made when amending their returns did not result in any tax effect. The main reason for this was that these taxpayers originally paid on a tax base other than income, such as capital or capital stock. The changes made on VCI filings primarily affected income, but did not have enough of an effect to change the basis of tax to the income base.

Tax, Interest, and Penalty Liability

Chart 1 shows the share of total liability due to tax, penalty, and interest. Total liability includes amounts paid with VCI returns and all additional amounts assessed, whether paid or not. The total tax liability of VCI participants is approximately $240.9 million, or almost 70% of the total. Total interest liability is about $108.3 million, and makes up nearly all the remaining total. Only a few participants in the VCI program were subject to penalties on their returns. The total penalty liability was minimal.



State and Local Shares of Tax and Interest

Table 5 shows the shares of total tax and interest liability attributable to state and local revenue sources. The category *New York State Taxes* includes the State personal income tax and state business taxes. Participants subject to New York City personal income taxes are included in the second category. The category *MTA Surcharges* is the 17 percent surcharge imposed on business taxpayers who do business in the Metropolitan Commuter Transportation District.

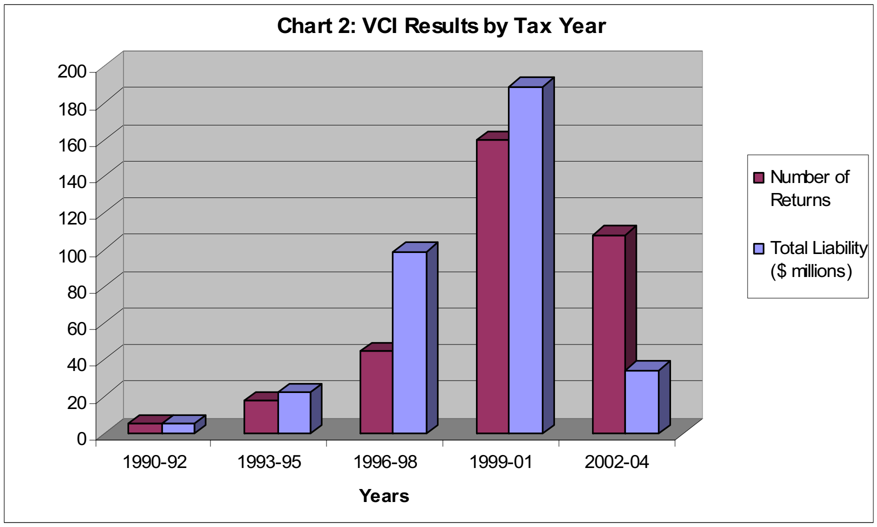
Table 5: State and Local Shares of Tax and Interest

	Total Tax Liability	Total Interest Liability	Total Tax and Interest Liability
New York State Taxes	$209,224,387	$95,670,022	$304,894,409
New York City Income Taxes	12,350,083	4,343,111	16,693,194
MTA Surcharges	17,583,633	8,301,867	25,885,500

New York State taxes account for the vast majority of total tax liability. State tax liability is approximately $209.2 million, or about 87 percent of total tax liability. The amount of tax liability due to New York City income taxes and the MTA Surcharges was each less than $20 million. The share of total interest liability attributable to each of the three revenue categories was imputed based on the share of total tax liability. The breakdown of total interest liability is therefore identical to that of total tax liability.

VCI Results by Tax Year

Chart 2 profiles the results of the VCI program by the tax years for which VCI filings were received. For reasons of confidentiality, the data is presented in five three-year periods, from 1990-1992 to 2002-2004. The chart shows the number of returns filed and total liability for tax years beginning in each period. Total liability is presented in terms of millions of dollars. There were no VCI returns filed for tax years beginning before 1990.



The period of 1999-2001 produced almost half the total number of returns and more than half of the total liability. Several of the largest VCI filings were for these tax years. This is believed to be the period when tax sheltering activity in general reached its peak nationwide. The most recent eligible period, 2002-2004, produced the second most number of returns, but the period of 1996-1998 produced the second highest amount total liability. There were comparatively few filings for tax years beginning before 1996.

Tax Shelter Transaction Types Reported

Participants in the VCI program were required to disclose the nature of the tax shelter activities in which they had taken part. Taxpayers identified almost two dozen different types of activities that fell under the definition of federal reportable transactions. A federal reportable transaction is a transaction that taxpayers are required to report to the IRS.

Such transactions fall into five different categories: listed transactions, confidential transactions, transactions with contractual protection, loss transactions, transactions with a significant book-tax difference, and transactions with a brief asset holding period. The majority of transactions identified by participants in the VCI fell under the category of listed transactions.

Listed transactions are those that are the same as or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction. These transactions are identified by notice, regulation, or other form of published guidance as a listed transaction. As of the publication of this report, the IRS has identified thirty separate types of transactions as listed transactions.

The following listed transactions were identified by participants in the VCI. For more detailed information on other types of reportable transactions, as well as the full text of the associated IRS Notices, see Appendices D and E.

Distressed Assets Shelter

This shelter, also known as an IRC§754 Election Failure, may be structured in various ways depending on the promoter. In a common version, a foreign business that has large losses on publicly-traded U.S. stocks contributes the stocks to a partnership formed by the promoter. It then sells its partnership interest to an U.S. taxpayer (for the fair market value of the stocks) who can utilize the losses. When the partnership sells the stocks, a large loss is generated and passed on to the U.S. taxpayer. Other versions of this shelter use non-performing loans from tax-indifferent foreign banks as the underlying assets. In effect, the U.S. taxpayer is buying a loss (in many cases real) forma foreign entity that had no use for the loss.)

Contingent Liability Transactions

A contingent liability transaction involves the transfer of a high basis asset in order to generate accelerated or duplicated loss deductions. The transferred asset is exchanged for the stock of the transferee and the assumption of a liability held by the transferor. The transaction is intended to qualify as an exchange under IRC §351. However, the liability is not properly taken into account, enabling both parties to generate tax losses that would not otherwise be allowed.

Inflated Partnership Basis Transactions (Son of BOSS)

This type of transaction is popularly known as “Son of BOSS.” It involves the transfer of assets or liabilities to a partnership in order to create an artificially high basis in the taxpayer’s interest in the partnership. The taxpayer will then dispose of the partnership interest and claim a tax loss. No real economic loss is suffered by the taxpayer as a result of the entire transaction. Losses resulting from this type of transaction or similar transactions are not allowed as deductions.

Deduction of Certain Contributions to IRC §401(k) Plans

A §401(k) plan can be used to generate accelerated deductions for plan contributions. A corporation will deduct contributions made to the plan for a taxable year, even though a portion of the contributions are attributable to compensation earned after the close of the taxable year. The plan year is not the same as the corporation's taxable year. However, only contributions attributable to compensation earned during the taxable year may be properly deducted.

Lease In/Lease Out (LILO) Transactions

A LILO transaction involves the use of leasing arrangements in order to generate rent and interest deductions. A corporation will lease property from a tax exempt entity, and will then sublease the property back to the entity. The parties will also enter into loan arrangements that will offset much of the financial risk involved. The corporation will then claim deductions for rental payments made on the lease and interest payments made on loans taken out during the transaction.

Common Trust Fund Straddle Tax Shelter

A common trust fund can be used to generate tax losses for investors. The fund invests in straddles, which are offsetting gain and loss positions in foreign currencies. Initially, the fund investors will be tax indifferent parties, and will be allocated gain when the gain position is sold. A new investor will then purchase a large majority share in the fund. When the loss position is sold, this investor is allocated a large majority of the loss. This loss is then claimed as a deduction.

Company Owned Life Insurance (COLI)

A company that maintains a defined benefit plan to provide life insurance for employees can use the plan to defer or eliminate tax on employee compensation or generate accelerated deductions. The plan is intended to be a qualified pension plan under IRC 412(i) and purchases life insurance and annuity contracts for the benefit of plan participants. The contracts may provide benefits at normal retirement age in excess of the terms of the plan, or have face value exceeding death benefit of participants under the plan. The excess amounts are distributed back to the plan. The company fully deducts all contributions to the plan for premiums (including contributions for excess coverage) on its current tax returns.

Custom Adjustable Rate Debt (CARDS) Transactions

This type of transaction involves the use of a loan assumption agreement to claim an inflated basis in assets acquired from another party. The taxpayer acquires the assets in exchange for assuming a portion of the outstanding liability on the loan. The taxpayer will then dispose of the assets, claiming an inflated basis that includes the entire principal amount of the loan. The result is that the taxpayer is able to generate a tax loss on the disposition.

Improper Use of Contested Liability Trusts

A trust may be used by a taxpayer to generate accelerated deductions for a contested liability. The taxpayer will create a trust and transfer assets to the trust to provide for the satisfaction of the liability. The transaction is intended to qualify for an exception under IRC §461(f) to accounting rules, which allows acceleration of a contested liability under certain circumstances. The transaction is considered to be a tax shelter if the taxpayer retains control of the trust and its assets, or the liability itself does not appear to be genuine.

Lease Stripping Transactions

A lease strip is a transaction in which one taxpayer claims to realize rental or other income from property and another taxpayer claims the deductions related to that income. This normally involves the assignment of the right to receive future lease payments from one party to the other. The lease can take a variety of forms. This type of transaction has been identified as a tax shelter because it improperly separates income from related deductions.

Partnership Straddle Tax Shelters

A taxpayer will manipulate partnership transactions in a complicated series of steps designed to generate a permanent non-economic loss. The taxpayer will purchase interests in a tiered partnership structure from a corporation which is a tax indifferent party in these transactions. The lower-tier partnership will have investments in straddles, which are offsetting gain and loss positions in foreign currencies. The partnership will engage in transactions designed to increase the taxpayer’s basis in it. The taxpayer will realize a loss when one of the straddles is terminated and will not recognize gain when it sells its partnership interest.

Sale In/Lease Out (SILO) Transactions

A SILO transaction is similar to a LILO transaction, except that the property will be sold to the corporation, not leased. The parties will similarly enter into loan arrangements that will offset much of the financial risk involved. The corporation will claim deductions for interest payments and depreciation on the property. A SILO transaction also often involves a service contract between the parties, which is intended to provide the corporation with additional return on its investment. These deductions are not allowed, as this type of arrangement is not considered to be a true transfer of ownership.

S Corporation Tax Shelter

This type of transaction involves a taxpayer or taxpayers which are shareholders of a historically profitable Subchapter S corporation. The S corporation creates non-voting stock, which is 90 percent or more of total stock, and donates it to a tax exempt organization. The S corporation then allocates a proportional share of income to the tax exempt organization, but does not actually distribute any cash or assets to it. The S corporation buys back the stock and makes a tax-free distribution of cash back to the original shareholders. The shareholders are able to avoid tax on the income by allocating it to the tax exempt organization, but the income remains with the S corporation to be distributed to the shareholders in a future year.

Stock Compensation Transactions

This type of transaction involves the use of a stock compensation plan to generate capital losses. A corporation will transfer cash to a subsidiary in exchange for stock. The subsidiary will then use the cash to purchase stock in the parent. This stock is used to make distributions to the parent's employees as part of the compensation plan. The transfer of the stock is treated as a deemed capital contribution, allowing both parties to generate capital losses when the subsidiary is liquidated or sold. In reality, the transfer should be treated as a distribution of stock, requiring both parties to adjust their basis in the stock.

Tax Avoidance Using Notional Principal Contracts

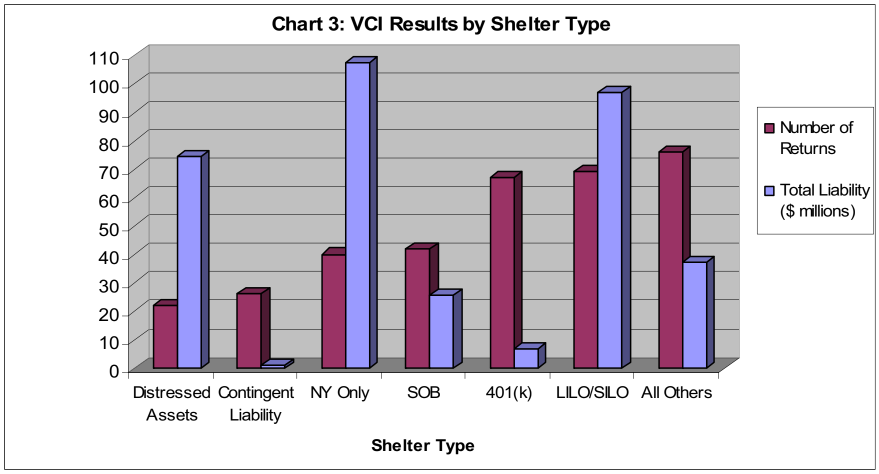
A notional principal contract (NPC) can be used by a taxpayer to generate deductions from income. The NPC requires the taxpayer to make periodic payments to another entity. This entity, in turn, will make a single payment back to the taxpayer at the end of the contract. The taxpayer will deduct each periodic payment it makes in the tax year it is made, but will not realize income from the payment it receives until the contract is over. This arrangement allows the taxpayer to delay tax on this income, which should have been properly accrued over the term of the NPC instead of as a single payment at the end.

Tax Avoidance Using Offshore Foreign Currency Option Contracts

A taxpayer will use offsetting foreign currency option contracts to create tax losses and unrecognized gains. The taxpayer will purchase options on a foreign currency, while at the same time itself writing options on another foreign currency. The gains and losses from the options are expected to offset each other. The taxpayer then assigns a purchased option with a loss and a written option with a gain to a charity. It will then claim a loss on the purchased option assigned to the charity, while not recognizing gain on the written option.

VCI Results by Tax Shelter Type

Chart 3 profiles the results of the VCI program according to which tax shelter VCI participants identified in their filings. The chart separately presents data for the six most utilized tax shelters, according to number of returns filed for each. The total liability attributable to each shelter is also shown and is presented in terms of millions of dollars. There are also ten other types of tax shelters identified, as well as some filings for which the type of shelter is unknown at the time of this report. This data is presented under the category *All Others*.



Excluding the combined *All Others* category, the most returns were filed due to LILO/SILO transactions. This type of shelter accounted for the most total liability of any federal listed transaction. Three other listed transactions were among the top five in terms of number of returns filed. This includes so-called "Son of BOSS" transactions. New York reportable transactions accounted for the second highest amount of total liability. These types of transactions are not applicable at the federal level.

Appendix A - VCI Publications, Instructions and Participant Forms

TIME RUNNING OUT FOR CORPORATIONS AND INDIVIDUALS TO REPORT ILLEGAL TAX SHELTERS

Civil Penalties, Legal Action Waived Against Those Who Report By March 1

FOR RELEASE:

IMMEDIATE, Wednesday

February 15, 2006

New York State Commissioner of Taxation and Finance Andrew S. Eristoff today reminded individuals or corporations who attempt to evade taxes through illegal shelters that they have until March 1, 2006, to take advantage of a special state program which waives civil penalties and legal action against those who voluntarily come forward.

Commissioner Eristoff said that New York's 'Voluntary Compliance Initiative,' which began October 1, 2005, is set to expire in two weeks. Until then, taxpayers who engaged in tax avoidance transactions have the opportunity to "do the right thing and voluntarily comply," the commissioner said.

"For those involved in illegal tax shelters, this unique program is an opportunity too good to pass up. We're allowing a company or individual to come clean on abusive tax shelters and pay any taxes owed with little or no consequence," Commissioner Eristoff said. "But once the program expires on March 1, our Department will vigorously pursue offenders and impose punitive interest and penalties which make it clear that tax fraud and abuse do not pay."

A tax avoidance transaction (tax shelter) is a plan or arrangement devised for the principal purpose of avoiding tax. These transactions include, but are not limited to, listed transactions that are the same as or similar to those identified by the Internal Revenue Service and available for reference at www.irs.gov. They also include tax avoidance transactions designed to avoid New York State tax by utilizing an 'intangible holding company' or similar arrangements that inappropriately shift taxable income to lower taxing jurisdictions or tax exempt entities.

Throughout the five-month period, corporate and individual taxpayers have been encouraged to voluntarily disclose their participation in abusive tax shelters for years prior to January 1, 2005, and pay underreported tax liabilities and interest attributable to tax avoidance transactions, without incurring any of the new penalties recently enacted for participating in tax shelters.

Eligible New York State taxpayers may take advantage of the Tax Shelter Voluntary Compliance Initiative by submitting a completed Form DTF-671 for each year for which the tax avoidance transaction was used, file an original or amended return and remit full payment of tax and interest for each year attributable to the tax avoidance transaction.

Taxpayers who participate in the program may opt to do so with or without appeal rights. For taxpayers opting to waive their appeal rights, all penalties attributable to the use of the tax shelter will be waived and the taxpayer may not file a claim for credit or refund with respect to the use of the tax shelter for that year. For taxpayers who choose to retain their appeal rights, all penalties attributable to the use of the tax shelter will be waived except for negligence and substantial understatement of tax penalties, and the taxpayer will retain their right to file a claim for credit or refund. With either option, the Commissioner of Taxation and Finance will not bring or seek civil, administrative, or criminal action against the taxpayer for the tax years involved.

Eligible taxpayers who fail to participate in the Tax Shelter Voluntary Compliance Initiative will be subject to additional penalties, including a penalty equal to 100% of the interest attributable to the tax due based on the tax shelter transaction. In addition, tax law sections 683(c) and 1083(c) have been amended to extend the statute of limitations. Tax may be assessed for tax avoidance transactions within six years from filing the return.

Further information regarding participation and eligibility requirements is available by visiting the New York State tax department website at www.nystax.gov or by calling toll free 1-800-225-5829 for income tax or 1-800-972-1233 for corporation tax.

STATE TARGETS ILLEGAL TAX SHELTERS BY OFFERING VOLUNTARY COMPLIANCE INITIATIVE

Civil Penalties, Legal Action Waived Against Those Involved In Illegal Tax Schemes

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FOR RELEASE:

IMMEDIATE, Thursday

September 15, 2005

New York State Commissioner of Taxation and Finance Andrew S. Eristoff today announced that individuals or corporations who attempt to evade taxes through illegal shelters can avoid legal action and civil penalties under a special state program.

Commissioner Eristoff said that New York will offer a 'Voluntary Compliance Initiative' from October 1, 2005 through March 1, 2006, in which taxpayers who engaged in tax avoidance transactions have the opportunity to "do the right thing."

"The State of New York is providing this opportunity to come clean on abusive tax shelters and pay any taxes owed," said Commissioner Eristoff. "Once this limited program expires, the Department of Taxation and Finance will vigorously pursue offenders and impose punitive interest and penalties which make it clear that tax fraud and abuse do not pay."

A tax avoidance transaction (tax shelter) is a plan or arrangement devised for the principal purpose of avoiding tax. These transactions include, but are not limited to, listed transactions that are the same as or similar to those identified by the Internal Revenue Service and available for reference at www.irs.gov.

Through the five-month period, corporate and individual taxpayers are encouraged to voluntarily disclose their participation in abusive tax shelters for years prior to January 1, 2005 and pay underreported tax liabilities and interest attributable to tax avoidance transactions, without incurring any of the new penalties recently enacted for participating in tax shelters.

Eligible New York State taxpayers may take advantage of the Tax Shelter Voluntary Compliance Initiative by submitting a completed Form DTF-671 for each year for which the tax avoidance transaction was used, file an original or amended return and remit full payment of tax and interest for each year attributable to the tax avoidance transaction.

Taxpayers participating in the program may opt to do so with or without appeal rights. For taxpayers opting to waive their appeal rights, all penalties attributable to the use of the tax shelter will be waived and the taxpayer may not file a claim for credit or refund with respect to the use of the tax shelter for that year. For taxpayers who choose to retain their appeal rights, all penalties attributable to the use of the tax shelter will be waived except for negligence and substantial understatement of tax penalties, and the taxpayer will retain their right to file a claim for credit or refund. With either option, the Commissioner of Taxation and Finance will not bring or seek civil, administrative, or criminal action against the taxpayer for the tax years involved.

Eligible taxpayers who fail to participate in the Tax Shelter Voluntary Compliance Initiative will be subject to additional penalties, including a penalty equal to 100% of the interest attributable to the tax due based on the tax shelter transaction. In addition, tax law sections 683(c) and 1083(c) have been amended to extend the statute of limitations. Tax may be assessed for tax avoidance transactions within six years from filing the return.

Further information regarding participation and eligibility requirements is available by visiting the New York State tax department website at www.nystax.gov or by calling toll free 1-800-225-5829 for income tax or 1-800-972-1233 for corporation tax.

New York State
Department of
Taxation
and Finance

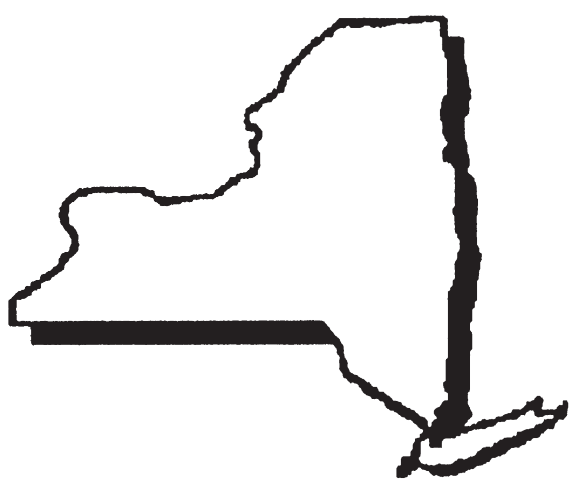
Publication 671
(9/05)

New York State Tax Shelter

Voluntary Compliance Initiative

October 1, 2005, through March 1, 2006

Questions and Answers



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Introduction

The New York State Department of Taxation and Finance announces a Voluntary Compliance Initiative for taxpayers involved in tax shelters

New York State recently enacted legislation which establishes a Voluntary Compliance Initiative (VCI). The VCI allows eligible taxpayers to report and pay underreported tax liabilities and interest attributable to tax avoidance transactions (tax shelters). This gives individual and corporate taxpayers who may have engaged in any tax shelters an opportunity to voluntarily resolve their tax liabilities associated with these transactions. These include, but are not limited to, transactions the Internal Revenue Service (IRS) has identified as *listed transactions*.

Under this legislation, the Tax Department may waive penalties attributable to the tax avoidance transaction and will not seek civil, administrative, or criminal action for those taxpayers who elect to participate in the VCI. The taxpayer can elect one of two options to participate either with, or without, appeal rights. For more information about these options, see Appendix B.

The New York State Tax Shelter VCI will be in effect from October 1, 2005, through March 1, 2006. Participation in the program requires completion of Form DTF-671, *Election to Participate in the Tax Shelter Voluntary Compliance Initiative*, filing New York State original or amended tax returns for each year for which the taxpayer used any tax avoidance transaction, and remittance of full payment of tax and interest for each tax year attributable to the tax avoidance transaction.

Individual and corporate taxpayers who have engaged in tax avoidance transactions that reduce or eliminate their New York State tax liability are encouraged to participate. If you are eligible but fail to participate in this initiative, you will be subject to additional penalties, including an interest penalty equal to 100% of the interest payable on any deficiency assessment.

For more information about participation and eligibility requirements, please refer to the enclosed information, or visit our Web site at *www.nystax.gov*.

About this publication

This publication contains answers to the most commonly asked questions regarding the Voluntary Compliance Initiative (VCI), including information on eligibility requirements and on how to apply for the VCI by mail.

Generally, the VCI applies to:

- personal income tax (Articles 22, 30, 30-A, and 30-B)
- corporation and franchise taxes (Articles 9, 9-A, 32, and 33)

For a complete listing of taxes eligible for the VCI, see Appendix A.

There are two options available for the VCI:

- without appeal rights
- with appeal rights

For a complete description of the two options available for the VCI, see Appendix B.

See *Need help?* inside the back cover of this publication for assistance.

The Tax Department's Web site, *www.nystax.gov*, is the best place to obtain more information and access to the VCI online information. Click on *Tax Shelter Legislation – Reporting Requirements and the Voluntary Compliance Initiative.* For example, this Web site provides:

- Information about how to apply and pay under the VCI.
- Additional questions and answers related to the VCI.
- Tax returns for prior years (original and amended), including many that may be filled in (but not computed) using your personal computer and then printed for filing with the Tax Department.
- Disclosure requirements, forms, instructions, and frequently asked questions, as well as technical memos TSB-M-05(4)I and TSB-M-05(2)C, *Disclosure of Certain Transactions and Related Information Regarding Tax Shelters,* and TSB-M-05(4.1)I and TSB-M-05(2.1)C, *Supplement to the Disclosure of Certain Transactions and Related Information Regarding Tax Shelters.*
- An online calculator that displays the estimated amount of interest due.

For general information about our Tax Shelter VCI, please call toll free 1 800 225-5829 for personal income tax, or 1 800 972-1233 for corporation tax.

If you have access to a fax machine, you can also obtain Form DTF-671 and many other tax returns and forms by dialing toll free 1 800 748-3676. The fax transmission code for Form DTF-671 is 11135. Indexes of fax transmission codes for various forms can be found on the Tax Department's main Web site, *www.nystax.gov,* on the *Forms and Instructions* page.

Frequently asked questions

1. What is the Voluntary Compliance Initiative?

The Voluntary Compliance Initiative (VCI) allows taxpayers to report and pay underreported tax liabilities and interest attributable to the use of tax avoidance transactions (tax shelters). This voluntary compliance program applies to tax liabilities under Articles 9, 9-A, 22, 30, 30-A, 30-B, 32, and 33 of the Tax Law attributable to the use of tax avoidance transactions for tax years beginning before January 1, 2005. Taxpayers participating in this initiative will have the option to participate with a waiver of the right to appeal their liability for any taxes paid under the program, or to participate with the right to appeal. If a taxpayer forgoes the right to appeal, all applicable penalties attributable to a tax avoidance transaction are waived. Participation with appeal rights results in a waiver of all penalties attributable to a tax avoidance transaction except the negligence and substantial underpayment penalties under the Tax Law in effect on December 31, 2004.

2. When does the VCI begin?

The VCI begins **October 1, 2005**, and ends **March 1, 2006.**

3. What is a tax avoidance transaction?

A tax avoidance transaction (tax shelter) is any plan or arrangement devised for the principal purpose of avoiding tax, and includes, but is not limited to, *listed transactions* as designated by the Internal Revenue Service (IRS).

Generally, but not exclusively, a tax shelter:

- Is promoted with the promise of tax benefits,
- Has predictable tax losses or tax consequences,
- Has no true or correlating economic loss with respect to the taxpayer's income or assets; **or**
- Follows the literal reading of a tax statute in a manner inconsistent with the intent of the tax statute.

Characteristics may include, but are not limited to:

- Separation of income and expenses,
- Use of pass through entities,
- Use of third-party accommodators,
- Double benefit for the same tax loss; **or**
- Transactions conducted over a short period of time.

4. What tax years and transactions can be settled under the VCI?

Any tax year beginning before January 1, 2005, for which you participated in a tax shelter, or derived a tax benefit from a tax shelter can be settled under the VCI.

5. How long do I have to file for the Tax Shelter VCI?

Applications must be postmarked by March 1, 2006. You should consider filing and paying as soon as the VCI period begins on October 1, 2005, to stop the accrual of interest charges.

6. How do I participate in the VCI?

You may download forms and instructions needed to apply for the VCI from the Tax Department's Web site at *www.nystax.gov*. Certain forms and returns are available as "fill-in" forms that may be filled in (but not computed) on a computer and printed. See *Need help?* on page 19.

To participate in the VCI, you must:

- Complete a separate Form DTF-671 for each tax year for which you wish to participate.

(continued)

- Complete an original or amended return for each tax year you wish to participate in the VCI. (If you did not file a return as a result of participation in a tax shelter, you must file an original return.)
- If this is the first return or report filed on or after June 13, 2005 (the date New York State tax shelter disclosure requirements went into effect), and you were required to disclose reportable or listed transactions to the IRS (typically IRS Form 8886, *Reportable Transaction Disclosure Statement*) for any tax year, you must attach copies of the IRS disclosure statement along with Form DTF-686, *Tax Shelter Reportable Transactions,* to your original or amended returns. For more information about the disclosure requirements, see the instructions for Form DTF-686.
- If you were under IRS audit for this same tax shelter transaction and the IRS audit is final, provide a copy of the final federal determination.
- Pay all tax and interest due.
- Attach a completed Form DTF-671 to the front of each original or amended return(s) being filed. Attach the payment and any other required information. Completed form(s), return(s), payments, and attachments must be filed by **March 1, 2006.**

  Mail to: **NYS DEPARTMENT OF TAXATION & FINANCE**
TAX SHELTER DISCLOSURE
PO BOX 22104
ALBANY NY 12201-2104

Do not mail to the address on the original or amended return.

7. Who is eligible to participate in the VCI?

Generally, a taxpayer who used a tax avoidance transaction (tax shelter) is eligible to participate in the VCI if **all** of the following apply:

a. The taxpayer filed a tax return using a tax shelter to underreport their tax liability or failed to file a tax return due to the use of a tax shelter.
b. The taxpayer is **not** under criminal investigation with regard to the underreporting or underpayment of tax.
c. The taxpayer has **not** been convicted of a crime relating to the tax that is the basis of the penalty for which relief is sought for any period or assessment for that tax.
d. The taxpayer is **not** a party to any administrative proceeding or civil or criminal litigation relating to the tax that is the basis of the penalty for which relief is sought.
e. The taxpayer was **not** eligible to participate in the 2003 New York Offshore Voluntary Compliance Initiative (OVCI).

8. If I have a case that is in civil litigation or if I have a Notice of Deficiency protest case before the Bureau of Conciliation and Mediation Services (BCMS) or the Division of Tax Appeals, may I still apply for the VCI?

You must withdraw from civil litigation for the disputed tax year to be eligible for the VCI. Protest cases before the Bureau of Conciliation and Mediation Services (BCMS) or the Division of Tax Appeals shall not be deemed pending on the date of the application if the taxpayer withdraws from such proceeding or litigation on or after the date of application, but prior to the waiver of the penalties. However, a taxpayer should not withdraw from a pending proceeding prior to submission of a VCI application.

9. If I participated in the 2003 New York OVCI or the IRS OVCI, may I apply for the new VCI?

If the tax avoidance transaction is different from the transactions covered by the 2003 New York OVCI or the IRS OVCI (Revenue Procedure 2003-11), you may participate in the new VCI.

(continued)

If you were eligible to participate in the 2003 New York OVCI and failed to take part, you may not participate in the new VCI if the transactions are the same as those described in the 2003 New York OVCI.

10. What are my filing options under the VCI?

You can elect one of two filing options under the VCI. If you are participating in the VCI for more than one tax year, you may elect different options for each tax year. Once an election is made it is irrevocable.

- **Option 1 — Voluntary compliance WITHOUT appeal rights**
  - — You file an original tax return or amend your tax return to eliminate the tax avoidance transaction (tax shelter).
  - — You pay the tax and interest due.
  - — Penalties that apply to your participation in the tax avoidance transaction are waived or abated.
  - — The Commissioner of Taxation and Finance will not bring or seek criminal, civil, or administrative action against you.
  - — You cannot file a claim for credit or refund for amounts paid under the VCI.

- **Option 2 — Voluntary compliance WITH appeal rights**
  - — You file an original tax return or amend your original tax return to eliminate the tax avoidance transaction.
  - — You pay the tax and interest due.
  - — Penalties that apply to your participation in the tax avoidance transaction are waived or abated, **except** the penalties imposed under Tax Law sections 685(b), 1085(b) (deficiency due to negligence), 685(p), and 1085(k) (substantial underpayment of tax liability).
  - — The Commissioner of Taxation and Finance will not bring or seek criminal, civil, or administrative action against you.
  - — You reserve the right to file a claim for credit or refund for the amounts paid under the VCI, including certain penalties.

11. Do I have to be a New York State resident to be eligible to participate in the VCI?

No, you do not have to be a New York State resident to be able to participate in the VCI. Generally, any taxpayer that had a filing requirement with New York State for any tax year that involved a tax avoidance transaction (tax shelter) may participate in the VCI.

12. May I file for an extension of time to participate in the VCI if I need more time?

No, there is no extension of time to participate in the VCI. To participate in the VCI, you must file Form DTF-671 between October 1, 2005, and March 1, 2006, with your original or amended tax return and payment.

13. If I am a tax shelter promoter or material advisor and I participated in a tax avoidance transaction, am I eligible to participate in the VCI?

Yes, if you are a tax shelter promoter or material advisor you may participate in the VCI. The same procedures that apply to any taxpayer participating in the VCI apply to you.

14. How will I know if I have been accepted in the VCI?

You will only be contacted if your VCI election Form DTF-671 and attached return cannot be processed, you are ineligible, or if more information is required. Otherwise, your VCI election Form DTF-671 and attached return is accepted as filed.

15. May I participate in the VCI if I am currently under examination by the Tax Department?

Yes. If you or one of your related entities is currently under examination by the Tax Department, you can still participate in the VCI if you meet the requirements. Immediately notify the auditor conducting the examination that you choose to participate in the VCI.

16. If I have already entered into a closing agreement with the Tax Department or I have a finalized assessment because of an examination of a tax avoidance transaction (tax shelter), can I participate in the VCI?

No. Once your assessment becomes final you are not allowed to participate in the VCI for the same tax shelter for the same tax years. You may, however, participate in the VCI for tax avoidance transactions (tax shelters) and tax years not covered by your outstanding or previously paid assessment.

17. May I participate if I am currently under IRS audit, or recently completed an IRS audit for a tax avoidance transaction (tax shelter)?

Yes. See below for guidance on how to file an original or amended tax return depending on whether your IRS determination is final (amounts not in dispute) or pending (audit still open or determination in dispute). Under either option, the full amount of tax and interest is due by March 1, 2006.

- **Under Option 1 — WITHOUT appeal rights**
  - IRS results are final: file an original or amended tax return applying the results of the IRS audit. If the IRS assessed penalties regarding the tax avoidance transaction, corresponding New York State penalties would be waived under this option.
  - IRS results are pending: file an original or amended tax return to eliminate the tax shelter and indicate that the issue is pending a final IRS determination with respect to a tax avoidance transaction.
- **Under Option 2 — WITH appeal rights**
  - IRS results are final: file an original or amended tax return applying the results of the IRS audit and maintain your appeal rights with the New York State Department of Taxation and Finance. You remain subject to penalties imposed under Tax Law sections 685(b), 1085(b) (deficiency due to negligence), 685(p), and 1085(k) (substantial underpayment of tax liability).
  - IRS results are pending: file an original or amended tax return to eliminate the tax avoidance transaction and indicate the issue is pending a final IRS determination with regard to the tax avoidance transaction. You remain subject to penalties imposed under Tax Law sections 685(b), 1085(b) (deficiency due to negligence), 685(p), and 1085(k) (substantial underpayment of tax liability). You may file a claim for refund with a copy of the federal determination after the final federal determination is made.

18. May I file a tax return under the VCI reversing less than 100% of the tax avoidance transaction (tax shelter)?

If you reverse only a portion of the tax avoidance transaction under the VCI and the reversal is not based on a final determination issued by the IRS, the portion not reversed may be subject to the negligence, fraud and substantial understatement penalties, as well as the 100% of the interest penalty.

19. May my representative, who has my power of attorney, sign Form DTF-671, or the tax returns attached to Form DTF-671, on my behalf?

Yes. Attach the signed power of attorney (Form POA-1), showing the representative's designated authority to sign agreements and tax returns on your behalf, to Form DTF-671.

20. May I still participate in the VCI if I am involved in litigation against the law firm, accounting firm, and/or promoter that sold, designed, and/or recommended the tax shelter to me?

Yes, you may participate in the VCI if you are involved in litigation against the law firm, accounting firm, and/or promoter that sold, designed, and/or recommended the tax shelter to you.

21. May I still participate in the VCI if I don't have the ability to pay the full amount of tax and interest by March 1, 2006?

Yes. Although the VCI requires you to pay the full amount of tax and interest for all tax years you participate in the VCI by March 1, 2006, if you do not have the ability to fully pay, you may request an installment payment

(continued)

agreement. Complete Form DTF-383, *Income Tax Installment Payment Agreement Request,* and attach it to your Form(s) DTF-671 and return(s).

However, the burden is on you to establish the inability to pay based on full disclosure of all assets and income sources. Assuming that the Tax Department determines your inability to fully pay is genuine, you may enter into an Installment Payment Agreement with the consent of the Commissioner of Taxation and Finance. For more information about installment payment agreements, call 1 800 570-4372.

If you fail to fully comply with the terms of the installment payment agreement, the waiver of penalties becomes null and void, and the total amount of tax, interest, and all penalties will be due immediately.

22. What happens if I don't compute the tax and interest correctly?

When you file Form DTF-671 and elect to participate in the VCI, you must pay a best estimate of the tax and interest due. You can visit the Tax Department's Web site at *www.nystax.gov* and click on *Tax Shelter Legislation – Reporting Requirements and the Voluntary Compliance Initiative* and go to the *Interest calculator* that will display the estimated amount of interest due. If you compute the tax and/or interest incorrectly, the Tax Department will calculate the correct tax and interest due, and, if required, will send you a bill for the balance due. The billing document will specify the payment due date. You must pay the total amount due by the due date. Failure to do so will prevent the waiver of penalties.

23. May I pay by wire transfer?

Yes, you may pay by wire transfer.

24. Will a refund be granted if I pay too much tax or interest under the VCI?

A refund will be granted if the Tax Department determines an overpayment was made on a return that was filed with Form DTF-671. However, the overpayment will first be applied to any other outstanding tax liabilities or other debts you may have that are collected by the Tax Department.

25. Does participating in the VCI fulfill my tax shelter disclosure requirements?

No. Participation in the VCI does not fulfill the reporting requirements provided for in Tax Law section 25(a). If the tax return filed with Form DTF-671 is the first return or report filed on or after June 13, 2005, attach Form DTF-686 to your return. For more information about the disclosure requirements, see the instructions for Form DTF-686 and TSB-M-05(4)I, TSB-M-05(2)C, TSB-M-05(4.1)I, and TSB-M-05(2.1)C. These forms and TSB-Ms are available on our Web site at *www.nystax.gov*. Click on *Tax Shelter Legislation – Reporting Requirements and the Voluntary Compliance Initiative*.

26. What happens if I don't participate in the VCI?

After the VCI ends, the Tax Department will vigorously pursue taxpayers who have engaged in tax avoidance transactions (tax shelters). For those found to be involved in these transactions, civil penalties can be substantial.

If you are an eligible taxpayer and do not participate in the VCI, you will be subject to additional penalties, including an interest penalty equal to 100% of the interest payable on any deficiency assessment.

The statute of limitations has been extended for tax shelter transactions. Tax may be assessed within six (6) years of filing your tax return if there is a tax avoidance transaction. See Tax Law sections 683(c) and 1083(c).

(continued)

27. What penalties may be avoided by participating in the VCI?

The following is a summary of penalties that may be avoided by participating in the VCI:

- Deficiency due to negligence penalty (see Tax Law sections 685(b) and 1085(b)):
  - An amount equal to 5% of the deficiency; **plus**
  - an amount equal to 50% of the interest payable.

Note: Taxpayers participating in the VCI who choose to maintain their appeal rights **remain subject to the negligence penalty.**

- Deficiency due to fraud penalty (see Tax Law sections 685(e) and 1085(f)):
  - An amount equal to 50% of the deficiency; **plus**
  - an amount equal to 50% of the interest payable.
- Substantial understatement of liability penalty (see Tax Law sections 685(p) and 1085(k)):
  - An amount equal to 10% of the amount of any underpayment attributable to such understatement.

  Note: Taxpayers participating in the VCI who choose to maintain their appeal rights **remain subject to the substantial understatement penalty.**
- Reportable transaction understatement penalty (see Tax Law sections 685(p-1) and 1085(k-1)):
  - An amount equal to 20% of the understatement due to a listed transaction, or a reportable transaction with significant tax avoidance or evasion purposes.
  - The penalty is increased to 30% if the transaction is not adequately disclosed.
- Penalty in the amount of 100% of the interest payable is added to the tax. See Chapter 61 of the Laws of 2005, Part N, section 11(l).

28. If I already paid penalties prior to the VCI, may I apply for VCI and request a refund of those penalties paid?

No. If you already paid penalties prior to the VCI, you may not request a refund of those penalties paid.

29. Am I eligible to receive interest on the overpayment of tax if I participate in the VCI with right of appeal, and successfully appeal?

Yes. If you prevail on the merits of the transaction and a refund is ultimately due, normal rules apply regarding accrued interest on overpayments and offsetting refunds against other unpaid tax liabilities.

30. If I have questions regarding my specific situation or need additional information about the VCI, whom can I contact?

If you have questions, call 1 800 225-5829 or visit our Web site at *www.nystax.gov*. Information given will only be an overall explanation of the VCI program and its requirements. We will not be able to address hypothetical situations, because of the potential for misunderstanding that exists when there is no assurance that the hypothetical contains all relevant facts.

31. Will the New York State Department of Taxation and Finance share information with the IRS or other states regarding taxpayer participation in the VCI?

Yes. We have a long-standing sharing agreement with the IRS, other states, and other taxing authorities. Accordingly, the Tax Department shares any information the IRS, other states, or other taxing authorities are authorized to receive.

32. Will faxed copies of Form DTF-671 or tax returns be accepted?

No. Faxed copies of Form DTF-671 or tax returns are not acceptable. Original signatures are required for both the form and any attached returns.

33. Does participation in the VCI exempt me from criminal prosecution?

The Tax Department will not initiate criminal action for amounts reported during the VCI if you are eligible to participate in the VCI and comply with all requirements.

34. Can I enter into an Offer in Compromise for amounts owed under the VCI?	No. You cannot enter into an Offer in Compromise for amounts owed under the VCI.
35. If I filed a return or report after June 13, 2005, to fulfill the disclosure requirements under Tax Law section 25(a), may I still participate in the VCI for that tax period?	Yes. The VCI is a compliance initiative and you may participate even though you have disclosed the reportable transaction with your return or report prior to your election to participate in the VCI, regarding that reportable transaction.
36. If I participate in the VCI, is this considered an admission that I am involved in a tax shelter?	No. A taxpayer's participation in the VCI shall not be considered evidence that the taxpayer engaged in a tax avoidance transaction.

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DTF-671
(9/05)

New York State Department of Taxation and Finance

Election to Participate in the Tax Shelter Voluntary Compliance Initiative

Tax Law — Articles 9, 9-A, 22, 30, 30-A, 30-B, 32, and 33

All filers must enter tax period:
Beginning ☐ Ending ☐

Section 1 — Taxpayer information (see instructions, Form DTF-671-*I*)

Name(s) as shown on your return	Taxpayer identification number as shown on page 1 of your return
Spouse's name (for individuals, if applicable) or contact name (for businesses)	Spouse's identification number (if applicable)
Mailing address (number and street or PO Box)	Form number of return attached
City, village, town, or post office	Type of entity if other than an individual
State ZIP code Country	If currently under NYS audit, enter audit case ID # and auditor name
Daytime telephone number with area code ( )	Combined and consolidated group information

Section 2 — Voluntary Compliance Initiative (VCI) options (see instructions)

You must complete a Form DTF-671 for each tax year and for each tax return you are filing. You must elect one option for each tax year for which you are filing a tax return. You do not have to elect the same option for all tax years. However, once made, the election is irrevocable.

Option 1 - Without appeal rights	**Option 2 - With appeal rights**
☐ I elect to participate in the VCI under Option 1 for the tax period indicated above. I understand this option is irrevocable, and waive the right to file a claim for credit or refund for any amounts paid under this option.	☐ I elect to participate in the VCI under Option 2 for the tax period indicated above. I understand this option is irrevocable, and retain the right to file a claim for credit or refund for any amounts paid under this option.

Section 3 — Tax shelter information (see instructions; attach a separate schedule if necessary)

Promoter's name and address	Internal Revenue Service (IRS) Notice number (If other than an IRS Notice number, explain)
Partnership's or other entity's name	Partnership's or other entity's employer identification number (EIN)

Entity involved in transaction	Total loss, expense, or deduction amount	Ordinary loss amount	Capital loss amount	Tax return (form, schedule, line item)

Are you under audit, or have you been audited or participated in a settlement for this tax shelter by the IRS or another tax jurisdiction (mark an **X** in one box)? Yes ☐ No ☐	If Yes, enter the name of the tax jurisdiction and the tax years.

Section 4 — Perjury statement (see instructions)

Under penalties of perjury, I declare that I have examined this form, including any accompanying statements, and to the best of my knowledge it is true, correct, and complete. Taxpayer participation in the voluntary compliance initiative will not be considered evidence that the taxpayer engaged in a tax avoidance transaction.

Signature	Official title	Date
Signature	Official title	Date

Mail Form DTF-671, your tax return, and payment to:

NYS DEPARTMENT OF TAXATION AND FINANCE, TAX SHELTER DISCLOSURE, PO BOX 22104, ALBANY NY 12201-2104

If you are using a private delivery service, see the instructions for the address to use.

Instructions for Form DTF-671
Election to Participate in the Tax Shelter Voluntary Compliance Initiative

General information

New York State is offering a Voluntary Compliance Initiative (VCI) for eligible taxpayers who participated in tax avoidance transactions (tax shelters). The VCI allows taxpayers to report and pay underreported tax liabilities and interest attributable to tax shelters. The VCI applies to tax liabilities under Articles 9, 9-A, 22, 30, 30-A, 30-B, 32, or 33 of the Tax Law attributable to the use of tax shelters for tax years beginning before January 1, 2005. The VCI begins October 1, 2005, and ends March 1, 2006. For more information, please see Publication 671, New York State Tax Shelter Voluntary Compliance Initiative.

Purpose of Form DTF-671, Election to Participate in the Tax Shelter Voluntary Compliance Initiative

Form DTF-671 allows eligible taxpayers who underreported their tax liabilities by participating in tax shelters to participate in the VCI and pay the associated liabilities without incurring any of the new penalties recently enacted for participating in tax shelters. An eligible taxpayer may elect one of two options to participate in the VCI, either with or without appeal rights (see Section 2 on the back).

How to participate

Complete an original or amended tax return for each tax year for which you wish to participate in the VCI. If you did not file a return because of participation in a tax shelter, you must file an original return. A separate Form DTF-671 must be completed for each tax year and for each tax return. Form DTF-671 must be completed and attached to the front of the original or amended return that is being filed as part of the VCI. If you were under Internal Revenue Service (IRS) audit for this same tax shelter transaction and the IRS audit is final, attach a copy of the final federal determination.

Note: Every taxpayer or person required to file a return or report under Articles 9, 9-A, 22, 32, or 33 of the Tax Law on or after June 13, 2005, who is or was also required to file a disclosure statement related to a reportable transaction or a listed transaction with the IRS (pursuant to section 6011 of the Internal Revenue Code (IRC)), must disclose that information with the New York State return or report. For more information, see the instructions for Form DTF-686, Tax Shelter Reportable Transactions.

Definitions

A tax avoidance transaction (a tax shelter) is a plan or arrangement devised for the principal purpose of avoiding tax. These transactions include, but are not limited to listed transactions. A listed transaction is a transaction that is the same as or substantially similar to one that the IRS has determined to be a tax avoidance transaction and is identified by an IRS notice or other form of published guidance.

Eligibility

An eligible taxpayer is an individual, partnership, estate, trust, corporation, limited liability company, joint stock company, or any other entity or person, who or which has a tax liability under Articles 9, 9-A, 22, 30, 30-A, 30-B, 32, or 33 of the New York State Tax Law with regard to a tax avoidance transaction for tax years beginning before January 1, 2005.

An otherwise eligible taxpayer is **not** entitled to participate in the VCI if any of the following apply:

- The taxpayer is a party to any criminal investigation by any federal agency or New York State or any political subdivision thereof, with regard to underreporting or underpayment of tax; **or**
- The taxpayer is a party to any litigation pending at the date of the taxpayer's application in the Bureau of Conciliation and Mediation Services (BCMS) or Tax Appeals or any court of this state or the United States relating to any action or failure to act which is the basis for the penalty with respect to which relief is sought; **or**
- The taxpayer has been convicted of a crime relating to the tax that is the basis for the penalty with respect to which relief is sought for any period or assessment for that tax; **or**
- The taxpayer was eligible to participate in the 2003 New York Offshore Voluntary Compliance Initiative (OVCI), and the transactions are the same as those described in the 2003 OVCI program. (The taxpayer may still participate in the VCI if the transactions were not the same as those that were the basis for participation in the OVCI.)

Specific instructions

Section 1 — Taxpayer information

Individuals

Complete the appropriate lines, including the name and social security number (SSN), spouse's name and SSN (if applicable), mailing address and daytime telephone number. Also enter the form number of the tax return attached to Form DTF-671 (Form IT-200, IT-201, IT-201-X, IT-203, IT-203-X, or IT-113-X). If you are currently under NYS audit, enter the audit case ID number and auditor's name.

Businesses

For purposes of Form DTF-671, a business means a corporation, S corporation, partnership, trust, estate, limited liability company, joint stock company, or any other entity other than an individual. Complete the appropriate lines, including the name and federal employer identification number (EIN), contact name, mailing address and daytime telephone number. Enter the form number of the tax return attached to Form DTF-671 (Form CT-3, CT-3-A, CT-3M/4M, CT-3-S, CT-3-S-A, CT-4, CT-4-S, CT-32, CT-32-A, CT-32-M, CT-32-S, CT-33, CT-33-A, CT-33-C, CT-33-M, CT-33-NL, CT-183, CT-183-M, CT-184, CT-184-M, CT-185, CT-186, CT-186-A, CT-186-A/M, CT-186-E, CT-186-EZ, CT-186-M, CT-186-P, CT-186-P/M, CT-8, CT-9, CT-3360, IT-204, IT-205, or IT-113-X). Also enter the type of entity (corporation, S corporation, partnership, trust, estate, limited liability company, joint stock company, etc.). If you are currently under NYS audit, enter the audit case ID number and auditor's name.

Combined and consolidated group information

If the taxpayer is a member of a New York State combined group, Form DTF-671 must be completed and filed by the designated parent or payer corporation on behalf of the group. If a tax shelter reported on this form was reported on a federal return filed by some other entity, enter the name and EIN of that other entity. For example, if the taxpayer is included in a federal consolidated return, but files a separate New York State return, enter the name and EIN of the parent who filed the federal consolidated return. If the taxpayer is the designated parent or payer corporation of a New York State combined group, and if one of the group's members participated in a tax shelter reported on Form DTF-671, enter that member's name and EIN. Attach a separate schedule if more space is needed.

Section 2 — Voluntary Compliance Initiative (VCI) options

You must elect either Option 1 (without appeal rights) or Option 2 (with appeal rights). Read the descriptions below to determine the benefits and agreements for each option. Under either option, the full amount of tax and interest is due by March 1, 2006. A separate election may be made for each tax year in which you elect to participate in the VCI. The election of either option is irrevocable.

Option 1 – Without appeal rights

If you elect to participate under this option, you may not file a claim for credit or refund with respect to the use of a tax shelter for that tax year. In exchange, all penalties applicable to the underreporting or underpayment of tax liabilities attributable to the use of the tax shelter for that tax year will be waived. Additionally, the Commissioner of Taxation and Finance will not bring or seek civil, administrative, or criminal action against the taxpayer for that tax year with respect to the tax shelter.

Option 2 – With appeal rights

If you elect to participate under this option, you retain your right to file a claim for credit or refund with respect to the use of a tax shelter for that tax year. Under this option, however, negligence and substantial understatement penalties, imposed under Tax Law sections 685(b) and (p), and 1085(b) and (k) may apply. All other penalties applicable to the underreporting or underpayment of tax liabilities attributable to the use of the tax shelter for that tax year will be waived. Additionally, the Commissioner of Taxation and Finance will not bring or seek civil, administrative, or criminal action against the taxpayer for that tax year with respect to the tax shelter.

Section 3 — Tax shelter information

Enter the promoter names and addresses. Promoters are persons and organizations you paid a fee for promoting, soliciting, or recommending the tax shelter to you. If the tax shelter being reported is a listed transaction (or substantially similar), enter the IRS notice number. If the tax shelter is not a listed transaction, explain the transaction. List the names, addresses, and EIN of all entities involved in the tax shelter being reported. If you are filing an amended return, enter the loss, expense or deduction amounts, the ordinary loss amount, the capital loss amount, and the form, schedule, and line item number of the item on your original return. If you are currently under audit, or have been audited or have participated in a settlement for this same transaction with the IRS or another taxing jurisdiction, mark an **X** in the Yes box and enter the name of the jurisdiction and the tax years involved. If you need more space for any of the above items, attach a separate schedule.

Section 4 — Perjury statement

Individuals

Sign and date Form DTF-671 in the spaces provided. If you are filing a joint return, both spouses must sign and date Form DTF-671. You do not need to enter a title. If one spouse is unable or refuses to sign Form DTF-671, you must provide a statement explaining why that spouse is unable or refuses to sign.

Businesses

Form DTF-671 must be signed and dated by an appropriate owner, officer, or fiduciary for the business. Include the title of the person signing. If more than one signature is needed, use the second line provided. For more information on signature requirements, see the instructions for the tax return you are filing with Form DTF-671.

Mailing instructions

Attach a completed Form DTF-671 to the front of each original or amended return being filed. Completed form(s), tax return(s), and payment(s) must be filed by **March 1, 2006** to:

NYS DEPARTMENT OF TAXATION AND FINANCE
TAX SHELTER DISCLOSURE
PO BOX 22104
ALBANY NY 12201-2104

Do not mail to the address shown on the original or amended return.

Private delivery services — If you choose, you may use a private delivery service, instead of the U.S. Postal Service, to file your return. However, if, at a later date, you need to establish the date you filed your return, you cannot use the date recorded by a private delivery service unless you used a delivery service that has been designated by the U.S. Secretary of the Treasury or the Commissioner of Taxation and Finance. (Currently designated delivery services are listed in Publication 55, Designated Private Delivery Services. See Need help? below for information on ordering forms and publications.) If you have used a designated private delivery service and need to establish the date you filed your return, contact that private delivery service for instructions on how to obtain written proof of the date your return was given to the delivery service for delivery.

If you use any private delivery service, whether it is a designated service or not, address your return to: NYS Tax Department, Tax Shelter Disclosure, W A Harriman Campus, Albany NY 12227

Need help?

Internet access: www.nystax.gov
(for information, forms, and publications)

Fax-on-demand forms:	1 800 748-3676
Business Tax Information Center:	1 800 972-1233
Personal Income Tax Information Center:	1 800 225-5829
From areas outside the U.S. and outside Canada:	(518) 485-6800

Privacy notification — The Commissioner of Taxation and Finance may collect and maintain personal information pursuant to the New York State Tax Law, including but not limited to, sections 171, 171-a, 287, 308, 429, 475, 505, 697, 1096, 1142, and 1415 of that Law; and may require disclosure of social security numbers pursuant to 42 USC 405(c)(2)(C)(i).

This information will be used to determine and administer tax liabilities and, when authorized by law, for certain tax offset and exchange of tax information programs as well as for any other lawful purpose.

Information concerning quarterly wages paid to employees is provided to certain state agencies for purposes of fraud prevention, support enforcement, evaluation of the effectiveness of certain employment and training programs and other purposes authorized by law.

Failure to provide the required information may subject you to civil or criminal penalties, or both, under the Tax Law.

This information is maintained by the Director of Records Management and Data Entry, NYS Tax Department, W A Harriman Campus, Albany NY 12227; telephone 1 800 225-5829. From areas outside the United States and outside Canada, call (518) 485-6800.

Appendix A: Eligibility for the Tax Shelter Voluntary Compliance Initiative

Personal income tax

- Personal income tax — Article 22
- New York City resident tax — Article 30
- Yonkers resident income tax surcharge — Article 30-A
- Yonkers earnings tax on nonresidents — Article 30-B

Corporation and franchise taxes

- Franchise tax on corporations — Article 9
- Franchise tax on business corporations — Article 9-A
- Bank franchise tax — Article 32
- Insurance franchise tax — Article 33

To be eligible for the initiative, the taxpayer must be:

- An individual,
- A partnership,
- An estate,
- A trust,
- A corporation,
- A limited Liability Company; **or**
- Any other entity or person.

An otherwise eligible taxpayer is NOT entitled to participate in the VCI if any of the following apply:

- Taxpayer is a party to any criminal investigation by any federal agency or the state of New York or any political subdivision thereof, in regard to underreporting or underpayment of tax.
- Taxpayer has been convicted of a crime relating to the tax that is the basis of the penalty for which relief is sought for any period or assessment for that tax.
- Taxpayer is a party to any litigation pending at the date of the taxpayer's application in BCMS, Tax Appeals, or any court of this state or the United States relating to any action or failure to act which is the basis of the penalty with respect to which relief is sought.
- Taxpayer was eligible to participate in the 2003 New York OVCI, and the transactions are the same as those described in the 2003 OVCI program. (The taxpayer may still participate in the VCI if the transactions were not the same as those described in the OVCI.)

Appendix B: Options for the Voluntary Compliance Initiative

You must elect either option 1 or option 2 for each tax year and article of the Tax Law. You do **NOT** need to elect the same option for all tax years. However, once made, the election is irrevocable.

Option 1 — Without appeal rights

If you elect this option, you may not file a claim for credit or refund with respect to the use of a tax shelter for that tax year. In exchange, all penalties applicable to the underreporting or underpayment of tax liabilities attributable to the use of the tax shelter for that tax year will be waived. Additionally, the Commissioner of Taxation and Finance will not bring or seek civil, administrative, or criminal action against the taxpayer for that tax year with respect to the tax shelter.

Option 2 — With appeal rights

If you elect this option, you retain your right to file a claim for credit or refund with respect to the use of a tax shelter for that tax year. Under this option, however, negligence and substantial understatement penalties, imposed under Tax Law sections 685(b) and (p), and 1085(b) and (k), may apply. All other penalties applicable to the underreporting or underpayment of tax liabilities attributable to the use of the tax shelter for that year will be waived. Additionally, the Commissioner of Taxation and Finance will not bring or seek civil, administrative, or criminal action against the taxpayer for that tax year with respect to the tax shelter.

Need help?

Internet access
Access the Tax Department's Web site for information about the Voluntary Compliance Initiative (VCI), including applications and tax returns, frequently asked questions, and more detailed information.

www.nystax.gov

Telephone assistance is available from 8:00 A.M. to 5:00 P.M. (eastern time), Monday through Friday.

Personal income tax	**1 800 225-5829**
Business taxes	**1 800 972-1233**
From outside the U.S. and outside Canada	**(518) 485-6800**

Fax-on-demand forms: Forms are available 24 hours a day, 7 days a week.

1 800 748-3676
1 800 748-FORM
The fax-on-demand code for Form DTF-671 is 11135

For general inquiries about the Voluntary Compliance Initiative, address your letter to:

NYS TAX DEPARTMENT
TAXPAYER CONTACT CENTER — VCI
W A HARRIMAN CAMPUS
ALBANY NY 12227

To obtain a withdrawal of your protest for a proceeding before the Bureau of Conciliation and Mediation Services (BCMS), address your letter to:

NYS TAX DEPARTMENT
BUREAU OF CONCILIATION AND
MEDIATION SERVICES
W A HARRIMAN CAMPUS
ALBANY NY 12227

To obtain a withdrawal of your protest for a proceeding in the Division of Tax Appeals (either an Administrative Law Judge hearing or a review before the Tax Appeals Tribunal), address your letter to:

NYS TAX DEPARTMENT
OFFICE OF COUNSEL — LITIGATION SECTION
W A HARRIMAN CAMPUS
ALBANY NY 12227

To obtain a withdrawal of your protest for civil or surrogate court litigation:

Contact the court with jurisdiction over the case (for example, Appellate Division of the Supreme Court, Third Department)

Hotline for the hearing and speech impaired:
If you have access to a telecommunications device for the deaf (TDD), contact us at 1 800 634-2110.

If you do not own a TDD, check with independent living centers or community action programs to find out where machines are available for public use.

Persons with disabilities: In compliance with the Americans with Disabilities Act, we will ensure that our lobbies, offices, meeting rooms, and other facilities are accessible to persons with disabilities. If you have questions about special accommodations for persons with disabilities, please call 1 800 972-1233.

NYS TAX DEPARTMENT
W A HARRIMAN CAMPUS
ALBANY NY 12227

Publication 671 (9/05)

New York State Tax Shelter Voluntary Compliance Initiative Fact Sheet

DTF-671.1
(9/05)

General information

New York State is offering a Voluntary Compliance Initiative (VCI) for eligible taxpayers who participated in tax avoidance transactions (tax shelters). The VCI allows taxpayers to report and pay underreported tax liabilities and interest attributable to tax shelters. The VCI applies to tax liabilities under Articles 9, 9-A, 22, 30, 30-A, 30-B, 32, or 33 of the Tax Law attributable to the use of tax shelters for tax years beginning before January 1, 2005. The VCI begins October 1, 2005, and ends March 1, 2006. For more information, please see Publication 671, New York State Tax Shelter Voluntary Compliance Initiative.

Purpose of Form DTF-671, Election to Participate in the Tax Shelter Voluntary Compliance Initiative

Form DTF-671 allows eligible taxpayers who underreported their tax liabilities by participating in tax shelters to participate in the VCI and pay the associated liabilities without incurring any of the new penalties recently enacted for participating in tax shelters. An eligible taxpayer may elect one of two options to participate in the VCI, either with or without appeal rights.

How to participate

Complete an original or amended tax return for each tax year for which you wish to participate in the VCI. If you did not file a return because of participation in a tax shelter, you must file an original return. A separate Form DTF-671 must be completed for each tax year and for each tax return. Complete Form DTF-671 and attach it to the front of the original or amended return that is being filed as part of the VCI. If you were under Internal Revenue Service (IRS) audit for this same tax shelter and the IRS audit is final, attach a copy of the final federal determination.

Definitions

A tax avoidance transaction (a tax shelter) is a plan or arrangement devised for the principal purpose of avoiding tax. These transactions include, but are not limited to, listed transactions. A listed transaction is a transaction that is the same as or substantially similar to one that the IRS has determined to be a tax avoidance transaction and is identified by an IRS notice or other form of published guidance.

Voluntary Compliance Initiative (VCI) options

You must elect either Option 1 (without appeal rights) or Option 2 (with appeal rights). Read the descriptions below to determine the benefits and agreements for each option. Under either option, the full amount of tax and interest is due by March 1, 2006. A separate election may be made for each tax year in which you elect to participate in the VCI. Once an election is made for a tax year, it is irrevocable.

Option 1 - Without appeal rights

If you elect to participate under this option, you may not file a claim for credit or refund with respect to the use of a tax shelter for that year. In exchange, all penalties applicable to the underreporting or underpayment of tax liabilities attributable to the use of the tax shelter for that tax year will be waived. Additionally, the Commissioner of Taxation and Finance will not bring or seek civil, administrative, or criminal action against the taxpayer for that tax year with respect to the tax shelter.

Option 2 - With appeal rights

If you elect to participate under this option, you retain your right to file a claim for credit or refund with respect to the use of a tax shelter for that tax year. Under this option, however, negligence and substantial understatement penalties, imposed under Tax Law sections 685(b) and (p), and 1085(b) and (k), may apply. All other penalties applicable to the underreporting or underpayment of tax liabilities attributable to the use of the tax shelter for that tax year will be waived. Additionally, the Commissioner of Taxation and Finance will not bring or seek civil, administrative, or criminal action against the taxpayer for that tax year with respect to the tax shelter.

Eligibility

An eligible taxpayer is an individual, partnership, estate, trust, corporation, limited liability company, joint stock company, or any other entity or person, who or which has a tax liability under Articles 9, 9-A, 22, 30, 30-A, 30-B, 32 or 33 of the New York State Tax Law with regard to a tax avoidance transaction for tax years beginning before January 1, 2005.

An otherwise eligible taxpayer is **not** entitled to participate in the VCI if any of the following apply:

- The taxpayer is a party to any criminal investigation by any federal agency or the state of New York or any political subdivision thereof, with regard to underreporting or underpayment of tax; **or**
- The taxpayer is a party to any litigation pending at the date of the taxpayer's application in the Bureau of Conciliation and Mediation Services (BCMS) or Tax Appeals or any court of this state or the United States relating to any action or failure to act which is the basis for the penalty with respect to which relief is sought; **or**
- The taxpayer has been convicted of a crime relating to the tax that is the basis for the penalty with respect to which relief is sought for any period or assessment for that tax; **or**
- The taxpayer was eligible to participate in the 2003 New York Offshore Voluntary Compliance Initiative (OVCI), and the transactions are the same as those described in the 2003 OVCI program. (The taxpayer may still participate in the VCI if the transactions were not the same as those that were the basis for participation in the OVCI.)

What happens if an eligible taxpayer does not apply for the VCI?

Penalties — If a taxpayer is eligible but fails to apply for the VCI, a penalty in the amount of 100% of the interest attributable to the tax due based on the tax shelter transaction will be added to the tax due. In addition, the taxpayer may be subject to other applicable penalties such as:

- Negligence, Tax Law sections 685(b) and 1085(b).
- Substantial understatement of tax, Tax Law sections 685(p) and 1085(k).
- Reportable transaction understatement, Tax Law sections 685(p-1) and 1085(k-1).

Extended statute of limitations — Tax Law sections 683(c) and 1083(c) have been amended. Tax may be assessed for tax avoidance transactions within six years of filing the return.

Need help?

Internet access: www.nystax.gov
(for information, forms, and publications)

Fax-on-demand forms:	1 800 748-3676
Business Tax Information Center:	1 800 972-1233
Personal Income Tax Information Center:	1 800 225-5829
From areas outside the U.S. and outside Canada:	(518) 485-6800

New York State Department of
Taxation and Finance
W A Harriman Campus — VCI
Albany NY 12227

New York State Department of Taxation and Finance
Tax Shelter Voluntary Compliance Initiative

New York State recently enacted legislation which establishes a Tax Shelter Voluntary Compliance Initiative (VCI). The VCI allows eligible taxpayers to report and pay underreported tax liabilities and interest attributable to tax avoidance transactions. If you have engaged in any tax avoidance transactions, you now have an opportunity to voluntarily resolve your tax issues associated with these transactions. These include, but are not limited to, transactions that the Internal Revenue Service (IRS) has identified as listed transactions.

Under this new legislation, the Tax Department may waive any penalties attributable to the tax avoidance transactions and will not seek civil, administrative, or criminal action for those taxpayers who elect to participate in the initiative. Taxpayers can elect one of two options to participate, either with or without appeal rights. For additional information regarding this and other reporting requirements, see the enclosed Form DTF-671.1, New York State Tax Shelter Voluntary Compliance Initiative Fact Sheet.

The New York State Tax Shelter Voluntary Compliance Initiative will be in effect from October 1, 2005, through March 1, 2006. To participate in the VCI program, you must complete Form DTF-671, Election to Participate in the Tax Shelter Voluntary Compliance Initiative, file New York State original or amended return(s) for each tax year for which the tax avoidance transaction was used, **and** remit the full payment of tax and interest for each year attributable to the tax avoidance transaction.

Individual and corporate taxpayers who have engaged in tax avoidance transactions that reduce or eliminate their New York State tax liability are encouraged to participate. If you are an eligible taxpayer but fail to participate in this initiative, you will be subject to additional penalties, including an interest penalty equal to 100% of the interest charged on any deficiency assessment attributable to a tax avoidance transaction.

For more information regarding participation and eligibility requirements, please visit our Web site at www.nystax.gov or see the enclosed Form DTF-671.1.

Enclosures: DTF-671.1

Disclosure of Certain Transactions and Related Information Regarding Tax Shelters

The Tax Law has been amended to provide new reporting requirements with respect to the disclosure of information relating to transactions that present the potential for tax avoidance (a tax shelter). These new reporting requirements are similar to the tax shelter disclosure requirements for federal income tax purposes. Separate reporting requirements are imposed on those who utilize tax shelters and those who promote the use of tax shelters. The amendments also impose penalties for nondisclosure and the underpayment of taxes due to participation in these transactions, extend the statute of limitations for assessments relating to these transactions, and create a voluntary compliance initiative to allow taxpayers to report and pay underreported tax liabilities and interest attributable to these transactions with a waiver of penalties.

Reporting requirements for taxpayers and persons required to file returns or reports under Articles 9, 9-A, 22, 32, or 33

Who must file a disclosure and what must be disclosed

Every taxpayer or person who files a return or report under Articles 9, 9-A, 22, 32, or 33 of the Tax Law on or after June 13, 2005, who is **or was** also required to file a disclosure statement related to a reportable transaction or a listed transaction with the Internal Revenue Service (IRS), pursuant to section 6011 of the Internal Revenue Code (IRC), must disclose that information with the New York State return or report as described below (see **How to report** on page 2). Generally, the date filed is the date postmarked by the U.S. Postal Service. For more information about postmarks, see Publication 55, *Designated Private Delivery Services*. Disclosure is required if the taxpayer or person participated in tax shelter activities prior to July 1, 2007, for which a disclosure statement related to a reportable transaction or a listed transaction was required to be filed with the IRS. The term *return or report* includes original returns or reports, amended returns or reports, and applications for credit or refund of tax.

Each taxpayer or person must make its own disclosure, even though one member of an affiliated group, as defined by section 1504 of the IRC, may file the disclosure statement with the IRS on behalf of its affiliates including the taxpayer or person. For purposes of Article 22, a group agent who is authorized to file a group return on behalf of a group of nonresident members must make this disclosure with the group return; the individual group members are not required to make this disclosure.

A taxpayer or person who files a return or report under Articles 9, 9-A, 22, 32, or 33 of the Tax Law includes:

- corporations subject to tax under sections 183, 184, 185 or 186 and persons subject to tax under sections 186-a or 186-e of the Tax Law (Article 9);
- general business corporations (Article-9-A);

- individuals including sole proprietors, partnerships (including a limited liability company (LLC) that is treated as a partnership for federal income tax purposes), estates and trusts, partners in a partnership (including members of a LLC that is treated as a partnership for federal income tax purposes), shareholders of an S corporation, and beneficiaries of an estate or trust (Article 22);
- banking corporations (Article 32); and
- insurance corporations and captive insurance companies (Article 33).

How to report

A new form, Form DTF-686, *Tax Shelter Reportable Transactions- Attachment to New York State Return*, has been developed to assist taxpayers and persons in complying with New York State's disclosure requirements. Attach a duplicate of the IRS disclosure statement and any related information submitted to the IRS to Form DTF-686 and attach Form DTF-686 to the return or report filed by the taxpayer or person for the current tax year. Currently, the IRS uses IRS Form 8886 and Schedule M-3 as its disclosure statement. Any disclosure information attached to Form DTF-686 must include the taxpayer or person's name(s) and taxpayer identification number(s) shown on Form DTF-686.

In addition, the taxpayer or person must also disclose with its **first** return or report filed on or after June 13, 2005:

- all disclosure statements that were required to be filed with the IRS at any time with respect to listed transactions for which the taxpayer or person filed a New York State return or report for the tax year in which the transaction occurred under Articles 9, 9-A, 22, 32, or 33 of the Tax Law, and
- all disclosure statements that were required to be filed with the IRS with respect to reportable transactions, other than listed transactions, in which the taxpayer participated during any tax year for which the statute of limitations for assessment has not expired as of April 12, 2005. For this purpose, the statute of limitations for assessment under sections 683 and 1083 of the Tax Law in effect prior to April 12, 2005, is used and the new extended statutes of limitations for tax avoidance transactions, described below, do not apply.

However, disclosure is not required for tax shelter activities in which the taxpayer or person participated on or after July 1, 2007.

Examples

Example 1: Corporation XYZ, a corporation subject to tax under Article 9-A of the Tax Law (the business corporation franchise tax) since 1996, has a fiscal year ending March 31, 2005. Its franchise tax return is filed June 15, 2005. It must include with that first return Form DTF-686 and attach thereto a copy of:

1. the IRS disclosure statements for all listed transactions required to be reported to the IRS since 1996, even those transactions for which the statute of limitations for assessment has expired,
2. the IRS disclosure statements for all reportable transactions, other than listed transactions, in which the corporation participated during any tax year for which the statute of limitations for assessment has not expired as of April 12, 2005, and
3. the IRS disclosure statement (currently IRS Form 8886 and Schedule M-3) and any related information submitted to the IRS for the current tax year.

For tax years ending March 31, 2006, and March 31, 2007, the corporation must attach to Form DTF-686 only a copy of the IRS disclosure statement (currently IRS Form 8886 and Schedule M-3) and any related information that was filed with the IRS for that particular tax year. When the corporation's tax return is filed for that particular tax year, whenever filed, Form DTF-686 and any attachment is attached to that return.

For tax year ending March 31, 2008, the corporation must attach to Form DTF-686 only a copy of the IRS disclosure statement (currently IRS Form 8886 and Schedule M-3) and any related information that was filed with the IRS for that tax year. When the corporation's tax return is filed for that particular tax year, whenever filed, Form DTF-686 and any attachment is attached to that return. However, only tax shelter activities that occurred prior to July 1, 2007, must be disclosed.

Example 2: Corporation ABC, a foreign corporation, first becomes subject to tax under Article 9-A of the Tax Law in 2006. The corporation is a calendar year filer. Its return for calendar year 2006 is due March 15, 2007. The corporation is granted an extension of time to file its return until September 15, 2007. When the return is filed, the corporation must attach to Form DTF-686 only a copy of the IRS disclosure statement (currently IRS Form 8886 and Schedule M-3) and any related information that was filed with the IRS for that tax year, and Form DTF-686 is attached to its tax return. No disclosure of listed and reportable transactions that were reported to the IRS for tax years prior to 2006 is required because the corporation was not subject to tax in New York State for those tax years.

For calendar year 2007, the corporation is granted an extension of time to file its return until September 15, 2008. When the return is filed, the corporation must attach to Form DTF-686 only a copy of the IRS disclosure statement (currently IRS Form 8886 and Schedule M-3) and any related information that was filed with the IRS for that tax year, and Form DTF-686 is attached to that return. However, only tax shelter activities that occurred prior to July 1, 2007, must be disclosed.

Example 3: Mr. Smith, a taxpayer subject to tax under Article 22 of the Tax Law (the personal income tax) since 1998, files his 2004 tax return on April 15, 2005, and his 2005 tax return on April 13, 2006. No disclosure of listed and reportable transactions that were reported to the IRS is required with his 2004 tax return. However, he must include with his 2005 tax return, Form DTF-686 and attach a copy of:

1. the IRS disclosure statements for all listed transactions required to be reported to the IRS since 1998, even those transactions for which the statute of limitations for assessment has expired,
2. the IRS disclosure statements for all reportable transactions, other than listed transactions, in which he participated during any tax year for which the statute of limitations for assessment has not expired as of April 12, 2005, and
3. the IRS disclosure statement (currently IRS Form 8886 and Schedule M-3) and any related information submitted to the IRS for the current tax year.

Example 4: Assume the same facts as described in *Example 3*, except Mr. Smith files an amended 2004 tax return on June 27, 2005. He must include with that amended return, Form DTF-686 and attach a copy of:

1. the IRS disclosure statements for all listed transactions required to be reported to the IRS since 1998, even those transactions for which the statute of limitations for assessment has expired,
2. the IRS disclosure statements for all reportable transactions, other than listed transactions, in which he participated during any tax year for which the statute of limitations for assessment has not expired as of April 12, 2005, and
3. the IRS disclosure statement (currently IRS Form 8886 and Schedule M-3) and any related information submitted to the IRS for the current tax year.

However, since he disclosed all transactions described in items 1 and 2 above with his amended 2004 tax return, which is the first return filed on or after June 13, 2005, when he files his 2005 tax return on April 13, 2006, he must attach to Form DTF-686 only a copy of the IRS disclosure statement (currently IRS Form 8886 and Schedule M-3) and any related information that was filed with the IRS for his 2005 tax year, and Form DTF-686 is attached to his 2005 tax return.

Example 5: Assume the same facts as described in *Example 4*, except the amended 2004 tax return was filed pursuant to the voluntary compliance initiative described on page 8. He must include with that amended return, Form DTF-686 and attach a copy of:

1. the IRS disclosure statements for all listed transactions required to be reported to the IRS since 1998, even those transactions for which the statute of limitations for assessment has expired,
2. the IRS disclosure statements for all reportable transactions, other than listed transactions, in which he participated during any tax year for which the statute of limitations for assessment has not expired as of April 12, 2005, and
3. the IRS disclosure statement (currently IRS Form 8886 and Schedule M-3) and any related information submitted to the IRS for the current tax year.

However, since he disclosed all transactions described in items 1 and 2 above with his amended 2004 tax return, which is the first return filed on or after June 13, 2005, when he files his 2005 tax return on April 13, 2006, he must attach to Form DTF-686 only a copy of the IRS disclosure statement (currently IRS Form 8886 and Schedule M-3) and any related information that was filed with the IRS for his 2005 tax year, and Form DTF-686 is attached to his 2005 tax return.

Example 6: Ms. Jones is a taxpayer subject to tax under Article 22 of the Tax Law (the personal income tax) since 2001. Ms. Jones is granted an extension of time to file her 2004 tax return until August 15, 2005. She files her 2004 tax return on August 15, 2005. She must include with that return, Form DTF-686 and attach a copy of:

1. the IRS disclosure statements for all listed transactions required to be reported to the IRS since 2001, even those transactions for which the statute of limitations for assessment has expired,
2. the IRS disclosure statements for all reportable transactions, other than listed transactions, in which she participated during any tax year for which the statute of limitations for assessment has not expired as of April 12, 2005, and
3. the IRS disclosure statement (currently IRS Form 8886 and Schedule M-3) and any related information submitted to the IRS for the current tax year.

Example 7: Assume the same facts as described in *Example 6*, except Ms. Jones is not granted an extension of time to file her 2004 tax return. She files her 2004 tax return on June 15, 2005. She must include with that return, Form DTF-686 and attach a copy of:

1. the IRS disclosure statements for all listed transactions required to be reported to the IRS since 2001, even those transactions for which the statute of limitations for assessment has expired,
2. the IRS disclosure statements for all reportable transactions, other than listed transactions, in which she participated during any tax year for which the statute of limitations for assessment has not expired as of April 12, 2005, and
3. the IRS disclosure statement (currently IRS Form 8886 and Schedule M-3) and any related information submitted to the IRS for the current tax year.

Example 8: Assume the same facts as described in *Example 6* and Ms. Jones files an amended 2004 tax return on August 29, 2005. She must include with that return, Form DTF-686 and attach only a copy of the IRS disclosure statement (currently IRS Form 8886 and Schedule M-3) and any related information submitted to the IRS for the 2004 tax year.

(Tax Law, section 25(a)(1); Ch. 61 of the Laws of 2005, Part N, section 12)

New York reportable transactions

The Tax Law has also been amended to allow the Commissioner of Taxation and Finance to prescribe by regulation New York reportable transactions. A *New York reportable transaction* is a transaction that has the potential to be a tax avoidance transaction with regard to returns or reports required under Articles 9, 9-A, 22, 32, or 33 of the Tax Law. Once regulations are prescribed, the Commissioner may designate specific transactions as New York tax avoidance transactions by public notice or some other form of published guidance.

(Tax Law, section 25(a)(2), (3), and (4))

Reporting requirements for material advisors

Who must report and what must be reported

Every person required to make and file a statement or return pursuant to section 6111 of the IRC (a material advisor) on or after April 12, 2005, and prior to July 1, 2007, must file a duplicate of that statement or return (currently IRS Form 8264), including all documentation submitted to the IRS in connection with the statement or return, with the Commissioner of Taxation and Finance if **any** of the following conditions apply:

(A) the person is organized in this state,
(B) the person is doing business in this state,
(C) the person is deriving income in this state, or
(D)(i) the list, required to be maintained by this person pursuant to section 6112 of the IRC, identifies or is required to identify a taxpayer subject to tax under Articles 9, 9-A, 22, 32, or 33 of the Tax Law, and
(ii) this person is a material advisor, as defined in section 6111 of the IRC, who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction.

How to report

A new form, Form DTF-664, *Tax Shelter Disclosure for Material Advisors,* has been developed to assist material advisors in complying with New York State's disclosure requirements. The duplicate statement or return as described above (see **Who must report and what must be reported**) must be filed with the Commissioner of Taxation and Finance by the later of:

- 60 days from the date required for filing the statement or return with the IRS,
- 60 days from the date that any of the conditions ((A), (B), (C), or (D)) described above first applies, or
- September 9, 2005.

Attach a copy of IRS Form 8264, *Application for Registration of a Tax Shelter,* to Form DTF-664, *Tax Shelter Disclosure for Material Advisors*, and mail to:

NYS Department of Taxation and Finance
Tax Shelter Disclosure
PO Box 22104
Albany NY 12201

(Tax Law, section 25(b)(1))

Additional reporting requirements for material advisors

Every person who is required to maintain a list of persons pursuant to section 6112 of the IRC (a material advisor), must maintain a duplicate of this list if any of the conditions ((A), (B), (C), or (D)) described above applies to this person. The material advisor must furnish a copy of the list to the Commissioner of Taxation and Finance within 20 days after written request is made for the list.

(Tax Law, section 25(c))

Additional tax shelter recordkeeping requirements

Every person required by section 25 of the Tax Law to disclose any transaction, file any duplicate report, or maintain any list, must retain all relevant correspondence, memoranda, notes, valuation studies, meeting minutes, spreadsheets, models, opinions, records required to be retained pursuant to section 6011 of the IRC, and all other records or documents related to the disclosure, filing and list maintenance requirements of section 25 of the Tax Law for six years. The information must be made available for inspection in connection with any examination.

(Tax Law, section 25(d))

Extended statutes of limitations

If a taxpayer or person fails to file, disclose or provide any statement, return or other information for any tax year with respect to a listed transaction, the time for assessment of any tax imposed under Articles 9, 9-A, 22, 32, or 33 of the Tax Law with respect to the listed transaction does not expire before the date that is one year after the earlier of the:

- date the required statement, return, or information is furnished, or
- date that the material advisor provides a copy of the list maintained pursuant to section 6112 of the IRC that pertains to the listed transaction.

Tax may be assessed at any time within 6 years after the return was filed if the deficiency is attributable to an abusive tax avoidance transaction. An *abusive tax avoidance transaction* means a plan or arrangement devised for the principal purpose of avoiding tax. Abusive tax avoidance transactions include, but are not limited to, listed transactions. A listed transaction includes any transaction designated as a tax avoidance transaction by the IRS or the Commissioner of Taxation and Finance.

(Tax Law, sections 683(c)(11) and 1083(c)(11))

Penalties

The Tax Law was also amended to provide new stiffer penalties for:

- taxpayers' substantial understatement of tax where the understatement is attributable to a tax shelter transaction;
- taxpayers' understatement of tax where the understatement is attributable to a reportable transaction;
- paid preparers that aid or assist in the giving of fraudulent returns, reports, statements, or other documents under Article 22 of the Tax Law;
- taxpayers or persons who fail to disclose or provide reportable transaction information;
- material advisors who fail to disclose or provide the reportable transaction statement or return;
- material advisors who fail to provide a duplicate of the list maintained pursuant to 6112 of the IRC;
- tax return preparers who fail to disclose the tax position taken on a return or claim for refund that results in an understatement of tax liability, or if disclosed, the position taken had no reasonable basis, or who willfully attempts to understate the tax liability or recklessly or intentionally disregard the rules and regulations; and
- promoters of abusive tax shelters.

(Tax Law, sections 685(p), 685(p-1), 685(r), 685(x), 685(y), 685(z), 685(aa), 685(bb), 1085(k), 1085(k-1), 1085(p), 1085(q), 1085(r), 1085(s), and 1085(t))

Voluntary Compliance Initiative

The Tax Law was also amended to establish a voluntary compliance initiative (VCI) to be administered by the Commissioner of the Department of Taxation and Finance. The VCI allows taxpayers to report and pay underreported tax liabilities and interest attributable to abusive tax avoidance transactions. This voluntary compliance program applies to tax liabilities under Articles 9, 9-A, 22, 30, 32, or 33 of the Tax Law attributable to the use of tax avoidance transactions for tax years beginning before January 1, 2005. Taxpayers participating in this initiative will have the option to participate with a waiver of the right to appeal their liability for any taxes paid under the program, or to participate with the right to appeal. If a taxpayer forgoes the right to appeal, all applicable penalties are waived. Participation with appeal rights results in a waiver of all penalties except the negligence and substantial understatement penalties under the Tax Law in effect on December 31, 2004. The VCI begins October 1, 2005, and ends March 1, 2006. Further details of the VCI will be announced in a forthcoming publication.

(Ch. 61 of the Laws of 2005, Part N, section 11)

TSB-M-05(2.1)C
Corporation Tax
TSB-M-05(4.1)I
Income Tax
July 28, 2005

Supplement to the Disclosure of Certain Transactions and Related Information Regarding Tax Shelters

TSB-M-05(2)C and TSB-M-05(4)I are supplemented to:

- provide an exception to the tax shelter disclosure reporting requirements if the taxpayer is a partner of one or more large partnerships,
- provide an exception to the tax shelter disclosure reporting requirements for reportable transactions that have been de-listed by the Internal Revenue Service (IRS),
- clarify the reporting requirement of nonresident individuals who participate in a group return for purposes of Article 22,
- provide exceptions to the reporting requirements and the additional reporting requirements for material advisors, and
- announce the expansion of the voluntary compliance initiative to include tax liabilities under Articles 30-A and 30-B of the Tax Law.

Exception to the reporting requirements for taxpayers and persons required to file returns or reports under Articles 9, 9-A, 22, 32, or 33 for partners of large partnerships

For taxable years beginning prior to January 1, 2004, a taxpayer that is a partner of one or more large partnerships may file an abbreviated disclosure statement if the large partnership elects "collective disclosure" by providing a list of the names, addresses, and tax identification numbers of each of its partners, by taxable year, who were entitled to participate in one or more of the partnership's reportable transactions or listed transactions for those prior taxable years. Collective disclosure may **not** be made with regard to the disclosure statement required to be filed with the IRS for taxable years beginning on or after January 1, 2004. Therefore, for taxable years beginning on or after January 1, 2004, both the partnership and each of its partners must attach a duplicate of the IRS disclosure statement to Form DTF-686, *Tax Shelter Reportable Transactions*. A large partnership may elect collective disclosure for:

- all disclosure statements that were required to be filed with the IRS at any time with respect to listed transactions for which the partnership filed a New York State return (Form IT-204) for the tax year in which the transaction occurred, and
- all disclosure statements that were required to be filed with the IRS with respect to reportable transactions, other than listed transactions, in which the partnership participated during any tax year for which the statute of limitations for assessment against any partner has not expired as of April 12, 2005. For this purpose, the statute of limitations for assessment under sections 683 and 1083 of the Tax Law in effect prior to April 12, 2005, is used.

To make the election, the large partnership must:

- write **Collective Disclosure** on the top of Form DTF-686,
- complete Form DTF-686, and attach all required tax shelter disclosure information for listed and reportable transactions,
- attach a list of the names, addresses, and tax identification numbers of all partners for each relevant year, by taxable year, who were entitled to participate in a reportable transaction or listed transaction for taxable years beginning prior to January 1, 2004,
- attach completed Form DTF-686 to the first return (Form IT-204) filed on or after June 13, 2005, and
- notify its partners of the election.

To file an abbreviated disclosure statement, the taxpayer must:

- write **Collective Disclosure** on the top of Form DTF-686,
- complete the information preceding Line 2 of Form DTF-686,
- complete Line 2 of Form DTF-686 and attach all required tax shelter disclosure information for listed and reportable transactions that **are not included** in a collective disclosure filed by a large partnership of which it is a partner, and
- complete Line 2 of Form DTF-686 and (instead of attaching the required tax shelter disclosure information for listed and reportable transactions that are included in a collective disclosure filed by a large partnership of which it is a partner) list the name, address, and tax identification number of the large partnership that elected collective disclosure and provide a brief description of the listed or reportable transactions.

In any event, the Department may require a taxpayer to provide, upon written request, all disclosure statements and any related information.

A *large partnership* is a partnership with more than 100 partners as of the last day of the partnership's calendar or fiscal year ending during the last taxable year for which collective disclosure is made. A large partnership includes a limited liability company (LLC) that is treated as a partnership for federal income tax purposes with more than 100 members as of the last day of the LLC's calendar or fiscal year ending during the last taxable year for which collective disclosure is made.

Exception to the reporting requirements for taxpayers and persons required to file returns or reports under Articles 9, 9-A, 22, 32, or 33 for reportable transactions that have been de-listed by the IRS

A reportable transaction previously identified as a listed transaction by the IRS is not required to be disclosed if for taxable years ending prior to the taxable year covered by a taxpayer's or person's first report or return filed on or after June 13, 2005, the IRS has determined that a transaction is no longer a listed transaction. However, as provided for in TSB-

M-05(2)C and TSB-M-05(4)I, if the transaction is an otherwise reportable transaction, all disclosure statements required to be filed with the IRS with respect to reportable transactions in which the taxpayer participated during any tax year for which the statute of limitations for assessment has not expired as of April 12, 2005, must be disclosed.

Reporting requirements for taxpayers and persons required to file returns or reports under Article 22 who are nonresident individuals who participate in a group return clarified

For purposes of Article 22, a nonresident individual who participates in a group return is not required to disclose listed or reportable transactions that do not affect New York source income.

Exception to the reporting requirements for material advisors

A material advisor required to file a duplicate of the statement or return submitted to the IRS pursuant to section 6111 of the Internal Revenue Code (IRC) may file an abbreviated disclosure statement if: (1) the material advisor has designated one person as the designated material advisor for federal income tax purposes (a designation agreement), and (2) the designated material advisor elects “collective disclosure” by providing a list of the names, addresses, and tax identification numbers of each of the material advisors included in the IRS designation agreement.

To make the election, the designated material advisor must:

- write **Collective Disclosure** on the top of Form DTF- 664, *Tax shelter Disclosure for Material Advisors,*
- attach a list of the names, addresses, and tax identification numbers of each of the material advisors covered by the IRS designation agreement,
- complete and file Form DTF-664, and attach a copy of any statement or return submitted to the IRS pursuant to section 6111 of the IRC, including all documentation submitted to the IRS in connection with the statement or return, and
- notify each of the material advisors included in the IRS designation agreement of the election.

To file an abbreviated disclosure statement, the material advisor must:

- write **Collective Disclosure** on the top of Form DTF- 664,
- attach a copy of the IRS designation agreement,
- attach a copy of any statement or return submitted to the IRS pursuant to section 6111 of the IRC, including all documentation submitted to the IRS in connection with the statement or return that **is not covered** by the IRS designation agreement, and

- complete and file Form DTF-664 and list the name, address, and tax identification number of the designated material advisor.

In any event, the Department may require any material advisor (including but not limited to the designated material advisor) to provide, upon written request, a copy of any statement or return submitted to the IRS pursuant to section 6111 of the IRC and all documentation submitted to the IRS in connection with the statement or return.

Exception to the additional reporting requirements for material advisors

If a material advisor required to maintain a duplicate of the list of persons maintained pursuant to section 6112 of the IRC has designated one person as the designated material advisor for federal income tax purposes (a designation agreement) to maintain the list or a portion of the list and the designated material advisor has elected collective disclosure on Form DTF-664, the designated material advisor must maintain the duplicate list and furnish a copy of the list within 20 days after written request is made for the list.

In any event, the Department may require any material advisor (including but not limited to the designated material advisor) to furnish a copy of the list within 20 days after written request is made for the list.

Voluntary compliance initiative expanded

The voluntary compliance initiative (VCI) has been expanded to include tax liabilities under Articles 30-A and 30-B of the Tax Law. Accordingly, the voluntary compliance program applies to tax liabilities under Articles 9, 9-A, 22, 30, 30-A, 30-B, 32, or 33 of the Tax Law attributable to the use of tax avoidance transactions for tax years beginning before January 1, 2005. Further details of the VCI will be announced in a forthcoming publication.

(Ch. 161 of the Laws of 2005, section 34)

Appendix B - Reportable Transaction Disclosure & VCI Participation Forms

DTF-671

(9/05)

New York State Department of Taxation and Finance

Election to Participate in the Tax Shelter Voluntary Compliance Initiative

Tax Law — Articles 9, 9-A, 22, 30, 30-A, 30-B, 32, and 33

All filers must enter tax period:

Beginning ☐ Ending ☐

Section 1 — Taxpayer information (see instructions, Form DTF-671-*I*)

Name(s) as shown on your return	Taxpayer identification number as shown on page 1 of your return
Spouse's name (for individuals, if applicable) or contact name (for businesses)	Spouse's identification number (if applicable)
Mailing address (number and street or PO Box)	Form number of return attached
City, village, town, or post office	Type of entity if other than an individual
State ZIP code Country	If currently under NYS audit, enter audit case ID # and auditor name
Daytime telephone number with area code ( )	Combined and consolidated group information

Section 2 — Voluntary Compliance Initiative (VCI) options (see instructions)

You must complete a Form DTF-671 for each tax year and for each tax return you are filing. You must elect one option for each tax year for which you are filing a tax return. You do not have to elect the same option for all tax years. However, once made, the election is irrevocable.

Option 1 - Without appeal rights	**Option 2 - With appeal rights**
☐ I elect to participate in the VCI under Option 1 for the tax period indicated above. I understand this option is irrevocable, and waive the right to file a claim for credit or refund for any amounts paid under this option.	☐ I elect to participate in the VCI under Option 2 for the tax period indicated above. I understand this option is irrevocable, and retain the right to file a claim for credit or refund for any amounts paid under this option.

Section 3 — Tax shelter information (see instructions; attach a separate schedule if necessary)

Promoter's name and address	Internal Revenue Service (IRS) Notice number (If other than an IRS Notice number, explain)
Partnership's or other entity's name	Partnership's or other entity's employer identification number (EIN)

Entity involved in transaction	Total loss, expense, or deduction amount	Ordinary loss amount	Capital loss amount	Tax return (form, schedule, line item)

Are you under audit, or have you been audited or participated in a settlement for this tax shelter by the IRS or another tax jurisdiction (mark an **X** in one box)? Yes ☐ No ☐	If Yes, enter the name of the tax jurisdiction and the tax years.

Section 4 — Perjury statement (see instructions)

Under penalties of perjury, I declare that I have examined this form, including any accompanying statements, and to the best of my knowledge it is true, correct, and complete. Taxpayer participation in the voluntary compliance initiative will not be considered evidence that the taxpayer engaged in a tax avoidance transaction.

Signature	Official title	Date
Signature	Official title	Date

Mail Form DTF-671, your tax return, and payment to:

NYS DEPARTMENT OF TAXATION AND FINANCE, TAX SHELTER DISCLOSURE, PO BOX 22104, ALBANY NY 12201-2104

If you are using a private delivery service, see the instructions for the address to use.

New York State Department of Taxation and Finance

Instructions for Form DTF-671

Election to Participate in the Tax Shelter Voluntary Compliance Initiative

DTF-671-I (9/05)

General information

New York State is offering a Voluntary Compliance Initiative (VCI) for eligible taxpayers who participated in tax avoidance transactions (tax shelters). The VCI allows taxpayers to report and pay underreported tax liabilities and interest attributable to tax shelters. The VCI applies to tax liabilities under Articles 9, 9-A, 22, 30, 30-A, 30-B, 32, or 33 of the Tax Law attributable to the use of tax shelters for tax years beginning before January 1, 2005. The VCI begins October 1, 2005, and ends March 1, 2006. For more information, please see Publication 671, New York State Tax Shelter Voluntary Compliance Initiative.

Purpose of Form DTF-671, Election to Participate in the Tax Shelter Voluntary Compliance Initiative

Form DTF-671 allows eligible taxpayers who underreported their tax liabilities by participating in tax shelters to participate in the VCI and pay the associated liabilities without incurring any of the new penalties recently enacted for participating in tax shelters. An eligible taxpayer may elect one of two options to participate in the VCI, either with or without appeal rights (see Section 2 on the back).

How to participate

Complete an original or amended tax return for each tax year for which you wish to participate in the VCI. If you did not file a return because of participation in a tax shelter, you must file an original return. A separate Form DTF-671 must be completed for each tax year and for each tax return. Form DTF-671 must be completed and attached to the front of the original or amended return that is being filed as part of the VCI. If you were under Internal Revenue Service (IRS) audit for this same tax shelter transaction and the IRS audit is final, attach a copy of the final federal determination.

Note: Every taxpayer or person required to file a return or report under Articles 9, 9-A, 22, 32, or 33 of the Tax Law on or after June 13, 2005, who is or was also required to file a disclosure statement related to a reportable transaction or a listed transaction with the IRS (pursuant to section 6011 of the Internal Revenue Code (IRC)), must disclose that information with the New York State return or report. For more information, see the instructions for Form DTF-686, Tax Shelter Reportable Transactions.

Definitions

A tax avoidance transaction (a tax shelter) is a plan or arrangement devised for the principal purpose of avoiding tax. These transactions include, but are not limited to listed transactions. A listed transaction is a transaction that is the same as or substantially similar to one that the IRS has determined to be a tax avoidance transaction and is identified by an IRS notice or other form of published guidance.

Eligibility

An eligible taxpayer is an individual, partnership, estate, trust, corporation, limited liability company, joint stock company, or any other entity or person, who or which has a tax liability under Articles 9, 9-A, 22, 30, 30-A, 30-B, 32, or 33 of the New York State Tax Law with regard to a tax avoidance transaction for tax years beginning before January 1, 2005.

An otherwise eligible taxpayer is **not** entitled to participate in the VCI if any of the following apply:

- The taxpayer is a party to any criminal investigation by any federal agency or New York State or any political subdivision thereof, with regard to underreporting or underpayment of tax; **or**
- The taxpayer is a party to any litigation pending at the date of the taxpayer's application in the Bureau of Conciliation and Mediation Services (BCMS) or Tax Appeals or any court of this state or the United States relating to any action or failure to act which is the basis for the penalty with respect to which relief is sought; **or**
- The taxpayer has been convicted of a crime relating to the tax that is the basis for the penalty with respect to which relief is sought for any period or assessment for that tax; **or**
- The taxpayer was eligible to participate in the 2003 New York Offshore Voluntary Compliance Initiative (OVCI), and the transactions are the same as those described in the 2003 OVCI program. (The taxpayer may still participate in the VCI if the transactions were not the same as those that were the basis for participation in the OVCI.)

Specific instructions

Section 1 — Taxpayer information

Individuals

Complete the appropriate lines, including the name and social security number (SSN), spouse's name and SSN (if applicable), mailing address and daytime telephone number. Also enter the form number of the tax return attached to Form DTF-671 (Form IT-200, IT-201, IT-201-X, IT-203, IT-203-X, or IT-113-X). If you are currently under NYS audit, enter the audit case ID number and auditor's name.

Businesses

For purposes of Form DTF-671, a business means a corporation, S corporation, partnership, trust, estate, limited liability company, joint stock company, or any other entity other than an individual. Complete the appropriate lines, including the name and federal employer identification number (EIN), contact name, mailing address and daytime telephone number. Enter the form number of the tax return attached to Form DTF-671 (Form CT-3, CT-3-A, CT-3M/4M, CT-3-S, CT-3-S-A, CT-4, CT-4-S, CT-32, CT-32-A, CT-32-M, CT-32-S, CT-33, CT-33-A, CT-33-C, CT-33-M, CT-33-NL, CT-183, CT-183-M, CT-184, CT-184-M, CT-185, CT-186, CT-186-A, CT-186-A/M, CT-186-E, CT-186-EZ, CT-186-M, CT-186-P, CT-186-P/M, CT-8, CT-9, CT-3360, IT-204, IT-205, or IT-113-X). Also enter the type of entity (corporation, S corporation, partnership, trust, estate, limited liability company, joint stock company, etc.). If you are currently under NYS audit, enter the audit case ID number and auditor's name.

Combined and consolidated group information

If the taxpayer is a member of a New York State combined group, Form DTF-671 must be completed and filed by the designated parent or payer corporation on behalf of the group. If a tax shelter reported on this form was reported on a federal return filed by some other entity, enter the name and EIN of that other entity. For example, if the taxpayer is included in a federal consolidated return, but files a separate New York State return, enter the name and EIN of the parent who filed the federal consolidated return. If the taxpayer is the designated parent or payer corporation of a New York State combined group, and if one of the group's members participated in a tax shelter reported on Form DTF-671, enter that member's name and EIN. Attach a separate schedule if more space is needed.

Section 2 — Voluntary Compliance Initiative (VCI) options

You must elect either Option 1 (without appeal rights) or Option 2 (with appeal rights). Read the descriptions below to determine the benefits and agreements for each option. Under either option, the full amount of tax and interest is due by March 1, 2006. A separate election may be made for each tax year in which you elect to participate in the VCI. The election of either option is irrevocable.

Option 1 – Without appeal rights

If you elect to participate under this option, you may not file a claim for credit or refund with respect to the use of a tax shelter for that tax year. In exchange, all penalties applicable to the underreporting or underpayment of tax liabilities attributable to the use of the tax shelter for that tax year will be waived. Additionally, the Commissioner of Taxation and Finance will not bring or seek civil, administrative, or criminal action against the taxpayer for that tax year with respect to the tax shelter.

Option 2 – With appeal rights

If you elect to participate under this option, you retain your right to file a claim for credit or refund with respect to the use of a tax shelter for that tax year. Under this option, however, negligence and substantial understatement penalties, imposed under Tax Law sections 685(b) and (p), and 1085(b) and (k) may apply. All other penalties applicable to the underreporting or underpayment of tax liabilities attributable to the use of the tax shelter for that tax year will be waived. Additionally, the Commissioner of Taxation and Finance will not bring or seek civil, administrative, or criminal action against the taxpayer for that tax year with respect to the tax shelter.

Section 3 — Tax shelter information

Enter the promoter names and addresses. Promoters are persons and organizations you paid a fee for promoting, soliciting, or recommending the tax shelter to you. If the tax shelter being reported is a listed transaction (or substantially similar), enter the IRS notice number. If the tax shelter is not a listed transaction, explain the transaction. List the names, addresses, and EIN of all entities involved in the tax shelter being reported. If you are filing an amended return, enter the loss, expense or deduction amounts, the ordinary loss amount, the capital loss amount, and the form, schedule, and line item number of the item on your original return. If you are currently under audit, or have been audited or have participated in a settlement for this same transaction with the IRS or another taxing jurisdiction, mark an **X** in the Yes box and enter the name of the jurisdiction and the tax years involved. If you need more space for any of the above items, attach a separate schedule.

Section 4 — Perjury statement

Individuals

Sign and date Form DTF-671 in the spaces provided. If you are filing a joint return, both spouses must sign and date Form DTF-671. You do not need to enter a title. If one spouse is unable or refuses to sign Form DTF-671, you must provide a statement explaining why that spouse is unable or refuses to sign.

Businesses

Form DTF-671 must be signed and dated by an appropriate owner, officer, or fiduciary for the business. Include the title of the person signing. If more than one signature is needed, use the second line provided. For more information on signature requirements, see the instructions for the tax return you are filing with Form DTF-671.

Mailing instructions

Attach a completed Form DTF-671 to the front of each original or amended return being filed. Completed form(s), tax return(s), and payment(s) must be filed by **March 1, 2006** to:

NYS DEPARTMENT OF TAXATION AND FINANCE
TAX SHELTER DISCLOSURE
PO BOX 22104
ALBANY NY 12201-2104

Do not mail to the address shown on the original or amended return.

Private delivery services — If you choose, you may use a private delivery service, instead of the U.S. Postal Service, to file your return. However, if, at a later date, you need to establish the date you filed your return, you cannot use the date recorded by a private delivery service unless you used a delivery service that has been designated by the U.S. Secretary of the Treasury or the Commissioner of Taxation and Finance. (Currently designated delivery services are listed in Publication 55, Designated Private Delivery Services. See Need help? below for information on ordering forms and publications.) If you have used a designated private delivery service and need to establish the date you filed your return, contact that private delivery service for instructions on how to obtain written proof of the date your return was given to the delivery service for delivery.

If you use any private delivery service, whether it is a designated service or not, address your return to: NYS Tax Department, Tax Shelter Disclosure, W A Harriman Campus, Albany NY 12227

Need help?

Internet access: www.nystax.gov
(for information, forms, and publications)

Fax-on-demand forms:	1 800 748-3676
Business Tax Information Center:	1 800 972-1233
Personal Income Tax Information Center:	1 800 225-5829
From areas outside the U.S. and outside Canada:	(518) 485-6800

Privacy notification — The Commissioner of Taxation and Finance may collect and maintain personal information pursuant to the New York State Tax Law, including but not limited to, sections 171, 171-a, 287, 308, 429, 475, 505, 697, 1096, 1142, and 1415 of that Law; and may require disclosure of social security numbers pursuant to 42 USC 405(c)(2)(C)(i).

This information will be used to determine and administer tax liabilities and, when authorized by law, for certain tax offset and exchange of tax information programs as well as for any other lawful purpose.

Information concerning quarterly wages paid to employees is provided to certain state agencies for purposes of fraud prevention, support enforcement, evaluation of the effectiveness of certain employment and training programs and other purposes authorized by law.

Failure to provide the required information may subject you to civil or criminal penalties, or both, under the Tax Law.

This information is maintained by the Director of Records Management and Data Entry, NYS Tax Department, W A Harriman Campus, Albany NY 12227; telephone 1 800 225-5829. From areas outside the United States and outside Canada, call (518) 485-6800.

DTF-664
(11/05)

New York State Department of Taxation and Finance

Tax Shelter Disclosure for Material Advisors

Tax Law Section 25(b)(1)

Material advisor's name			Employer identification number (EIN) or social security number
Mailing address of material advisor (number and street or rural route)			
City, village, town, or post office	State	ZIP code	Telephone number ( )

Attach a copy of the statement or return filed with the Internal Revenue Service (IRS) pursuant to section 6111 of the Internal Revenue Code (IRC) (currently IRS Form 8264, Application for Registration of a Tax Shelter). Also include all documentation submitted to the IRS in connection with the statement or return and mail to the address shown below. For more information, see the instructions on the back of this form.

Certification: I certify that this return and any attachments are to the best of my knowledge and belief true, correct, and complete.

Signature	Official title	Date

Paid preparer use only						
Signature of individual preparing this return	Firm's name (or yours if self-employed)					
Address	City	State	ZIP code	ID number	Date	

Mail Form DTF-664 to:

NYS DEPARTMENT OF TAXATION AND FINANCE
TAX SHELTER DISCLOSURE
PO BOX 22104
ALBANY NY 12201-2104

If you are using a private delivery service, see the instructions on the back for more information.

Privacy notification — The Commissioner of Taxation and Finance may collect and maintain personal information pursuant to the New York State Tax Law, including but not limited to, sections 171, 171-a, 287, 308, 429, 475, 505, 697, 1096, 1142, and 1415 of that Law; and may require disclosure of social security numbers pursuant to 42 USC 405(c)(2)(C)(i).

This information will be used to determine and administer tax liabilities and, when authorized by law, for certain tax offset and exchange of tax information programs as well as for any other lawful purpose.

Information concerning quarterly wages paid to employees is provided to certain state agencies for purposes of fraud prevention, support enforcement, evaluation of the effectiveness of certain employment and training programs and other purposes authorized by law.

Failure to provide the required information may subject you to civil or criminal penalties, or both, under the Tax Law.

This information is maintained by the Director of Records Management and Data Entry, NYS Tax Department, W A Harriman Campus, Albany NY 12227; telephone 1 800 225-5829. From areas outside the United States and outside Canada, call (518) 485-6800.

Need help?

Internet access: www.nystax.gov
(for information, forms, and publications)

Fax-on-demand forms: 1 800 748-3676

Business Tax Information Center: 1 800 972-1233
Personal Income Tax Information Center: 1 800 225-5829
From areas outside the U.S. and outside Canada: (518) 485-6800

Instructions

General information

The Tax Law has been amended to provide new reporting requirements with respect to the disclosure of information relating to transactions that present the potential for tax avoidance (a tax shelter). These requirements are similar to the tax shelter disclosure requirements for federal income tax purposes. The amendments also impose penalties for nondisclosure and the underpayment of taxes due to participation in these transactions, extend the statute of limitations for assessments relating to these transactions, and create a voluntary compliance initiative to allow taxpayers to report and pay under-reported tax liabilities and interest attributable to these transactions with a waiver of penalties. For more information, see TSB-M-05(2)C or TSB-M-05(4)I, Disclosure of Certain Transactions and Related Information Regarding Tax Shelters, and TSB-M-05(2.1)C or TSB-M-05(4.1)I, Supplement to the Disclosure of Certain Transactions and Related Tax Shelters.

Who must file

Every person (material advisor) required to make and file a statement or return pursuant to Internal Revenue Code (IRC) section 6111 on or after April 12, 2005, and prior to July 1, 2007, must file a duplicate of that statement or return (currently Internal Revenue Service (IRS) Form 8264), including all documentation submitted to the IRS in connection with the statement or return, with the Commissioner of Taxation and Finance if **any** of the following conditions apply:

A the person is organized in this state;

B the person is doing business in this state;

C the person is deriving income in this state; **or**

D (i) the list, required to be maintained by this person pursuant to IRC section 6112, identifies or is required to identify a taxpayer subject to tax under Tax Law Articles 9, 9-A, 22, 32, or 33, and (ii) this person is a material advisor, as defined in IRC section 6111, who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction.

Exception: A material advisor who is required to file a duplicate of the statement or return submitted to the IRS pursuant to IRC section 6111 may file an abbreviated disclosure statement if:

- the material advisor has designated one person as the designated material advisor for federal income tax purposes (a designation agreement); **and**
- the designated material advisor elects collective disclosure by supplying a list of names, addresses, and tax identification numbers for each of the material advisors included in the IRS designation agreement.

For more information concerning collective disclosure elections and abbreviated disclosure statements, refer to TSB-M-05(2.1)C or TSB-M-05(4.1)I.

When to file

Form DTF-664 and the accompanying duplicate statement or return must be filed with the Commissioner of Taxation and Finance by whichever of the following dates occurs last:

- 60 days from the date required for filing the statement or return with the IRS,
- 60 days from the date that any of the conditions (A, B, C, or D) described above first applies; **or**
- September 9, 2005.

Where to file

Attach a copy of your completed IRS Form 8264, Application for Registration of a Tax Shelter, to Form DTF-664 and mail to:

NYS DEPARTMENT OF TAXATION AND FINANCE
TAX SHELTER DISCLOSURE
PO BOX 22104
ALBANY NY 12201-2104

Private delivery services — If you choose, you may use a private delivery service, instead of the U.S. Postal Service, to file your return. However, if, at a later date, you need to establish the date you filed your return, you cannot use the date recorded by a private delivery service unless you used a delivery service that has been designated by the U.S. Secretary of the Treasury or the Commissioner of Taxation and Finance. (Currently designated delivery services are listed in Publication 55, Designated Private Delivery Services. See Need help? on the front of this form for information on ordering forms and publications.) If you have used a designated private delivery service and need to establish the date you filed your return, contact that private delivery service for instructions on how to obtain written proof of the date your return was given to the delivery service for delivery. If you use any private delivery service, whether it is a designated service or not, address your form to: NYS Tax Department, Tax Shelter Disclosure, W A Harriman Campus, Albany NY 12227.

Additional reporting requirements for material advisors

Every person (material advisor) who is required to maintain a list of persons pursuant to IRC section 6112, must maintain a duplicate of this list if any of the conditions (A, B, C, or D) described above under Who must file applies to this person. The material advisor must furnish a copy of the list to the Commissioner of Taxation and Finance within 20 days after written request is made for the list.

Exception: If a material advisor required to maintain a duplicate of the list of persons maintained pursuant to IRC section 6112 has designated one person as the designated material advisor for federal income tax purposes (a designation agreement) to maintain the list, or a portion of the list, and the designated material advisor has elected collective disclosure of Form DTF-664, the designated material advisor must maintain the duplicate list. The designated material advisor must furnish a copy of the list to the Commissioner of Taxation and Finance within 20 days after written request for the list is made.

Additional tax shelter recordkeeping requirements

Every person required by Tax Law section 25 to disclose any transaction, file any duplicate return, or maintain any list, must retain all relevant correspondence, memoranda, notes, valuation studies, meeting minutes, spreadsheets, models, opinions, records required to be retained pursuant to IRC section 6011, and all other records or documents related to the disclosure, filing, and list maintenance requirements of Tax Law section 25 for six years. The information must be made available for inspection in connection with any examination.

DTF-686

(11/05)

New York State Department of Taxation and Finance

Tax Shelter Reportable Transactions

Attachment to New York State Return

Tax Law Section 25(a)(1)

All filers must enter tax period:

beginning ______ ending ______

Name(s) as shown on your return	Taxpayer identification number shown on page 1 of your tax return
Spouse's name (for personal income tax, if applicable)	Spouse's identification number (if applicable)
Mailing address	
City, village, town, or post office	State / ZIP code

File this form with your business tax return, Form CT-3, CT-3-A, CT-3-S, CT-3-S-A, CT-4, CT-4-S, CT-32, CT-32-A, CT-32-S, CT-33, CT-33-A, CT-33-C, CT-33-NL, CT-183, CT-184, CT-185, CT-186, CT-186-A, CT-186-E, CT-186-EZ, CT-186-P; with your applications for credit or refund of tax, Form CT-8, CT-9; with your report of federal changes, Form CT-3360; or with your personal income tax return, Form IT-150, IT-201, IT-203, IT-204, IT-205, IT-201-X, or IT-203-X; or with your claim for credit or refund of personal income tax paid, Form IT-113-X.

1 Identify the type of reportable transaction. Mark an **X** in the box(es) that apply (see instructions on the back of this form).

A. ● ☐ Listed transaction

B. ● ☐ Confidential transaction

C. ● ☐ Transaction with contractual protection

D. ● ☐ Loss transaction

E. ● ☐ Transaction with significant book-tax difference

F. ● ☐ Transaction with brief assets holding period

2 Enter the number of IRS forms attached to this form (see instructions on the back of this form) .... **2.** ________

Privacy notification — The Commissioner of Taxation and Finance may collect and maintain personal information pursuant to the New York State Tax Law, including but not limited to, sections 171, 171-a, 287, 308, 429, 475, 505, 697, 1096, 1142, and 1415 of that Law; and may require disclosure of social security numbers pursuant to 42 USC 405(c)(2)(C)(i).

This information will be used to determine and administer tax liabilities and, when authorized by law, for certain tax offset and exchange of tax information programs as well as for any other lawful purpose.

Information concerning quarterly wages paid to employees is provided to certain state agencies for purposes of fraud prevention, support enforcement, evaluation of the effectiveness of certain employment and training programs and other purposes authorized by law.

Failure to provide the required information may subject you to civil or criminal penalties, or both, under the Tax Law.

This information is maintained by the Director of Records Management and Data Entry, NYS Tax Department, W A Harriman Campus, Albany NY 12227; telephone 1 800 225-5829. From areas outside the United States and outside Canada, call (518) 485-6800.

Need help?

Internet access: www.nystax.gov
(for information, forms, and publications)

Fax-on-demand forms: 1 800 748-3676

Business Tax Information Center: 1 800 972-1233

Personal Income Tax Information Center: 1 800 225-5829

From areas outside the U.S. and outside Canada: (518) 485-6800

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Instructions

General information

The Tax Law has been amended to provide new reporting requirements with respect to the disclosure of information relating to transactions that present the potential for tax avoidance (a tax shelter). These requirements are similar to the tax shelter disclosure requirements for federal income tax purposes. The amendments also impose penalties for nondisclosure and the underpayment of taxes due to participation in these transactions, extend the statute of limitations for assessments relating to these transactions, and create a voluntary compliance initiative to allow taxpayers to report and pay under-reported tax liabilities and interest attributable to these transactions with a waiver of penalties.

For more information, see TSB-M-05(2)C or TSB-M-05(4)I, Disclosure of Certain Transactions and Related Information Regarding Tax Shelters, and TSB-M-05(2.1)C or TSB-M-05(4.1)I, Supplement to the Disclosure of Certain Transactions and Related Information Regarding Tax Shelters.

Who must file

Every taxpayer or person required to file a return or report under Articles 9, 9-A, 22, 32, or 33 of the Tax Law on or after June 13, 2005, who is or was also required to file a disclosure statement related to a reportable transaction or a listed transaction with the Internal Revenue Service (IRS) (pursuant to section 6011 of the Internal Revenue Code (IRC)) must disclose that information with the New York State return or report. Disclosure is required if the taxpayer or person participated in tax shelter activities prior to July 1, 2007, and if a disclosure statement related to a reportable transaction or a listed transaction was required to be filed with the IRS.

A reportable transaction previously identified as a listed transaction by the IRS is not required to be disclosed if, for tax years ending prior to the tax year covered by a taxpayer's or person's first report or return filed on or after June 13, 2005, the IRS has determined that a transaction is no longer a listed transaction. However, if the transaction is an otherwise reportable transaction, all disclosure statements required to be filed with the IRS with respect to reportable transactions in which the taxpayer participated during any tax year for which the statute of limitations for assessment has not expired as of April 12, 2005, must be disclosed.

The term return or report includes original returns or reports, amended returns or reports, and applications for credit or refund of tax.

Each taxpayer or person must make its own disclosure even though one member of an affiliated group, as defined by section 1504 of the IRC, may file the disclosure statement with the IRS on behalf of its affiliates including the taxpayer or person. For Article 22 taxpayers, a group agent who is authorized to file a group return on behalf of a group of nonresident members must make this disclosure with the group return; the individual group members are not required to make this disclosure. A nonresident individual who participates in a group return is not required to disclose listed or reportable transactions that do not affect New York source income.

A taxpayer or person who files a return or report under Articles 9, 9-A, 22, 32, or 33 of the Tax Law includes:

- corporations subject to tax under sections 183, 184, 185, or 186 and persons subject to tax under sections 186-a or 186-e of the Tax Law (Article 9);
- general business corporations (Article 9-A);
- individuals including sole proprietors, partnerships including a limited liability company (LLC) that is treated as a partnership for federal income tax purposes, estates and trusts, partners in a partnership including members of a LLC that is treated as a partnership for federal income tax purposes, shareholders of an S corporation, and beneficiaries of an estate or trust (Article 22);
- banking corporations (Article 32); **and**
- insurance corporations and captive insurance companies (Article 33).

Exception: For tax years beginning prior to January 1, 2004, see TSB-M-05(2.1)C or TSB-M-05(4.1)I concerning collective disclosure election for large partnerships and abbreviated disclosure statements for a taxpayer that is a partner of a large partnership.

When to file

Attach a duplicate of the IRS disclosure statement (currently IRS Form 8886 and Schedule M-3) and any related information submitted to the IRS to this Form DTF-686. Attach Form DTF-686 to the return or report filed by the taxpayer or person for the current tax year.

In addition, the taxpayer or person must also disclose with its **first** return or report filed on or after June 13, 2005:

- all disclosure statements that were required to be filed with the IRS at any time with respect to listed transactions for which the taxpayer or person was also required to file a New York State return or report for the tax year in which the transaction occurred under Articles 9, 9-A, 22, 32, or 33 of the Tax Law, and
- all disclosure statements that were required to be filed with the IRS with respect to reportable transactions, other than listed transactions, in which the taxpayer participated during any tax year for which the statute of limitations for assessment has not expired as of April 12, 2005. For this purpose, the statute of limitations for assessment under sections 683 and 1083 of the Tax Law in effect prior to April 12, 2005, is used.

However, disclosure is not required for tax shelter activities in which the taxpayer or person participated on or after July 1, 2007.

Line instructions

Line 1 — Mark an **X** in each box that you have identified and checked on the attached IRS Form(s) 8886. If you filed Schedule M-3 instead of Form 8886 for federal tax purposes, mark an **X** in box E.

Line 2 — Enter the number of IRS Form(s) 8886 and Schedule(s) M-3 attached to this Form DTF-686.

Additional tax shelter recordkeeping requirements

Every person, required by section 25 of the Tax Law to disclose any transaction, file any duplicate return, or maintain any list, must retain all relevant correspondence, memoranda, notes, valuation studies, meeting minutes, spreadsheets, models, opinions, records required to be retained pursuant to section 6011 of the IRC, and all other records or documents related to the disclosure, filing, and list maintenance requirements of section 25 of the Tax Law for six years. The information must be made available for inspection in connection with any examination.

New York State Department of Taxation and Finance

2005

Income Tax Installment Payment Agreement Request

DTF-383

- Unless you are filing this form electronically (see instructions on the back), attach this completed form to the front of your 2005 New York State income tax return.
- Complete this request form only if you cannot pay the full amount of income tax you owe as shown on your 2005 New York State income tax return. The Tax Department will consider your request based upon the information you provide below, and notify you whether your request is approved or denied.
- This form must be completed in its entirety. Be sure to include your daytime telephone number to avoid any unnecessary delay in the processing of your request.

Your social security number	Spouse's social security number (if joint return)	
Please enter your first name first. For a joint return, use both name lines.		
Your first name and middle initial	Your last name (for a joint return, enter spouse's name on line below)	
Spouse's first name and middle initial	Spouse's last name	
Mailing address (number and street or rural route)		Apartment number
City, village, or post office	State	ZIP code

In the space below, print or type your permanent home address if it is **not** the same as your mailing address above.		
Permanent home address (number and street or rural route)		Apartment number
City, village, or post office	State	ZIP code

Your daytime telephone number	Your evening telephone number
( )	( )

Employment information:
Your gross monthly salary .... $.

Your employer's name			
Employer's address			
City	County	State	ZIP code

Your spouse's gross monthly salary (if joint return) .... $.

Your spouse's employer's name			
Employer's address			
City	County	State	ZIP code

If we approve your request, we agree to let you pay the tax you owe in monthly installments (12 months maximum). Make your payment as large as possible (minimum $25 per month) to limit the interest and penalty charges. These charges will continue to be added to the unpaid balance. In return, you agree to make your monthly installments by a direct transfer from your bank account. Monthly installments will be directly withdrawn from your specified account on the 15th of every month until the tax, penalty, and interest you owe is paid in full.

- Enter the number of monthly payments (between 3 and 12) that you will need in the box ....

Direct debit information: Checking ☐ Savings ☐

Name and address of your bank

Bank routing and transit number (see instructions)

Account number (mark an **X** in one box above to specify either a checking or savings account)

Unless you are filing this form electronically (see instructions), attach this completed Form DTF-383 and your initial payment to the front of your 2005 income tax return when you file it. We will notify you whether your request is approved or denied.

I (we) hereby authorize the New York State Department of Taxation and Finance to initiate debit entries to the checking/savings account indicated above and the bank named above to debit the account for the amount of the monthly installment payment. This authority is to remain in full force and effect until the Tax Department and the bank have received written notification from me (or joint account holder) of its termination in such time and in such manner as to afford reasonable opportunity to act on it.

If the Tax Department cannot deduct the monthly payment from my account on the date specified because of insufficient funds or because my account is closed, the Tax Department may cancel my installment agreement. I will be responsible for any overdraft fees charged by my bank.

Your signature	Date	Spouse's signature (if joint return)	Date
Account holder's signature (if different from taxpayer)			Date

To inquire on the status of your request, please contact the Tax Department at **1 877 698-2907.**

Please file this original scannable form with the Tax Department.

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Instructions

General information

If you cannot pay the full amount of income tax you owe on your 2005 New York State income tax return, you may request monthly installment payments. However, you will be charged interest and you may be charged a late payment penalty on any tax not paid by its due date, even if we grant your request to pay in installments. To limit the interest and any penalty charges, file your return by April 17, 2006 (April 18, 2006, if you file your federal return at the IRS Service Center in Andover, MA), and pay as much of the tax as possible with your return.

To be considered for an installment payment agreement, complete all the information requested on the front page of this Form DTF-383. **You may instead complete and electronically submit an online version of Form DTF-383 by accessing our Web site at www.nystax.gov and clicking on Electronic Services.**

You will be required to establish a direct payment arrangement with your bank, under which installment payments will be automatically withdrawn and remitted on a monthly basis to the Tax Department's processing bank. Your request will be considered based upon the information you provide.

Note: Income tax installment agreements cannot be paid by credit card.

Before requesting an installment payment agreement with the Tax Department, you should consider other alternatives such as a commercial or private loan.

General instructions

Enter your name, address, and social security number (and your spouse's, if you file a joint return), and your employment and financial information.

Also answer the questions and enter the number of months you will need to complete your payment agreement. You must enter at least three months, but no more than 12 months.

Enter the name and address of your bank, your bank routing and transit number, select either Checking or Savings, and enter your account number. If you selected Checking, your routing and transit numbers are preprinted at the bottom left of your check. If you selected Savings and are unsure of your bank routing and transit number, check with your bank. This information is required to process your request for a payment agreement.

You (and your spouse, if you file a joint return) must sign and date your request, as well as any and all account holders of the account specified for direct debit.

Your completed Form DTF-383 must be accompanied by a check or money order equal to at least one month's projected payment. Make your check or money order payable to **NY State Income Tax**, and on the front of your check, write your social security number and the tax year(s) for which you are requesting an installment payment agreement. If you owe for other tax years as well as the current 2005 tax year, a Tax Department representative will contact you.

Unless you are filing this form electronically (see above), attach this completed Form DTF-383 and your initial payment to the front of your 2005 income tax return and send it to: State Processing Center, PO Box 61000, Albany NY 12261-0001. We will notify you whether your request is approved or denied.

If you wish to have the Tax Department contact someone else on your behalf to arrange installment payments (for example, your attorney, accountant, etc.), please also complete Form POA-1, Power of Attorney, and attach it to this Form DTF-383.

Conditions for approval

To qualify for an installment payment agreement:

- the amount you will pay every month must be reasonable as compared to your earnings and necessary expenses (minimum payment is $25.00 per month);
- you must have filed all of your required New York State income tax returns;
- you must not have defaulted on a prior installment payment agreement; and,
- you must not be currently under protection of the bankruptcy court.

If we approve your installment payment agreement, we will send you a monthly billing statement until a direct payment account can be established at your bank. The due date for your payment will be the 15th of each month.

If you do not receive your first installment payment agreement bill within 120 days of filing this Form DTF-383, please call the Tax Department (see Need help? below).

If the Tax Department approves your request, you will be allowed to pay the tax you owe (plus interest and any penalty) in monthly installments. In addition to the initial payment you send in with your income tax return and your Form DTF-383, you also agree, in accepting this arrangement, to make your monthly payments on time (by the 15th of each month). You also agree to meet all of your withholding or estimated tax payments so that your tax liability for future years is paid in full when you file your return on time.

Suggestions to avoid owing a balance due in the future:

- If you are self-employed or your employer does not withhold New York State taxes, request Form IT-2105, Estimated Income Tax Payment Voucher for Individuals, and its instructions (see Need help? below).
- If your employer is not withholding enough New York State tax, request Form IT-2104, Employee's Withholding Allowance Certificate (see Need help? below).

Caution — We may withdraw the privilege of installment payments and file tax warrants against you (if not already filed) if:

- the information you provide is inaccurate or incomplete; **or**
- you do not make your payments on time; **or**
- you incur additional tax liability during the term of your agreement; **or**
- we determine that collection of this liability is in jeopardy.

We can collect the entire amount of your tax liability by any or all of the following methods:

- **garnishing your wages**
- **levy and seizure of assets**
- **other appropriate enforcement action**

If you are currently making payments on a New York State installment payment agreement and you cannot pay in full the amount of tax due on your 2005 income tax return, the Tax Department will likely default your current agreement and pursue other tax collection alternatives. Please call the Tax Department immediately to discuss your situation (see Need help? below).

Need help?

- For New York State income tax **installment payment agreement information only,** call toll free **1 877 698-2907.**
- Internet access: www.nystax.gov
- For New York State forms or publications, call toll free 1 800 462-8100.
- To order forms by fax at any time, call toll free 1 800 748-3676 on a touch-tone phone.
- From areas outside the U.S. and outside Canada, call (518) 485-6800.

Privacy notification — The Commissioner of Taxation and Finance may collect and maintain personal information pursuant to the New York State Tax Law, including but not limited to, sections 171, 171-a, 287, 308, 429, 475, 505, 697, 1096, 1142, and 1415 of that Law; and may require disclosure of social security numbers pursuant to 42 USC 405(c)(2)(C)(i).

This information will be used to determine and administer tax liabilities and, when authorized by law, for certain tax offset and exchange of tax information programs as well as for any other lawful purpose.

Information concerning quarterly wages paid to employees is provided to certain state agencies for purposes of fraud prevention, support enforcement, evaluation of the effectiveness of certain employment and training programs and other purposes authorized by law.

Failure to provide the required information may subject you to civil or criminal penalties, or both, under the Tax Law.

This information is maintained by the Director of Records Management and Data Entry, NYS Tax Department, W A Harriman Campus, Albany NY 12227; telephone 1 800 225-5829. From areas outside the United States and outside Canada, call (518) 485-6800.

Please file this original scannable form with the Tax Department.

New York State Department of Taxation and Finance

Power of Attorney

New York State Department of Taxation and Finance
and New York City Department of Finance

Please read the instructions for this form, Form POA-1-I, before completing. These instructions explain how the information entered on this power of attorney will be interpreted and the extent of the powers granted.

FINANCE NEW • YORK

1. Taxpayer information (Taxpayer(s) must sign and date this form - please print or type)

Taxpayer(s) name *(if joint income tax return, enter both names)*			Taxpayer's EIN or SS number
Mailing address			Spouse's SS number *(if applicable)*
City, village, town, or post office	State	ZIP code	State of incorporation *(if applicable)*

The taxpayer(s) named above appoints the person(s) named below as his/her/its attorney(s)-in-fact:

2. Representative information (Representatives must sign and date this form on back)

Representative's name	Mailing address *(include firm name, if any)*	Telephone and fax number

to represent the taxpayer(s) in connection with the following tax matter(s):

3. Tax matters (For estate tax matters, use Form ET-14 instead of this form)

Type(s) of tax(es) (may enter more than one)	Tax year(s), period(s), or transaction(s)	Notice/assessment number(s)

with full power to receive confidential information and to perform any and all acts that the taxpayer(s) can perform with respect to the above specified tax matter(s), except for signing tax returns or delegating his or her authority (unless authorized below). If you **do not** want any of the above representative(s) to have full power as described above, check this box and attach a signed and dated explanation. .... ▶ ☐

I/we authorize the above representative(s) to sign tax returns for tax matters indicated above: (sign here): ______________

I/we authorize the above representative(s) to delegate his or her authority to another (sign here): ______________

4. Retention/revocation of prior power(s) of attorney

The filing of this power of attorney automatically revokes all earlier power(s) of attorney on file for the same tax matter(s) and year(s), period(s), or transaction(s) covered by this document. Filing with one agency does not constitute filing with any other agency. If you **do not** want to revoke a prior power of attorney, check this box. Attach a copy of any power of attorney you want to remain fully in effect with the appropriate agency .... ▶ ☐

5. Notices and certain other communications

In those instances where statutory notices and certain other communications involving the above tax matter(s) are sent to a representative, these documents will be sent to the first representative named above. If you **do not** want notices and certain other communications sent to the first representative named above, enter the name of the representative designated above (or on the attached power of attorney previously filed and remaining in effect) that you want to receive notices, etc. ______________

6. Taxpayer's signature

If a joint New York State income tax return was filed and both spouses request the same representative(s), both husband and wife must sign below.

If the taxpayer named above is other than an individual: I certify that I am acting in the capacity of a corporate officer, partner (except a limited partner), member or manager of a limited liability company, or fiduciary on behalf of the taxpayer, and that I have the authority to execute this power of attorney on behalf of the taxpayer.

Signature	Taxpayer's telephone and fax number	Date
Type or print name of person signing this form if not the taxpayer(s) named above		Title, if applicable
Spouse's Signature	Spouse's telephone and fax number	Date

(affix corporate seal, if applicable)

7. Acknowledgment or witnessing the power of attorney

This Power of Attorney must be acknowledged before a notary public **or** witnessed by **two** disinterested individuals, unless the appointed representative is licensed to practice in New York State as an attorney-at-law, certified public accountant, or public accountant, or is a New York State resident enrolled as an agent to practice before the Internal Revenue Service.

The person(s) signing as the above taxpayer(s) appeared before us and executed this power of attorney.

Name of witness *(print and sign)*	Date	Name of witness *(print and sign)*	Date
Mailing address of witness *(please type or print)*		Mailing address of witness *(please type or print)*	

Acknowledgment — individual

State of ss:
County of
On this day of , ,
before me personally came,

to me known to be the person(s) described in the foregoing *Power of Attorney*; and he/she/they acknowledged that he/she/they executed the same.

Signature of notary public	Date

Notary public: affix stamp (or other indication of notary's authority).

Acknowledgment — corporate

State of ss:
County of
On this day of , ,
before me personally came,
to me known, who, being by me duly sworn, did say that he/she resides at *(insert address)* ;
that he/she is the of
, the corporation described in the foregoing *Power of Attorney;* and that he/she/they signed his/her/their name(s) thereto by authority of the board of directors of said corporation.

Signature of notary public	Date

Notary public: affix stamp (or other indication of notary's authority).

Acknowledgment — limited liability company

State of ss:
County of
On this day of , ,
before me personally came,
to me known, who, being by me duly sworn, did say that he/she/they/it reside(s) at *(insert address)* ;
that he/she/they is (are) a member(s) or manager(s) of ,
the limited liability company described in the foregoing *Power of Attorney*; and that he/she/they is (are) empowered to and did execute the same.

Signature of notary public	Date

Notary public: affix stamp (or other indication of notary's authority).

Acknowledgment — partnership/LLP

State of ss:
County of
On this day of , ,
before me personally came,
to me known, who, being by me duly sworn, did say that he/she/they/it reside(s) at *(insert address)* ;
that he/she/they is (are) a partner(s) of ,
the partnership described in the foregoing *Power of Attorney*; and that he/she/they is (are) empowered to and did execute the same.

Signature of notary public	Date

Notary public: affix stamp (or other indication of notary's authority).

8. Declaration of representative *(to be completed by representative)*

I agree to represent the above-named taxpayer(s) in accordance with this power of attorney.
I affirm that my representation will not violate the provisions of the Ethics in Government Act or section 2604(d) of the New York City Charter restricting appearances by former government employees before his or her former agency. I have read a summary of these restrictions reproduced in the instructions to this form.
I am *(indicate all that apply)*:

1 an attorney-at-law licensed to practice in New York State
2 a certified public accountant duly qualified to practice in New York State
3 a public accountant enrolled with the New York State Education Department
4 an agent enrolled to practice before the Internal Revenue Service
5 an employee not a corporate officer (if the taxpayer is a corporation)
6 other ____________

Designation (use number(s) from above list)	Representative's preparer tax identification number (**PTIN**), social security number, or employer identification number	Signature	Date

Appendix C - New York State Tax Shelter and VCI Legislation

Part N of Chapter 61 of the Laws of 2005 contained the legislation regarding New York State's treatment of tax shelters and the voluntary compliance initiative.

Section 1. The tax law is amended by adding a new section 25 to read as follows:
§ 25. Disclosure of certain transactions and related information.
(a)(1) Every taxpayer, or person as defined in section seven thousand seven hundred one of the internal revenue code, required to file a disclosure statement with the internal revenue service pursuant to section six thousand eleven of the internal revenue code, or the regulations promulgated thereunder, related to a reportable transaction or a listed transaction, as those terms are defined in such section or regulations, must attach a duplicate of such disclosure statement to the return or report required to be filed by such taxpayer or person for the taxable year under article nine, nine-A, twenty-two, thirty-two or thirty-three of this chapter, and provide such other information related to such disclosure as prescribed by the commissioner. Such disclosure shall be made notwithstanding that one member of an affiliated group, as defined by section fifteen hundred four of the internal revenue code, may file such disclosure statement with the internal revenue service on behalf of its affiliates including such taxpayer or person.
(2) Every taxpayer or such person who participates in a New York reportable transaction for a taxable year must disclose such participation with its return or report required to be filed under article nine, nine-A, twenty-two, thirty-two or thirty-three of this chapter for the taxable year in a form prescribed by the commissioner, and provide such other information related to such transaction as prescribed by the commissioner. A New York reportable transaction is a transaction that has the potential to be a tax avoidance transaction as determined by the commissioner.
(3)The commissioner may in his discretion prescribe, by regulation, New York reportable transactions.

(4) Provided the commissioner has prescribed regulations pursuant to paragraph three of this subdivision the commissioner is authorized to designate specific transactions that are the same as, or substantially similar to, transactions that the commissioner has determined to be tax avoidance transactions. The provisions of article two of the state administrative procedure act shall not apply to the designation of a specific transaction as a tax avoidance transaction; provided, however, that the commissioner shall designate any such transaction by notice or other form of published guidance.

(b)(1) Every person required to make and file a statement or return pursuant to section six thousand one hundred eleven of the internal revenue code must file a duplicate of such statement or return, including all documentation submitted to the internal revenue service in connection with such statement or return, with the commissioner if any of the following conditions apply:

(A) the person is organized in this state,

(B) the person is doing business in this state,

(C) the person is deriving income in this state, or

(D)(i) the list required to be maintained by such person pursuant to section six thousand one hundred twelve of the internal revenue code identifies or is required to identify a taxpayer subject to tax under article nine, nine-A, twenty-two, thirty-two or thirty-three of this chapter, and

(ii) such person is a material advisor, as defined in section six thousand one hundred eleven of the internal revenue code, who within the state of New York, provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction.

(2) Such duplicate statement or return must be filed within sixty days of the later of:

(A) the date required for filing the statement or return with the internal revenue service,

(B) the date that any of the conditions described in paragraph (1) of this subdivision first applies, or

(C) ninety days after the enactment of this section.

(c) Every person who is required to maintain a list of persons pursuant to section six thousand one hundred twelve of the internal revenue code, or the regulations promulgated thereunder, must maintain a duplicate of such list if any of the conditions described in paragraph one of subdivision (b) of this section applies to such person and must furnish a copy thereof to the commissioner within twenty days after written request is made for such list by the commissioner.

(d) Every person required by this section to disclose any transaction, file any duplicate return, or maintain any list shall retain all relevant correspondence, memoranda, notes, valuation studies, meeting minutes, spreadsheets, models, opinions, records required to be retained pursuant to section six thousand eleven of the internal revenue code, or the regulations promulgated thereunder, and all other records or documents related to the disclosure, filing and list maintenance requirements of this section for six years and must make such information available for inspection by the commissioner in connection with any examination.
(e) The filing, disclosure and retention requirements of this section shall be in addition to any other filing, disclosure or retention requirements, general or specific, provided by law. The commissioner may require electronic filing or disclosure of any or all submissions required under this section, shall have the authority to prescribe whether a signature, including an electronic signature, is required on any or all filings or disclosures under this section. If an electronic signature is so required, it shall be in a form consistent with the provisions of the electronic signatures and records act of the state technology law.
(f)(1) The penalties imposed for a violation of subdivision (a) of this section are contained in subsection (x) of section six hundred eighty-five and subsection (p) of section one thousand eighty-five of this chapter.
(2) The penalties imposed for a violation of subdivision (b) of this section are contained in subsection (y) of section six hundred eighty-five and subsection (q) of section one thousand eighty-five of this chapter.
(3) The penalties imposed for a violation of subdivision (c) of this section are contained in subsection (z) of section six hundred eighty-five and subsection (r) of section one thousand eighty-five of this chapter.

§ 2. Subsection (c) of section 683 of the tax law is amended by adding a new paragraph 11 to read as follows:
(11) Extended statute of limitations for tax avoidance transactions.
(A) If a taxpayer or person fails to file, disclose or provide any statement, return or other information for any taxable year with respect to a listed transaction, as defined in paragraph three of subsection (x) of section six hundred eighty-five of this article, which is required under subdivision (a) of section twenty-five of this chapter, the time for assessment of any tax imposed by

this article with respect to such transaction shall not expire before the date which is one year after the earlier of:
(i) the date on which the commissioner is furnished the statement, return, or information so required, or
(ii) the date that the requirements of subdivision (c) of section twenty-five of this chapter are met with respect to a request under such subdivision by the commissioner relating to such transaction.
(B) If later than the time for assessment otherwise provided by this section, tax may be assessed at any time within six years after the return was filed if the deficiency is attributable to an abusive tax avoidance transaction.
(C) For purposes of subparagraph (B) of this paragraph, an "abusive tax avoidance transaction" means a plan or arrangement devised for the principal purpose of avoiding tax. Abusive tax avoidance transactions include, but are not limited to, listed transactions described in paragraph five of subsection (p-1) of section six hundred eighty-five of this article.

§ 3. Subsection (p) of section 685 of the tax law, as amended by chapter 765 of the laws of 1985, is amended to read as follows:
(p) Substantial understatement of liability.-- (1) If there is a substantial understatement of income tax for any taxable year, there shall be added to the tax an amount equal to ten percent of the amount of any underpayment attributable to such understatement. For purposes of this subsection, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of ten percent of the tax required to be shown on the return for the taxable year, or two thousand dollars. For purposes of the preceding sentence, the term "understatement" means the excess of the amount of the tax required to be shown on the return for the taxable year, over the amount of tax imposed which is shown on the return reduced by any rebate (within the meaning of subsection (g) of section six hundred eighty-one). [The amount of such understatement shall be reduced by that portion of the understatement which is attributable to the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.] The excess under the preceding sentence shall be determined without regard to items to which subsection (p-1) of this section applies. The [tax

commission] commissioner may waive all or any part of the addition to tax provided by this subsection on a showing by the taxpayer that there was reasonable cause for the understatement, or part thereof, and that the taxpayer acted in good faith.
(2) The amount of the understatement under paragraph (1) shall be reduced by that portion of the understatement which is attributable to
(A) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or
(B) any item if the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.
(3)(A) Subparagraph (B) of paragraph two of this subsection shall not apply to any item attributable to a tax shelter.
(B) For purposes of this paragraph, the term "tax shelter" means
(i) a partnership or other entity,
(ii) any investment plan or arrangement, or
(iii) any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of tax.

§ 4. Section 685 of the tax law is amended by adding a new subsection (p-1) to read as follows:
(p-1) Reportable transaction understatement.-- (1) If a taxpayer has a reportable transaction understatement for any taxable year, there shall be added to the tax an amount equal to twenty percent of the amount of such understatement.
(2) For purposes of this section, the term "reportable transaction understatement" means the sum of:
(A) the product of--
(i) the amount of the increase (if any) in the applicable tax base which results from a difference between the proper tax treatment of an item to which this section applies and the taxpayer's treatment of such item (as shown on the taxpayer's return of tax), and
(ii) the highest rate of tax imposed by this article, and
(B) the amount of the decrease (if any) in the aggregate amount of credits determined under this article which results from a difference between the taxpayer's treatment of an item to which this section applies (as shown on the taxpayer's return of tax) and the proper tax treatment of such item. For purposes of subparagraph (A) of this paragraph, any reduction of the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to section one

thousand two hundred eleven of the internal revenue code) be allowed for such year, shall be treated as an increase in the applicable tax base.

(3) This subsection shall apply to any item which is attributable to--

(A) any listed transaction, and

(B) any reportable transaction (other than a listed transaction) if a significant purpose of such transaction is the avoidance or evasion of tax.

(4) Paragraph one of this subsection shall be applied by substituting "thirty percent" for "twenty percent" with respect to the portion of any reportable transaction understatement with respect to which the requirement of clause (i) of subparagraph (B) of paragraph ten of this subsection is not met.

(5) For purposes of this subsection, the terms "reportable transaction" and "listed transaction" have the meanings given to such terms by section twenty-five of this chapter, the term "reportable transaction" shall include a "New York reportable transaction" as defined in such section twenty-five, and the term "listed transaction" shall include any transaction designated as a tax avoidance transaction pursuant to such section twenty-five.

(6) In the case of an understatement (as defined in subsection (p) of this section):

(A) the amount of such understatement (determined without regard to this paragraph) shall be increased by the aggregate amount of reportable transaction understatements for purposes of determining whether such understatement is a substantial understatement under subsection (p) of this section, and (B) the addition to tax under subsection (p) of this section shall apply only to the excess of the amount of the substantial understatement (if any) after the application of this subparagraph over the aggregate amount of reportable transaction understatements.

(7) References to an understatement (or a deficiency) in subsection (e) of this section shall be treated as including references to a reportable transaction understatement.

(8) This subsection shall not apply to any portion of any understatement on which a penalty is imposed under subsection (e) of this section.

(9) Except as provided in regulations prescribed by the commissioner, in no event shall any tax treatment included with an amendment or supplement to a return of tax be taken into account in determining the amount of any reportable transaction understatement if the amendment or supplement is filed after

the earlier of the date the taxpayer is first contacted by the commissioner regarding the examination of the return or such other date as is specified by the commissioner.

(10)(A) No penalty shall be imposed under this subsection with respect to any portion of a reportable transaction understatement if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

(B) Subparagraph (A) of this paragraph shall not apply to any reportable transaction understatement unless

(i) the relevant facts affecting the tax treatment of the item are adequately disclosed in accordance with section twenty-five of this chapter,

(ii) there is or was substantial authority for such treatment, and

(iii) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. A taxpayer failing to adequately disclose in accordance with section twenty-five of this chapter shall be treated as meeting the requirements of clause (i) of this subparagraph if the penalty for such failure was rescinded under subsection (x) of this section.

(11)(A) A taxpayer shall be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief

(i) is based on the facts and law that exist at the time the return which includes such tax treatment is filed, and

(ii) relates solely to the taxpayer's chances of success on the merits of such treatment and does not take into account the possibility that a return will not be audited, such treatment will not be raised on audit, or such treatment will be resolved through settlement if it is raised.

(B)(i) An opinion of a tax advisor may not be relied upon to establish the reasonable belief of a taxpayer if

(I) the tax advisor is described in clause (ii) of this subparagraph, or

(II) the opinion is described in clause (iii) of this subparagraph.

(ii) A tax advisor is described in this clause if the tax advisor

(I) is a material advisor (within the meaning of section six thousand one hundred eleven of the internal revenue code or within such meaning as it also applies to a New York reportable transaction as defined in section twenty-five of this chapter) and participates in the organization, management, promotion, or sale of the transaction or is related (within the meaning of subsection (b) of section two hundred sixty-seven of the internal revenue code or subsection (b) of section seven hundred seven of the internal revenue code) to any person who so participates,

(II) is compensated directly or indirectly by a material advisor with respect to the transaction,
(III) has a fee arrangement with respect to the transaction which is contingent on all or part of the intended tax benefits from the transaction being sustained, or
(IV) has a disqualifying financial interest with respect to the transaction.
(iii) For purposes of clause (i) of this subparagraph, an opinion is disqualified if the opinion
(I) is based on unreasonable factual or legal assumptions (including assumptions as to future events),
(II) unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person,
(III) does not identify and consider all relevant facts, or
(IV) fails to meet any other requirement as the commissioner may prescribe.

§ 5. Subsection (r) of section 685 of the tax law, as added by chapter 65 of the laws of 1985, paragraph 1 as amended by chapter 765 of the laws of 1985, is amended to read as follows:
(r) Aiding or assisting in the giving of fraudulent returns, reports, statements or other documents.
(1) Any person who, with the intent that tax be evaded, shall, for a fee or other compensation or as an incident to the performance of other services for which such person receives compensation, aid or assist in, or procure, counsel, or advise the preparation or presentation under, or in connection with any matter arising under this article of any return, report, declaration, statement or other document which is fraudulent or false as to any material matter, or supply any false or fraudulent information, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, report, declaration, statement or other document shall pay a penalty not exceeding [one] five thousand dollars.
(2) For purposes of paragraph one of this subsection, the term "procures" includes ordering (or otherwise causing) a subordinate to do an act, and knowing of, and not attempting to prevent, participation by a subordinate in an act. The term "subordinate" means any other person (whether or not a director, officer, employee, or agent of the taxpayer involved) over whose activities the person has direction, supervision, or control.
(3) For purposes of paragraph one of this subsection, a person furnishing typing, reproducing, or other mechanical assistance

with respect to a document shall not be treated as having aided or assisted in the preparation of such document by reason of such assistance.
(4) The penalty imposed by this subsection shall be in addition to any other penalty provided by law.

§ 6. Section 685 of the tax law is amended by adding five new subsections (x), (y), (z), (aa) and (bb) to read as follows:
(x) Failure to disclose or provide reportable transaction information.
(1) Any person who fails to file, disclose or provide any statement, return or other document which is required under subdivision (a) of section twenty-five of this chapter shall pay a penalty in the amount determined under paragraph two of this subsection.
(2)(A) Except as provided in subparagraph (B) of this paragraph, the amount of the penalty under paragraph one of this subsection shall be ten thousand dollars.
(B) The amount of the penalty under paragraph one of this subsection with respect to a listed transaction shall be twenty-five thousand dollars.
(3) For purposes of this subsection, the terms "reportable transaction" and "listed transaction" shall have the same meanings as used in section twenty-five of this chapter, and the term "reportable transaction" shall include a "New York reportable transaction" as defined in such section twenty-five, and the term "listed transaction" shall include any transaction designated as a tax avoidance transaction pursuant to such section twenty-five.
(4) The commissioner may rescind all or any portion of any penalty imposed by this subsection with respect to any violation if
(A) the violation is with respect to a reportable transaction other than a listed transaction, and
(B) rescinding the penalty would promote compliance with the requirements of this chapter and effective tax administration.
(5) The penalty imposed by this section shall be in addition to any other penalty imposed by this chapter.
(y) Failure to disclose or provide reportable transaction return.
(1) Any person who fails to file, disclose or provide any statement, return or other document which is required under subdivision (b) of section twenty-five of this chapter shall pay a penalty in the amount determined under paragraph two of this subsection.

(2)(A) Except as provided in subparagraph (B) of this paragraph, the amount of the penalty under paragraph one of this subsection shall be twenty thousand dollars.
(B) The amount of the penalty under paragraph one of this subsection with respect to a listed transaction shall be the greater of
(i) fifty thousand dollars or,
(ii) fifty percent of the gross income that the organizer or material advisor derived with respect to activities that were the basis for the requirement to file, disclose or provide information pursuant to section six thousand eleven of the internal revenue code, to the extent such gross income is attributable to the avoidance of any tax imposed under this article.
(C) Clause (ii) of subparagraph (B) of this paragraph shall be applied by substituting "seventy-five percent" for "fifty percent" in the case of an intentional failure or act described in paragraph one of this subsection.
(3) For purposes of this subsection, the terms "reportable transaction" and "listed transaction" shall have the same meanings as used in section twenty-five of this chapter, the term "reportable transaction" shall include a "New York reportable transaction" as defined in such section twenty-five, and the term "listed transaction" shall include any transaction designated as a tax avoidance transaction pursuant to such section twenty-five.
(4) The commissioner may rescind all or any portion of any penalty imposed by this subsection with respect to any violation if
(A) the violation is with respect to a reportable transaction other than a listed transaction, and
(B) rescinding the penalty would promote compliance with the requirements of this chapter and effective tax administration.
(5) The penalty imposed by this subsection shall be in addition to any other penalty imposed by this chapter, except that no penalty shall be imposed under subparagraph (A) or clause (i) of subparagraph (B) of paragraph two of subsection (q) of section one thousand eighty-five of this chapter for the same failure that is the basis for a penalty under this subsection. Nothing in this paragraph shall preclude the imposition of a penalty under clause (ii) of subparagraph (B) of paragraph two of subsection (q) of section one thousand eighty-five of this chapter for the same failure that is the basis for a penalty under clause (ii) of subparagraph (B) of paragraph two of this subsection.
(z) Failure to maintain list of advisees.

(1) If any person who is required to maintain a list under subdivision (c) of section twenty-five of this chapter fails to make a duplicate of such list available, upon written request by the commissioner in accordance with such subsection within twenty business days after the date of the request, such person shall pay a penalty of ten thousand dollars for each day of such failure after such twentieth day.

(2) No penalty shall be imposed by paragraph one of this subsection with respect to the failure on any day if such failure is due to reasonable cause.

(aa) Tax preparer penalty.

(1) If:

(A) any part of any understatement of liability with respect to any return or claim for refund is due to a position for which there was not a reasonable belief that the tax treatment in that position was more likely than not the proper treatment,

(B) any person who is an income tax return preparer with respect to such return or claim knew of such position, and

(C) such position was not disclosed as provided in subsection (p) of this section or there was no reasonable basis for the tax treatment of that position, such person shall pay a penalty of up to one thousand dollars with respect to such return or claim unless it is shown that there is reasonable cause for the understatement and such person acted in good faith.

(2) If any part of any understatement of liability with respect to any return or claim for refund is due:

(A) to a willful attempt in any manner to understate the liability for tax by a person who is a tax return preparer with respect to such return or claim, or

(B) to any reckless or intentional disregard of rules or regulations by any such person, such person shall pay a penalty of up to five thousand dollars with respect to such return or claim. With respect to any return or claim, the amount of the penalty payable by any person by reason of this paragraph shall be reduced by the amount of the penalty paid by such person by reason of paragraph one of this subsection.

(3) For purposes of this subsection, the term "understatement of liability" means any understatement of the net amount payable with respect to any tax imposed under this article or any overstatement of the net amount creditable or refundable with respect to any such tax.

(4) This subsection shall not apply if the penalty under subsection (r) of this section is imposed on the tax return preparer with respect to such understatement.

(bb) Promoting abusive tax shelters.

(1) Any person who
(A)(i) organizes (or assists in the organization of)
(I) a partnership or other entity,
(II) any investment plan or arrangement, or
(III) any other plan or arrangement, or
(ii) participates (directly or indirectly) in the sale of any interest in an entity or plan or arrangement referred to in clause (i) of this subparagraph, and
(B) makes or furnishes or causes another person to make or furnish (in connection with such organization or sale)
(i) a statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter, or
(ii) a gross valuation overstatement as to any material matter, and
(C) satisfies any of the following conditions
(i) the person is organized in this state,
(ii) the person is doing business in this state,
(iii) the person is deriving income in this state, or
(iv) the person conducts any of the activities described in subparagraph (A) or (B) of this paragraph within the state of New York, shall pay, with respect to each activity described in subparagraph (A) of this paragraph, a penalty equal to one thousand dollars or, if the person establishes that it is lesser, one hundred percent of the gross income derived (or to be derived) by such person from such activity to the extent such gross income is attributable to the avoidance of any tax imposed under this article; provided, however, that if an activity with respect to which a penalty imposed under this subsection involves a statement described in clause (i) of subparagraph (B) of paragraph one of this subsection, the penalty shall be equal to fifty percent of the gross income derived (or to be derived) from that activity within the state by the person on which the penalty is imposed. For purposes of the preceding sentence, activities described in clause (i) of subparagraph (A) of this paragraph with respect to each entity or arrangement shall be treated as a separate activity and participation in each sale described in clause (ii) of subparagraph (A) of this paragraph shall be so treated.
(2)(A) For purposes of this subsection, the term "gross valuation overstatement" means any statement as to the value of any property or services if

(i) the value so stated exceeds two hundred percent of the amount determined to be the correct valuation, and
(ii) the value of such property or services is directly related to the amount of any deduction or credit allowable under this chapter to any participant.
(B) The commissioner may waive all or any part of the penalty provided by paragraph one of this subsection with respect to any gross valuation overstatement on a showing that there was a reasonable basis for the valuation and that such valuation was made in good faith.
(3) The penalty imposed by this subsection shall be in addition to any other penalty provided by law.

§ 7. Subsection (c) of section 1083 of the tax law is amended by adding a new paragraph 11 to read as follows:
(11) Extended statute of limitations for tax avoidance transactions.
(A) If a taxpayer fails to file, disclose or provide any statement, return or other information for any taxable year with respect to a listed transaction (as defined in paragraph three of subsection (p) of section one thousand eighty-five of this article) which is required under subdivision (a) of section twenty-five of this chapter, the time for assessment of any tax imposed by this article with respect to such transaction shall not expire before the date which is one year after the earlier of:
(i) the date on which the commissioner is furnished the statement, return, or information so required, or
(ii) the date that the requirements of subdivision (c) of section twenty-five of this chapter are met with respect to a request under such subdivision by the commissioner relating to such transaction.
(B) If later than the time for assessment otherwise provided by this section, tax may be assessed at any time within six years after the return was filed if the deficiency is attributable to an abusive tax avoidance transaction.
(C) For purposes of subparagraph (B) of this paragraph, an "abusive tax avoidance transaction" means a plan or arrangement devised for the principal purpose of avoiding tax. Abusive tax avoidance transactions include, but are not limited to, listed transactions described in paragraph five of subsection (k-1) of section one thousand eighty-five of this article.

§ 8. Subsection (k) of section 1085 of the tax law, as amended by chapter 765 of the laws of 1985, is amended to read as follows:

(k) Substantial understatement of liability.

(1) If there is a substantial understatement of tax for any taxable year, there shall be added to the tax an amount equal to ten percent of the amount of any underpayment attributable to such understatement. For purposes of this subsection, there is a substantial understatement of tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of ten percent of the tax required to be shown on the return for the taxable year or five thousand dollars. For purposes of the preceding sentence, the term "understatement" means the excess of the amount of the tax required to be shown on the return for the taxable year, over the amount of the tax imposed which is shown on the return reduced by any rebate (within the meaning of subsection (h) of section one thousand eighty-one of this article). [The amount of such understatement shall be reduced by that portion of the understatement which is attributable to the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.] The excess under the preceding sentence shall be determined without regard to items to which subsection (k-1) of this section applies. The [tax commission] commissioner may waive all or any part of the addition to tax provided by this section on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith.

(2) The amount of the understatement under paragraph one of this subsection shall be reduced by that portion of the understatement which is attributable to

(A) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

(B) any item if the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.

(3)(A) Subparagraph (B) of paragraph two of this subsection shall not apply to any item attributable to a tax shelter.

(B) For purposes of this paragraph, the term "tax shelter" means

(i) a partnership or other entity,

(ii) any investment plan or arrangement, or

(iii) any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of tax.

§ 9. Section 1085 of the tax law is amended by adding a new subsection (k-1) to read as follows:

(k-1) Reportable transaction understatement.

(1) If a taxpayer has a reportable transaction understatement for any taxable year, there shall be added to the tax an amount equal to twenty percent of the amount of such understatement.

(2) For purposes of this section, the term "reportable transaction understatement" means the sum of

(A) the product of--

(i) the amount of the increase (if any) in the applicable tax base which results from a difference between the proper tax treatment of an item to which this section applies and the taxpayer's treatment of such item (as shown on the taxpayer's return of tax), and

(ii) the highest rate of tax imposed under the article of this chapter that applies to the taxpayer, and

(B) the amount of the decrease (if any) in the aggregate amount of credits determined under the article of this chapter that applies to the taxpayer which results from a difference between the taxpayer's treatment of an item to which this section applies (as shown on the taxpayer's return of tax) and the proper tax treatment of such item. For purposes of subparagraph (A) of this paragraph, any reduction of the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to section one thousand two hundred eleven of the internal revenue code) be allowed for such year, shall be treated as an increase in the applicable tax base.

(3) This subsection shall apply to any item which is attributable to

(A) any listed transaction, and

(B) any reportable transaction (other than a listed transaction) if a significant purpose of such transaction is the avoidance or evasion of tax.

(4) Paragraph one of this subsection shall be applied by substituting "thirty percent" for "twenty percent" with respect to the portion of any reportable transaction understatement with respect to which the requirement of clause (i) of subparagraph (B) of paragraph ten of this subsection is not met.

(5) For purposes of this subsection, the terms "reportable transaction" and "listed transaction" have the meanings given to such terms by section twenty-five of this chapter, the term "reportable transaction" shall include a "New York reportable transaction" as defined in such section twenty-five, and the term "listed transaction" shall include any transaction

designated as a tax avoidance transaction pursuant to such section twenty-five.

(6) In the case of an understatement (as defined in subsection (k) of this section)

(A) the amount of such understatement (determined without regard to this paragraph) shall be increased by the aggregate amount of reportable transaction understatements for purposes of determining whether such understatement is a substantial understatement under subsection (k) of this section, and

(B) the addition to tax under subsection (k) of this section shall apply only to the excess of the amount of the substantial understatement (if any) after the application of subparagraph (A) of this paragraph over the aggregate amount of reportable transaction understatements.

(7) References to an understatement (or a deficiency) in subsection (f) of this section shall be treated as including references to a reportable transaction understatement.

(8) This subsection shall not apply to any portion of any understatement on which a penalty is imposed under subsection (f) of this section.

(9) Except as provided in regulations prescribed by the commissioner, in no event shall any tax treatment included with an amendment or supplement to a return of tax be taken into account in determining the amount of any reportable transaction understatement if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by the commissioner regarding the examination of the return or such other date as is specified by the commissioner.

(10)(A) No penalty shall be imposed under this subsection with respect to any portion of a reportable transaction understatement if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

(B) Subparagraph (A) of this paragraph shall not apply to any reportable transaction understatement unless:

(i) the relevant facts affecting the tax treatment of the item are adequately disclosed in accordance with section twenty-five of this chapter,

(ii) there is or was substantial authority for such treatment, and

(iii) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. A taxpayer failing to adequately disclose in accordance with section twenty-five of this chapter shall be treated as meeting the requirements of clause (i) of this subparagraph if the penalty for such failure was rescinded under subsection (p) of this section.

(11)(A) A taxpayer shall be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief
(i) is based on the facts and law that exist at the time the return of tax which includes such tax treatment is filed, and
(ii) relates solely to the taxpayer's chances of success on the merits of such treatment and does not take into account the possibility that a return will not be audited, such treatment will not be raised on audit, or such treatment will be resolved through settlement if it is raised.
(B)(i) An opinion of a tax advisor may not be relied upon to establish the reasonable belief of a taxpayer if
(I) the tax advisor is described in clause (ii) of this subparagraph, or
(II) the opinion is described in clause (iii) of this subparagraph.
(ii) A tax advisor is described in this clause if the tax advisor:
(I) is a material advisor (within the meaning of section six thousand one hundred eleven of the internal revenue code or within such meaning as it also applies to a New York reportable transaction as defined in section twenty-five of this chapter) and participates in the organization, management, promotion, or sale of the transaction or is related (within the meaning of subsection (b) of section two hundred sixty-seven of the internal revenue code or subsection (b) of section seven hundred seven of the internal revenue code) to any person who so participates,
(II) is compensated directly or indirectly by a material advisor with respect to the transaction,
(III) has a fee arrangement with respect to the transaction which is contingent on all or part of the intended tax benefits from the transaction being sustained, or
(IV) has a disqualifying financial interest with respect to the transaction.
(iii) For purposes of clause (i) of this subparagraph, an opinion is disqualified if the opinion
(I) is based on unreasonable factual or legal assumptions (including assumptions as to future events),
(II) unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person,
(III) does not identify and consider all relevant facts, or
(IV) fails to meet any other requirement as the commissioner may prescribe.

§ 10. Section 1085 of the tax law is amended by adding five new subsections (p), (q), (r), (s) and (t) to read as follows:

(p) Failure to disclose or provide reportable transaction information.

(1) Any person who fails to file, disclose or provide any statement, return or other document which is required under subdivision (a) of section twenty-five of this chapter shall pay a penalty in the amount determined under paragraph two of this subsection.

(2)(A) Except as provided in subparagraph (B) of this paragraph, the amount of the penalty under paragraph one of this subsection shall be twenty thousand dollars.

(B) The amount of the penalty under paragraph one of this subsection with respect to a listed transaction shall be fifty thousand dollars.

(3) For purposes of this subsection, the terms "reportable transaction" and "listed transaction" shall have the same meanings as used in section twenty-five of this chapter, the term "reportable transaction" shall include a "New York reportable transaction" as defined in such section twenty-five, and the term "listed transaction" shall include any transaction designated as a tax avoidance transaction pursuant to such section twenty-five.

(4) The commissioner may rescind all or any portion of any penalty imposed by this subsection with respect to any violation if

(A) the violation is with respect to a reportable transaction other than a listed transaction, and

(B) rescinding the penalty would promote compliance with the requirements of this chapter and effective tax administration.

(5) The penalty imposed by this section shall be in addition to any other penalty imposed by this chapter.

(q) Failure to disclose or provide reportable transaction return

(1) Any person who fails to file, disclose or provide any statement, return or other document which is required under subdivision (b) of section twenty-five of this chapter shall pay a penalty in the amount determined under paragraph two of this subsection.

(2)(A) Except as provided in subparagraph (B) of this paragraph, the amount of the penalty under paragraph one of this subsection shall be twenty thousand dollars.

(B) The amount of the penalty under paragraph one of this subsection with respect to a listed transaction shall be the greater of

(i) fifty thousand dollars or,

(ii) fifty percent of the gross income that the organizer or material advisor derived with respect to activities that were the basis for the requirement to file, disclose or provide information pursuant to section six thousand eleven of the internal revenue code, to the extent such gross income is attributable to the avoidance of any tax imposed under article nine, nine-A, thirty-two, or thirty-three of this chapter.

(C) Clause (ii) of subparagraph (B) of this paragraph shall be applied by substituting "seventy-five percent" for "fifty percent" in the case of an intentional failure or act described in paragraph one of this subsection.

(3) For purposes of this subsection, the terms "reportable transaction" and "listed transaction" shall have the same meanings as used in section twenty-five of this chapter, the term "reportable transaction" shall include a "New York reportable transaction" as defined in such section twenty-five, and the term "listed transaction" shall include any transaction designated as a tax avoidance transaction pursuant to such section twenty-five.

(4) The commissioner may rescind all or any portion of any penalty imposed by this subsection with respect to any violation if

(A) the violation is with respect to a reportable transaction other than a listed transaction, and

(B) rescinding the penalty would promote compliance with the requirements of this chapter and effective tax administration.

(5) The penalty imposed by this subsection shall be in addition to any other penalty imposed by this chapter, except that no penalty shall be imposed under subparagraph (A) or clause (i) of subparagraph (B) of paragraph two of subsection (y) of section six hundred eighty-five of this chapter for the same failure that is the basis for a penalty under this subsection. Nothing in this paragraph shall preclude the imposition of a penalty under clause (ii) of subparagraph (B) of paragraph two of subsection (y) of section six hundred eighty-five of this chapter for the same failure that is the basis for a penalty under clause (ii) of subparagraph (B) of paragraph two of this subsection.

(r) Failure to maintain list of advisees.

(1) If any person who is required to maintain a list under subdivision (c) of section twenty-five of this chapter fails to make a duplicate of such list available upon written request by the commissioner in accordance with such subdivision within twenty business days after the date of such request, such person shall pay a penalty of ten thousand dollars for each day of such failure after such twentieth day.

(2) No penalty shall be imposed by paragraph one of this subsection with respect to the failure on any day if such failure is due to reasonable cause.

(s) Tax preparer penalty.
(1) If:
(A) any part of any understatement of liability with respect to any return or claim for refund is due to a position for which there was not a reasonable belief that the tax treatment in that position was more likely than not the proper treatment,
(B) any person who is a tax return preparer with respect to such return or claim knew of such position, and
(C) such position was not disclosed as provided in subsection (k) of this section or there was no reasonable basis for the tax treatment of that position, such person shall pay a penalty of up to one thousand dollars with respect to such return or claim unless it is shown that there is reasonable cause for the understatement and such person acted in good faith.
(2) If any part of any understatement of liability with respect to any return or claim for refund is due
(A) to a willful attempt in any manner to understate the liability for tax by a person who is a tax return preparer with respect to such return or claim, or
(B) to any reckless or intentional disregard of rules or regulations by any such person, such person shall pay a penalty of up to five thousand dollars with respect to such return or claim. With respect to any return or claim, the amount of the penalty payable by any person by reason of this paragraph shall be reduced by the amount of the penalty paid by such person by reason of paragraph one of this subsection.
(3) For purposes of this subsection, the term "understatement of liability" means any understatement of the net amount payable with respect to any tax imposed under article nine, nine-A, thirty-two, or thirty-three of this chapter or any overstatement of the net amount creditable or refundable with respect to any such tax.
(4) This subsection shall not apply if the penalty under subsection (l) of this section is imposed on the tax return preparer with respect to such understatement.
(t) Promoting abusive tax shelters.
(1) Any person who
(A)(i) organizes (or assists in the organization of)
(I) a partnership or other entity,
(II) any investment plan or arrangement, or
(III) any other plan or arrangement, or
(ii) participates (directly or indirectly) in the sale of any interest in an entity or plan or arrangement referred to in clause (i) of this subparagraph, and

(B) makes or furnishes or causes another person to make or furnish (in connection with such organization or sale)
(i) a statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter, or
(ii) a gross valuation overstatement as to any material matter, and
(C) satisfies any of the following conditions
(i) the person is organized in this state,
(ii) the person is doing business in this state,
(iii) the person is deriving income in this state, or
(iv) the person conducts any of the activities described in subparagraph (A) or (B) of this paragraph within the state of New York, shall pay, with respect to each activity described in subparagraph (A) of this paragraph, a penalty equal to one thousand dollars or, if the person establishes that it is lesser, one hundred percent of the gross income derived (or to be derived) by such person from such activity to the extent such gross income is attributed to the avoidance of any tax imposed under articles nine, nine-A, thirty-two or thirty-three of this chapter; provided, however, that if an activity with respect to which a penalty imposed under this subsection involves a statement described in clause (i) of subparagraph (B) of paragraph one of this subsection, the penalty shall be equal to fifty percent of the gross income derived (or to be derived) from that activity within the state by the person on which the penalty is imposed. For purposes of the preceding sentence, activities described in clause (i) of subparagraph (A) of this paragraph with respect to each entity or arrangement shall be treated as a separate activity and participation in each sale described in clause (ii) of subparagraph (A) of this paragraph shall be so treated.
(2)(A) For purposes of this subsection, the term "gross valuation overstatement" means any statement as to the value of any property or services if--
(i) the value so stated exceeds two hundred percent of the amount determined to be the correct valuation, and
(ii) the value of such property or services is directly related to the amount of any deduction or credit allowable under this chapter to any participant.
(B) The commissioner may waive all or any part of the penalty provided by paragraph one of this subsection with respect to any gross valuation overstatement on a showing that there was a

reasonable basis for the valuation and that such valuation was made in good faith.

(3) The penalty imposed by this subsection shall be in addition to any other penalty provided by law.

§ 11. Voluntary Compliance Initiative.

(a) Notwithstanding the provisions of any other law to the contrary, there is hereby established a voluntary compliance initiative to be administered by the Commissioner of Taxation and Finance as provided in this section for eligible taxpayers as described herein.

(b) The tax shelter voluntary compliance program shall apply to tax liabilities under articles nine, nine-A, twenty-two, thirty-two or thirty-three of the tax law ("designated taxes") attributable to the use of tax avoidance transactions for taxable years beginning before January 1, 2005.

(c) For purposes of the voluntary compliance initiative established by this section and except as otherwise provided in this section, an "eligible taxpayer" is an individual, partnership, estate, trust, corporation, limited liability company, joint stock company, or any other company, trustee, receiver, assignee, referee, society, association, business or any other person as described in the tax law, who or which has a tax liability with regard to one or more of the designated taxes for the period of time described in subdivision (b) of this section.

(d) The commissioner of taxation and finance may adopt rules, issue forms and instructions, determine the period the initiative under this section shall be conducted, and take such other actions necessary to implement the provisions of the voluntary compliance initiative established by this section, provided such program shall be conducted no later than October 1, 2005 and shall end on March 1, 2006. The commissioner of taxation and finance shall cause to be prepared a written report on the voluntary compliance initiative. A copy of such report shall be delivered to the governor, the temporary president of the senate, and the speaker of the assembly no later than October 1, 2006.

(e) An eligible taxpayer that meets the requirements with respect to any taxable year to which this section applies may elect to participate in the voluntary compliance initiative under either method described in paragraphs (1) and (2) of this subdivision for any particular taxable year. Such election shall be made separately for each taxable year and in the form and manner prescribed by the commissioner of taxation and finance, and once made shall be irrevocable.

(1) Voluntary compliance without appeal. If an eligible taxpayer elects to participate under this paragraph and complies with the requirements for such participation, then
(A) the commissioner of taxation and finance shall waive any penalty that may be applicable to the underreporting or underpayment of tax liabilities under one or more designated taxes attributable to the use of tax avoidance transactions for such taxable year,
(B) except as otherwise provided in this section, the commissioner of taxation and finance shall not bring or seek civil, administrative or criminal action against the taxpayer for such taxable year with respect to any tax avoidance transactions,
(C) the taxpayer may not file a claim for credit or refund with respect to such tax avoidance transaction for such taxable year; provided, however, that nothing in this section shall preclude
(i) a taxpayer from filing a claim for credit or refund for the same taxable year in which such a tax avoidance transaction was reported if such credit or refund is not attributable to the tax avoidance transaction,
(ii) the commissioner of taxation and finance on his or her own motion from redetermining the amount of tax due including applicable interest, with respect to any taxes and interest paid under this initiative, and granting a refund or allowing a credit with respect to such redetermination, and
(D) no penalty may be waived under this section if the penalty imposed is attributable to an assessment of taxes that became final prior to the beginning date of the voluntary compliance initiative established by this section.
(2) Voluntary compliance with appeal. If an eligible taxpayer elects to participate under this paragraph and complies with the requirements for such participation, then
(A) the commissioner of taxation and finance shall waive any penalty that may be applicable to the underreporting or underpayment of tax liabilities under one or more designated taxes attributable to the use of tax avoidance transactions for such taxable year, except the penalties imposed under subsections (b) and (p) of section 685 of the tax law and subsections (b) and (k) of section 1085 of the tax law (as such subsections were in effect on December 31, 2004),
(B) except as otherwise provided in this section, the commissioner of taxation and finance shall not seek civil, administrative or criminal action against the taxpayer for such taxable year with respect to any tax avoidance transactions,

(C) the taxpayer may file a claim for credit or refund with respect to the use of a tax avoidance transaction for such taxable year pursuant to sections 686 and 687 or 1086 and 1087 of the tax law,

(D) notwithstanding clause (A) of subparagraph three of subsection (c) of section 689 or 1089 of the tax law, a taxpayer may not file a petition with the division of tax appeals until after either of the following:

(i) the date the commissioner of taxation and finance takes action on the claim for refund for the tax year to which this section applies and has notified the taxpayer pursuant to paragraph (3) of subsection (c) of section 689 or paragraph (3) of subsection (c) of section 1089 of the tax law; or

(ii) the earlier of the following dates:

(I) the date that is 180 days after the date of a final determination by the Internal Revenue Service with respect to the transaction or transactions to which this section applies; or

(II) the earlier of the date that is three years after the date the claim for refund was filed or two years after full payment of all tax, including penalty and interest was made,

(E) the taxpayer shall be subject to the accuracy related penalties under subsections (b) and (p) of section 685 and subsections (b) and (k) of section 1085 of the tax law (as such subsections were in effect on December 31, 2004),

(i) for purposes of assessing such penalty, the amount of underpayment is the difference between the amount of tax shown on the original return required to be filed and the correct amount of tax for the taxable year, and

(ii) notwithstanding article 40 or sections 681 or 1081 of the tax law, any notice issued to the taxpayer imposing a penalty under this subsection shall not be construed as a notice which gives a taxpayer the right to a hearing, and the taxpayer shall be allowed to file a petition under subparagraph (D) of this paragraph only after the taxpayer has paid all amounts due, including any penalty, and

(F) no penalty may be waived under this section if the penalty imposed is attributable to an assessment of taxes that became final prior to the beginning date of the voluntary compliance initiative established by this section.

(f) In order to participate in the voluntary compliance initiative established by this section, an eligible taxpayer must, during the period of the initiative prescribed by the commissioner of taxation and finance, do all of the following:

(1) file an application for participation in the voluntary compliance initiative in the form and manner prescribed by the commissioner of taxation and finance;
(2) file an amended return in the form and manner prescribed by the commissioner of taxation and finance for the taxable year for which the taxpayer used any tax avoidance transaction to underreport or underpay the taxpayer's New York tax liability, reporting the total New York income and tax liability for such taxable year computed without regard to any tax avoidance transaction; and
(3) make full payment of the additional New York tax liability and interest due for such taxable year that is attributable to the use of the tax avoidance transaction; provided, however, the commissioner of taxation and finance may enter into an installment payment agreement in lieu of the full payment required by this paragraph. Failure by the taxpayer to fully comply with the terms of the installment payment agreement shall render the waiver of penalties null and void, and the total amount of tax, interest, and all penalties shall be immediately due and payable.
(g) For purposes of this section, if the commissioner of taxation and finance subsequently determines that the correct amount of New York tax was not paid for the taxable year, then the penalty relief under this section, including forbearance from seeking civil, administrative or criminal action shall not apply to any unpaid portion of the underpayment attributable to a tax avoidance transaction.
(h) For purposes of this section, a "tax avoidance transaction" means a plan or arrangement devised for the principal purpose of avoiding tax. Tax avoidance transactions include, but are not limited to, “listed transactions" as described in subdivisions (a) or (b) of section 25 of the tax law.
(i) For purposes of this section the term "taxpayer" shall include any person subject to any designated tax described in subdivision (a) of this section.
(j) An otherwise eligible taxpayer shall not be entitled to participate in the voluntary compliance initiative established by this section if any of the following applies.
(1) Such taxpayer is a party to any criminal investigation being conducted by an agency of the federal government, the state or any political subdivision thereof in regard to the underreporting or underpayment of tax, is a party to any administrative proceeding or civil or criminal litigation which is pending on the date of the taxpayer's application in the bureau of conciliation and mediation services, the division of tax appeals

or any court of this state or the United States, relating to any action or failure to act which is the basis for the penalty with respect to which relief is sought. An administrative proceeding or civil litigation shall be deemed not to be pending on the date of the application if the taxpayer withdraws from such proceeding or litigation prior to the waiver of penalty provided for in this section.

(2) Such taxpayer has been convicted of a crime relating to a tax that is the basis of the penalty with respect to which relief is sought for any period or assessment for that tax.

(3) The taxpayer was eligible to participate in the New York Offshore Voluntary Compliance Initiative established in 2003, and the tax avoidance transactions described in subdivision (b) of this section that were used by the taxpayer to underreport or underpay the taxpayer's New York tax liability were all financial arrangements or payment card transactions described in the New York Offshore Voluntary Compliance Initiative or the Internal Revenue Service's Offshore Voluntary Compliance Initiative set forth in Revenue Procedure 2003-11; provided, that nothing in this paragraph shall preclude a taxpayer from participating in the voluntary compliance initiative with regard to transactions that were not the basis for participation in such Offshore Voluntary Compliance Initiatives.

(k) No refund or credit shall be granted with respect to any penalty paid prior to the time the taxpayer participates in the voluntary compliance initiative established by this section.

(l) If an eligible taxpayer entitled to participate in the voluntary compliance initiative established under this section fails to so participate and has a deficiency with respect to one or more designated taxes for a taxable year beginning before January 1, 2005 that is attributable to the use of a tax avoidance transaction for such taxable year (or years), then there shall be added to the tax an amount equal to one hundred percent of the interest payable for the period beginning on the last date prescribed by law for the payment of the tax (determined without regard to extensions) and ending on the date the notice of deficiency is mailed to the taxpayer.

(m) In addition to any other authority to examine returns, for the purpose of improving state tax administration, the commissioner of taxation and finance may inquire into the facts and circumstances related to the use of tax avoidance transactions to underreport the tax liabilities for which a taxpayer has participated in the voluntary compliance program under this section. Taxpayers shall cooperate fully with inquiries described in this subdivision. Failure by a taxpayer to

fully cooperate in an inquiry described in this subdivision shall render the waiver of penalties under this section null and void and the taxpayer may be assessed any penalties that may apply.
(n) The fact of a taxpayer's participation in the voluntary compliance program shall not be considered evidence that the taxpayer in fact engaged in a tax avoidance transaction.
(o) For purposes of this section, the returns, forms and other documents filed by taxpayers pursuant to the voluntary compliance initiative established pursuant to this section shall be deemed to be reports and returns
(i) subject to the secrecy provisions in the same manner and to the same extent as if such reports or returns were referred to in subdivision 1 of section 202, subdivision 8 of section 211, subsection (e) of section 697, subsection (a) of section 1467, or subdivision (a) of section 1518 of the tax law, and
(ii) for purposes of the criminal provisions of article 37 of the tax law.

§ 12. This act shall take effect immediately; provided, however, that (i) section one of this act shall apply to all disclosure statements described in paragraph 1 of subdivision (a) of section 25 of the tax law, as added by section one of this act, that were required to be filed with the internal revenue service at any time with respect to "listed transactions" as described in such paragraph 1, and shall apply to all disclosure statements described in paragraph 1 of subdivision (a) of section 25 of the tax law, as added by section one of this act, that were required to be filed with the internal revenue service with respect to "reportable transactions" as described in such paragraph 1, other than "listed transactions", in which a taxpayer participated during any taxable year for which the statute of limitations for assessment has not expired as of the date this act shall take effect, and shall apply to returns or statements described in such paragraph 1 required to be filed by taxpayers (or persons as described in such paragraph) with the commissioner of taxation and finance on or after the sixtieth day after this act shall have become a law;
(ii) sections two through four and seven through nine of this act shall apply to any tax liability for which the statute of limitations on assessment has not expired as of the date this act shall take effect; and
(iii) provided, further, that the provisions of this act shall expire and be deemed repealed July 1, 2007. The commissioner of taxation and finance shall cause to be prepared a written report on the tax shelter law. Notwithstanding any other provision of

law to the contrary, such report shall include, but not be limited to, statistical information regarding the listed and reportable transactions and avoidance transactions under this act. A copy of such report shall be delivered to the governor, the temporary president of the senate, and the speaker of the assembly no later than April 1, 2007; provided, that, such expiration and repeal shall not affect any requirement imposed pursuant to this act.

Sections 15 through 18 of Part A of Chapter 63 of the Laws of 2005 made several modifications to Part N of Chapter 61.

§ 15. Clause (ii) of subparagraph (D) of paragraph 1 of subdivision (b) of section 25 of the tax law, as added by section 1 of part N of a chapter of the laws of 2005, amending the tax law and other laws relating to implementing the state fiscal plan for the 2005-2006 state fiscal year, as proposed in legislative bill numbers S.3671 and A.6845, is amended to read as follows:
(ii) such person is a material advisor, as defined in section six thousand one hundred eleven of the internal revenue code, who [within the state of New York,] provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction.

§ 16. Subparagraph (B) of paragraph 1 of subsection (aa) of section 685 of the tax law, as added by section 6 of part N of a chapter of the laws of 2005, relating to implementing the state fiscal plan for the 2005-2006 state fiscal year, as proposed in legislative bill numbers S.3671 and A.6845, is amended to read as follows:
(B) any person who is an income tax return preparer with respect to such return or claim knew (or reasonably should have known) of such position, and

§ 17. Subparagraph (B) of paragraph 1 of subsection (s) of section 1085 of the tax law, as added by section 10 of part N of a chapter of the laws of 2005, relating to implementing the state fiscal plan for the 2005-2006 state fiscal year, as proposed in legislative bill numbers S.3671 and A. 6845, is amended to read as follows:
(B) any person who is a tax return preparer with respect to such return or claim knew (or reasonably should have known) of such position, and

§ 18. Subdivision (b) of section 11 of part N of a chapter of the laws of 2005 amending the tax law and other laws relating to implementing the state fiscal plan for the 2005-2006 state fiscal year, as proposed in legislative bill numbers S. 3671 and A.6845, is amended to read as follows:

(b) The tax shelter voluntary compliance program shall apply to tax liabilities under articles nine, nine-A, twenty-two, thirty, thirty-two or thirty-three of the tax law ("designated taxes") attributable to the use of tax avoidance transactions for taxable years beginning before January 1, 2005.

Appendix D - Federal Reportable Transactions

Confidential Transactions

A confidential transaction is one that is offered by an advisor to the taxpayer under conditions of confidentiality in exchange for a minimum fee. The transaction is considered confidential if the advisor limits the ability of the taxpayer to disclose the nature of the transaction. The minimum fee paid in order for it to be considered a reportable transaction is $250,000 for corporations and $50,000 for others.

Transactions with Contractual Protection

A transaction falls under this category if the taxpayer or a related party has the right to a full or partial refund if the intended tax consequences of the transaction are not sustained. This category also covers transactions where advisor fees are contingent on the realization of tax benefits.

Loss Transactions

This category includes transactions that result in claiming a loss under IRC§165 if the gross amount of the loss meets a certain threshold amount. Generally, the thresholds are $10 million in any one tax year and $20 million in a combination of tax years for corporations. These amounts are generally $2 million and $4 million for individual taxpayers.

Transactions with a Significant Book - Tax Difference

A transaction with a significant book-tax difference is one where the amount for tax purposes of any item of income, gain, expense, or loss from the transaction differs by more than $10 million on a gross basis from the amount of the item for book purposes in any taxable year. The reporting requirement for this type of transaction was eliminated for returns due after January 5, 2006. However, this action does not affect the tax years eligible for the VCI program.

Transactions with a Brief Asset Holding Period

This category includes transactions that result in a tax credit claimed of more than $250,000 if the asset giving rise to the credit was held for 45 days or less. This includes transactions generating a foreign tax credit for most taxes.

Appendix E - Internal Revenue Service Rulings and Notices

Part III. Administrative, Procedural, and Miscellaneous

Tax Avoidance Using Artificially High Basis

Notice 2000–44

In Notice 99–59, 1999–52 I.R.B. 761, the Internal Revenue Service and the Treasury Department described certain transactions that were being marketed to taxpayers for the purpose of generating artificial tax losses. This notice concerns other similar transactions that purport to generate tax losses for taxpayers.

As stated in Notice 99–59, a loss is allowable as a deduction for federal income tax purposes only if it is bona fide and reflects actual economic consequences. An artificial loss lacking economic substance is not allowable. See *ACM Partnership v. Commissioner*, 157 F.3d 231, 252 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999) ("Tax losses such as these . . . which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code and regulations."); *Scully v. United States*, 840 F.2d 478, 486 (7th Cir. 1988) (to be deductible, a loss must be a "genuine economic loss"); *Shoenberg v. Commissioner*, 77 F.2d 446, 448 (8th Cir. 1935) (to be deductible, a loss must be "actual and real"); § 1.165–1(b) of the Income Tax Regulations ("Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.").

Notice 99–59 describes an arrangement that purported to give rise to deductible losses on disposition of stock by applying the rules relating to distributions of encumbered property to shareholders in order to create artificially high basis in the stock. The Service and the Treasury have become aware of similar arrangements that have been designed to produce noneconomic tax losses on the disposition of partnership interests. These arrangements purport to give taxpayers artificially high basis in partnership interests and thereby give rise to deductible losses on disposition of those partnership interests.

One variation involves a taxpayer's borrowing at a premium and a partnership's subsequent assumption of that indebtedness. As an example of this variation, a taxpayer may receive $3,000X in cash from a lender under a loan agreement that provides for an inflated stated rate of interest and a stated principal amount of only $2,000X. The taxpayer contributes the $3,000X to a partnership, and the partnership assumes the indebtedness. The partnership thereafter engages in investment activities. At a later time, the taxpayer sells the partnership interest.

Under the position advanced by the promoters of this arrangement, the taxpayer claims that only the stated principal amount of the indebtedness, $2,000X in this example, is considered a liability assumed by the partnership that is treated as a distribution of money to the taxpayer that reduces the basis of the taxpayer's partnership interest under § 752 of the Internal Revenue Code. Therefore, disregarding any additional amounts the taxpayer may contribute to the partnership, transaction costs, and any income realized or expenses incurred at the partnership level, the taxpayer purports to have a basis in the partnership interest equal to the excess of the cash contributed over the stated principal amount of the indebtedness, even though the taxpayer's net economic outlay to acquire the partnership interest and the value of the partnership interest are nominal or zero. In this example, the taxpayer purports to have a basis in the partnership interest of $1,000X (the excess of the cash contributed ($3,000X) over the stated principal amount of the indebtedness ($2,000X)). On disposition of the partnership interest, the taxpayer claims a tax loss with respect to that basis amount, even though the taxpayer has incurred no corresponding economic loss.

In another variation, a taxpayer purchases and writes options and purports to create substantial positive basis in a partnership interest by transferring those option positions to a partnership. For example, a taxpayer might purchase call options for a cost of $1,000X and simultaneously write offsetting call options, with a slightly higher strike price but the same expiration date, for a premium of slightly less than $1,000X. Those option positions are then transferred to a partnership which, using additional amounts contributed to the partnership, may engage in investment activities.

Under the position advanced by the promoters of this arrangement, the taxpayer claims that the basis in the taxpayer's partnership interest is increased by the cost of the purchased call options but is not reduced under § 752 as a result of the partnership's assumption of the taxpayer's obligation with respect to the written call options. Therefore, disregarding additional amounts contributed to the partnership, transaction costs, and any income realized and expenses incurred at the partnership level, the taxpayer purports to have a basis in the partnership interest equal to the cost of the purchased call options ($1,000X in this example), even though the taxpayer's net economic outlay to acquire the partnership interest and the value of the partnership interest are nominal or zero. On the disposition of the partnership interest, the taxpayer claims a tax loss ($1,000X in this example), even though the taxpayer has incurred no corresponding economic loss.

The purported losses resulting from the transactions described above do not represent bona fide losses reflecting actual economic consequences as required for purposes of § 165. The purported losses from these transactions (and from any similar arrangements designed to produce noneconomic tax losses by artificially overstating basis in partnership interests) are not allowable as deductions for federal income tax purposes. The purported tax benefits from these transactions may also be subject to disallowance under other provisions of the Code and regulations. In particular, the transactions may be subject to challenge under § 752, or under § 1.701–2 or other anti-abuse rules. In addition, in the case of individuals, these transactions may be subject to challenge under § 165(c)(2). See *Fox v. Commissioner*, 82 T.C. 1001 (1984). Furthermore, tax losses from similar transactions designed to produce noneconomic tax losses by artificially overstating basis in corporate stock or other property are not allowable as deductions for federal income tax purposes.

Appropriate penalties may be imposed on participants in these transactions or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

Transactions that are the same as or substantially similar to the transactions described in this Notice 2000–44 are identified as "listed transactions" for the purposes of § 1.6011–4T(b)(2) of the Temporary Income Tax Regulations and § 301.6111– 2T(b)(2) of the Temporary Procedure and Administration Regulations. See also § 301.6112–1T, A-4. It should be noted that, independent of their classification as "listed transactions" for purposes of §§ 1.6011–4T(b)(2) and 301.6111–2T(b)(2), the transactions described in this Notice 2000–44 may already be subject to the tax shelter registration and list maintenance requirements of §§ 6111 and 6112 under the regulations issued in February 2000 (§§ 301.6111–2T and 301.6112–1T, A-4), as well as the regulations issued in 1984 and amended in 1986 (§§ 301.6111–1T and 301.6112–1T, A-3). Persons required to register these tax shelters who have failed to register the shelters may be subject to the penalty under § 6707(a) and to the penalty under § 6708(a) if the requirements of § 6112 are not satisfied.

In addition, the Service and the Treasury have learned that certain persons who have promoted participation in transactions described in this notice have encouraged individual taxpayers to participate in such transactions in a manner designed to avoid the reporting of large capital gains from unrelated transactions on their individual income tax returns (Form 1040). Certain promoters have recommended that taxpayers participate in these transactions through grantor trusts and use the same grantor trusts as vehicles to realize the capital gains. Further, although each separate capital gain and loss attributable to a portion of a trust that is treated as owned by a grantor under the grantor trust provisions of the Code (§ 671 and following) is properly reported as a separate item on the grantor's individual income tax return (see § 1.671–2(c) and the Instructions to Form 1041, U.S. Income Tax Return for Estates and Trusts), the Service and the Treasury understand that these promoters have advised that the capital gains and losses from these transactions may be netted, so that only a small net capital gain or loss is reported on the taxpayer's individual income tax return. In addition to other penalties, any person who willfully conceals the amount of capital gains and losses in this manner, or who willfully counsels or advises such concealment, may be guilty of a criminal offense under §§ 7201, 7203, 7206, or 7212(a) or other provisions of federal law.

The principal authors of this notice are David A. Shulman of the Office of Associate Chief Counsel (Passthroughs and Special Industries) and Victoria S. Balacek of the Office of Associate Chief Counsel (Financial Instruments and Products). For further information regarding this notice, contact Mr. Shulman at (202) 622-3080 or Ms. Balacek at (202) 622-3930 (not toll free calls).

List of Plants, Grown in Commercial Quantities in the United States, Having a Preproductive Period in Excess of Two Years Based on the Nationwide Weighted Average Preproductive Period for Such Plant

Notice 2000–45

PURPOSE

This notice provides guidance to taxpayers engaged in the trade or business of farming in determining whether a plant has a preproductive period in excess of 2 years for purposes of § 263A(d) of the Internal Revenue Code. This guidance is derived from the nationwide weighted average preproductive period for various plants grown in commercial quantities in the United States.

BACKGROUND

Section 263A requires generally that the direct costs and an allocable share of indirect costs of real or tangible personal property produced by a taxpayer be capitalized. Under § 263A, taxpayers generally are required to capitalize the costs of producing property in a farming business (including animals and plants without regard to the length of their preproductive period).

Sections 263A(d) and (e) set forth special rules for property produced in the trade or business of farming. Under § 263A(d)(1) and § 1.263A–4(a)(2) of the Income Tax Regulations, taxpayers neither required by § 447 to use an accrual method nor prohibited by § 448(a)(3) from using the cash method ("qualified taxpayers") are not required to capitalize the costs of producing plants that have a preproductive period of 2 years or less or animals. In addition, under § 263A(d)(3) and § 1.263A–4(d), a qualified taxpayer may elect to have § 263A not apply to the cost of producing plants in a farming business. Thus, unless an election is made to have § 263A not apply in accordance with § 263A(d)(3), qualified taxpayers generally are required to capitalize the costs of producing plants that have a preproductive period in excess of 2 years.

Section 263A(e)(3)(B) and § 1.263A–4(b)(2)(i)(B) provide that, for purposes of determining whether a plant has a preproductive period in excess of 2 years, the preproductive period of plants grown in commercial quantities in the United States must be based on the nationwide weighted average preproductive period for such plants. The legislative history of § 263A explains that Congress expected the Treasury Department to periodically publish a list of the preproductive periods of various plants based on the nationwide weighted averages for such plants. *See* H.R. Rep. No. 426, 99th Cong., 1st Sess. 628 (1985), 1986–3 (Vol. 2) C.B. 628. A proposed list was included in the preamble of the proposed § 1.263A–4 regulations (62 FR 44542). The Internal Revenue Service and Treasury Department received and considered comment letters relating to this proposed list.

Based upon information provided by the United States Department of Agriculture, the Service Treasury Department have determined that plants producing the following crops or yields have a nationwide weighted average preproductive period in excess of 2 years:

almonds, apples, apricots, avocados, blackberries, blueberries, cherries, chestnuts, coffee beans, currants, dates, figs, grapefruit, grapes, guavas, kiwifruit, kumquats, lemons, limes, macadamia nuts, mangoes, nectarines, olives, oranges, papayas, peaches, pears, pecans, persimmons, pistachio nuts, plums, pomegranates, prunes, raspberries, tangelos, tangerines, tangors, and walnuts.

Part III. Administrative, Procedural, and Miscellaneous

Intermediary Transactions Tax Shelter

Notice 2001–16

The Internal Revenue Service and the Treasury Department have become aware of certain types of transactions, described below, that are being marketed to taxpayers for the avoidance of federal income taxes. The Service and Treasury are issuing this notice to alert taxpayers and their representatives of certain responsibilities that may arise from participation in these transactions.

These transactions generally involve four parties: seller (X) who desires to sell stock of a corporation (T), an intermediary corporation (M), and buyer (Y) who desires to purchase the assets (and not the stock) of T. Pursuant to a plan, the parties undertake the following steps. X purports to sell the stock of T to M. T then purports to sell some or all of its assets to Y. Y claims a basis in the T assets equal to Y's purchase price. Under one version of this transaction, T is included as a member of the affiliated group that includes M, which files a consolidated return, and the group reports losses (or credits) to offset the gain (or tax) resulting from T's sale of assets. In another form of the transaction, M may be an entity that is not subject to tax, and M liquidates T (in a transaction that is not covered by § 337(b)(2) of the Internal Revenue Code or § 1.337(d)–4) of the Income Tax Regulations, resulting in no reported gain on M's sale of T's assets.

Depending on the facts of the particular case, the Service may challenge the purported tax results of these transactions on several grounds, including but not limited to one of the following: (1) M is an agent for X, and consequently for tax purposes T has sold assets while T is still owned by X, (2) M is an agent for Y, and consequently for tax purposes Y has purchased the stock of T from X, or (3) the transaction is otherwise properly recharacterized (*e.g.,* to treat X as having sold assets or to treat T as having sold assets while T is still owned by X). Alternatively, the Service may examine M's consolidated group to determine whether it may properly offset losses (or credits) against the gain (or tax) from the sale of assets.

The Service may impose penalties on participants in these transactions, or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

Transactions that are the same as or substantially similar to those described in the Notice 2001–16 are identified as "listed transactions" for the purposes of § 1.6011–4T(b)(2) of the Temporary Income Tax Regulations and § 301.6111–2T(b)(2) of the Temporary Procedure and Administration Regulations. See also § 301.6112–1T, A–4. It should be noted that, independent of their classification as "listed transactions" for purposes of §§ 1.6011–4T(b)(2) and 301.6111–2T(b)(2), such transactions may already be subject to the tax shelter registration and list maintenance requirements of §§ 6111 and 6112 under the regulations issued in February 2000 (§§ 301.6111–2T and 301.6112–1T, A–4). Persons required to register these tax shelters who have failed to register the shelters may be subject to the penalty under § 6707(a) and to the penalty under § 6708(a) if the requirements of § 6112 are not satisfied.

For further information regarding this notice, contact Theresa Abell, of the Office of Associate Chief Counsel (Corporate), at (202)622-7700 (not a toll-free call).

Contingent Liability Tax Shelter

Notice 2001–17

The Internal Revenue Service and the Treasury Department have become aware of certain types of transactions, described below, that are being marketed to taxpayers for the purpose of accelerating and, in some cases, duplicating tax deductions. This notice is intended to alert taxpayers and their representatives that the losses generated by such transactions are not properly allowable for federal income tax purposes. This notice also alerts taxpayers and their representatives of certain responsibilities that may arise from participation in such transactions.

FACTS

These transactions take several forms but, in all cases, involve the transfer of a high basis asset (*i.e.*, an asset with a basis that approximates its fair market value) to a corporation purportedly in exchange for stock of the transferee corporation, and the transferee corporation's assumption of a liability (such as a liability for deferred compensation or other deferred employee benefits or an obligation for environmental remediation) that the transferor has not yet taken into account for federal income tax purposes. The transferor typically remains liable on the underlying obligation. The basis and fair market value of the transferred asset, which may be a security of another member of the same affiliated group of corporations, are generally only marginally greater than the present value of the assumed liability. Therefore, the value of the stock of the transferee received by the transferor is minimal relative to the basis and fair market value of the asset transferred to the transferee corporation.

The transaction is purported to qualify as an exchange under § 351 of the Internal Revenue Code, with the intent that the basis of the stock that the transferor receives from the transferee corporation will be equal to the basis of the transferred asset, unreduced by the liability assumed by the transferee corporation. Under § 358(a), a transferor's basis in stock received in a § 351 exchange is equal to the transferor's basis in property exchanged for such stock, subject to certain adjustments, including a reduction for any money or other property received by the transferor. Under § 358(d)(1), liabilities assumed by the transferee corporation are treated as money received by the transferor. Under certain circumstances, however, liabilities assumed by a transferee corporation in a § 351 exchange are not treated as money received by the transferor and thus do not reduce the basis of the stock received in the exchange. *See* § 358(d)(2); § 357(c)(3).

The transferor typically sells the stock of the transferee corporation for its fair market value within a relatively short period of time after the purported § 351 exchange and claims a tax loss in an amount approximating the present value of the liability assumed by the transferee corporation. In the case of a transaction involving members of an affiliated group that has elected to file a consolidated return, the transaction is structured with the intention of avoiding the loss disallowance rule of § 1.1502–20 of the Income Tax Regulations. In addition to the transferor's purported loss on the sale of the stock of the transferee corporation, the transferee corporation may claim a § 162 deduction with respect to payments on the liability.

Taxpayers assert several business purposes for these transactions. However, the Service and the Treasury are not aware of any case in which a taxpayer has shown a legitimate non-tax business reason to carry out the combination of steps described above. Moreover, the Service and the Treasury believe that any business purposes taxpayers may assert for certain aspects of these transactions are far outweighed by the purpose to generate deductible losses for federal income tax purposes.

ANALYSIS

Depending on the facts of the particular case, the Service intends to disallow losses claimed by the transferor with respect to these transactions. For transfers after October 18, 1999, the Service will assert that such losses are disallowed because the transferor's basis in the stock received is reduced under § 358(h) (reducing stock basis by the amount of certain liabilities).

For transfers on or before October 18, 1999, as well as for transfers after October 18, 1999, that are not subject to § 358(h), the Service will disallow such losses for one or more reasons, including but not limited to the following: (1) that the purported § 351 exchange lacks sufficient business purpose to qualify as a § 351 exchange; (2) that the transfer of the asset to the transferee corporation is not, in substance, a transfer of property in exchange for stock within the meaning of § 351, but instead is either an agency arrangement for the transferor or simply a payment to the transferee for its assumption of a liability; (3) that the purported § 351 exchange constitutes an acquisition of control of the transferee corporation for the principal purpose of tax avoidance within the meaning of § 269(a) and thus the purported loss should be disallowed under § 269(a); (4) that the principal purpose of the transferee's assumption of the liability was a purpose to avoid federal income tax or was not a *bona fide* business purpose within the meaning of § 357(b)(1), and thus the assumption of the liability should be treated as money received by the transferor that reduces its basis in the transferee stock; (5) that the purported loss on the sale of the stock of the transferee corporation is disallowed or limited by the loss disallowance rules of § 1.1502–20, including the anti-avoidance rule in § 1.1502–20(e) and the duplicated loss rule in § 1.1502–20(c); (6) that the purported loss on the sale of the stock of the transferee corporation is not a *bona fide* loss actually sustained by the transferor, as required by § 1.165–1(b); and (7) that the overall transaction lacks sufficient economic substance to be respected for federal income tax purposes, *see ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999).

In addition, any deduction claimed by a transferee corporation for payments on a liability assumed in a transaction similar to that described above may, depending on the facts of the particular case, be subject to disallowance on one or more of several possible grounds, including that the payments are not for ordinary and necessary business expenses of the transferee corporation. Rev. Rul. 95–74, 1995–2 C.B. 36, which addressed the treatment of certain environmental liabilities assumed by a transferee of a manufacturing business, does not apply to the deductibility by the transferee of liabilities assumed in a transaction of the type described in this notice because Rev. Rul. 95–74 dealt with liabilities assumed by a transferee corporation in connection with the transfer of substantially all the assets associated with the operation of a manufacturing business to the transferee corporation in a transaction that qualified as a § 351 exchange.

The Service may impose penalties on participants in these transactions, or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

Transactions that are the same as or substantially similar to those described in this Notice 2001–17 (including transactions utilizing partnerships) are identified as "listed transactions" for the purposes of § 1.6011–4T(b)(2) of the Temporary Income Tax Regulations and § 301.6111–2T(b)(2) of the Temporary Procedure and Administration Regulations. *See also* § 301.6112–1T, A–4. It should be noted that, independent of their classification as "listed transactions" for purposes of §§ 1.6011–4T(b)(2) and 301.6111–2T(b)(2), such transactions may already be subject to the tax shelter registration and list maintenance requirements of §§ 6111 and 6112 under the regulations issued in February 2000 (§§ 301.6111–2T and 301.6112–1T, A–4), as well as the regulations issued in 1984 and amended in 1986 (§§ 301.6111–1T and 301.6112–1T, A–3). Persons required to register these tax shelters who have failed to register the shelters may be subject to the penalty under § 6707(a) and to the penalty under § 6708(a) if the requirements of § 6112 are not satisfied.

The principal author of this notice is Theresa Abell, of the Office of Associate Chief Counsel (Corporate). For further information regarding this notice, contact Ms. Abell at (202) 622-7700 (not a toll-free call).

Lease Exception to the Tax Shelter Regulations

Notice 2001–18

This notice provides an exception from the registration requirements under § 6111(d) of the Internal Revenue Code and the list maintenance requirements under § 6112 for certain leasing transactions, except as may be provided in subsequent guidance.

BACKGROUND

Section 301.6111–2T of the temporary Procedure and Administration Regulations provides rules regarding the registration of confidential corporate tax shelters under § 6111(d). A confidential corporate tax shelter is any entity, plan, arrangement, or transaction that satisfies the fol-

Part III - Administrative, Procedural, and Miscellaneous

Tax Avoidance Using Inflated Basis

Notice 2002-21

The Internal Revenue Service and the Treasury Department have become aware of a type of transaction, described below, that is used by taxpayers to generate tax losses. This Notice alerts taxpayers and their representatives that the tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. This Notice also alerts taxpayers, their representatives, and promoters of these transactions of certain responsibilities that may arise from participating in these transactions.

FACTS

In general, the transaction involves the use of a loan assumption agreement to claim an inflated basis in assets acquired from another party. This inflated basis is claimed as a result of a transfer of assets in which a U.S. taxpayer (Taxpayer) becomes jointly and severally liable on indebtedness of the transferor of the assets (Transferor), with the indebtedness having a stated principal amount substantially in excess of the fair market value of the assets transferred. Transferor may not be subject to U.S. tax or otherwise may be indifferent to the federal income tax consequences of the transaction.

In one variation of the transaction, Transferor borrows money from a lender (Lender) on a long term basis such as 30 years (the "Loan"). The amount borrowed may be in a foreign currency. Interest is payable at regular intervals, and principal is due at maturity. The Loan may permit prepayment. The Loan is made with full recourse to Transferor.

Transferor uses the proceeds to purchase assets (the "Assets"), such as short-term deposits, government bonds, or high-grade corporate debt, which may be denominated in a foreign currency. The Assets serve as collateral for the Loan pursuant to a loan agreement. As each interest payment becomes due, the collateral is used to satisfy such payments. Upon maturity or earlier payment, the Loan is satisfied, by its terms, first from the collateral, and only then against Transferor (or Transferor and any party that has assumed the liability as a joint and several obligor) to satisfy any shortfall.

Pursuant to a separate agreement between Transferor and Taxpayer, Transferor transfers a portion of the Assets to Taxpayer in consideration for Taxpayer's agreement to pay a portion of the Loan and become jointly and severally liable to Lender as a co-obligor on the Loan. The fair market value of the Assets transferred to Taxpayer (the "Conveyed Assets") equals the present value of the Loan's principal payment at maturity, determined by using a market rate of interest. Thus, the fair market value of the Conveyed Assets is substantially less than the Loan's stated principal amount. Taxpayer provides substitute collateral for the Loan, equal in value to the Conveyed Assets. The remainder of the Assets owned by Transferor continue to serve as collateral for the Loan.

Also pursuant to the agreement between Transferor and Taxpayer, Transferor agrees to make all interest payments on the Loan, and Taxpayer agrees to pay the principal due at maturity. The co-obligors and Lender anticipate that the collateral will be substantially (if not entirely) sufficient to repay the Loan.

Taxpayer subsequently disposes of the Conveyed Assets for their fair market value. Taxpayer claims that, as a result of its assumption of joint and several liability on the Loan, the entire principal amount of the Loan is included in Taxpayer's basis in the Conveyed Assets. As a result, Taxpayer claims a loss for federal income tax purposes in an amount equal to the excess of the stated principal amount of the Loan over the fair market value of the Conveyed Assets. If the Conveyed Assets are nonfunctional currency, Taxpayer claims an ordinary loss.

ANALYSIS

Section 1012 of the Internal Revenue Code provides that the basis of property is equal to the cost of the property. Section 1.1012-1(a) of the Income Tax Regulations defines "cost" to mean the "amount paid" for the property in cash or other property. Under general tax law principles, the amount paid for property generally includes the amount of the seller's liabilities assumed by the buyer. Commissioner v. Oxford Paper Co., 194 F.2d 190 (2d. Cir. 1952). The inclusion of liabilities in basis by a buyer, however, is predicated on the assumption that the liabilities will be paid in full by the buyer. See Commissioner v.

Tufts, 461 U.S. 300, 308 (1983), 1983-1 C.B. 120, 123.

In appropriate cases, the courts have rejected attempts to assign an inflated basis to property and have limited the basis of property to its fair market value. For example, the basis of property acquired with the issuance or assumption of recourse indebtedness has been limited to the acquired property's fair market value where "a transaction is not conducted at arm's-length by two economically self-interested parties or where a transaction is based upon 'peculiar circumstances' which influence the purchaser to agree to a price in excess of the property's fair market value." Lemmen v. Commissioner, 77 T.C. 1326, 1348 (1981) (citing Bixby v. Commissioner, 58 T.C. 757, 776 (1972)); Webber v. Commissioner, T.C. Memo. 1983-633, aff'd, 790 F.2d 1463 (9th Cir. 1986). See also Majestic Securities Corp. v. Commissioner, 42 B.T.A. 698, 701 (1940), aff'd, 120 F.2d 12 (8th Cir. 1941) ("The general rule that the price paid is the basis for determining gain or loss on future disposition presupposes a normal business transaction.")

Other cases have limited the portion of an assumed indebtedness that may be taken into account for federal income tax purposes. For example, where two or more persons are liable on the same indebtedness, or hold separate properties subject to the same indebtedness, the amount taken into account for federal income tax purposes by each person generally is based on all the facts and circumstances, including the economic realities of the situation and the parties' expectations as to how the liabilities will be paid. See Maher v. United States, No. 16253-1 (W.D. Mo. 1969) (property was not in substance "subject to" liability where lender was not actually relying on property as collateral); Maher v. Commissioner, 469 F.2d 225 (8th Cir. 1972) (corporation's assumption of primary liability on shareholder's indebtedness becomes taxable dividend only as corporation makes payments as promised); Snowa v. Commissioner, T.C. Memo 1995-336, rev'd on other grounds, 123 F.3d 190 (4th Cir. 1997) (co-obligor's cost of a new residence included only her ratable share of the liability due to state law's right of contribution).

Under the facts and circumstances of the transaction described in this Notice, as a matter of economic reality, the parties will bear responsibility for repayment of the Loan in accordance with their relative ownership of the Assets immediately after the transfer from Transferor to Taxpayer. Accordingly, the Service and the Treasury believe that Taxpayer's basis in the Conveyed Assets is equal to the fair market value of such assets upon their acquisition by Taxpayer. The losses purportedly resulting from the transaction described in this Notice (or substantially similar to the transaction described in this Notice) are not allowable to the extent Taxpayer derives a tax benefit that is attributable to a basis in excess of the fair market value of the Conveyed Assets. The purported tax benefits from these transactions also may be subject to challenge under other provisions of the Code and regulations, including but not limited to § 988 and, in the case of individuals, §§ 165(c)(2) and 465.

In addition, the Service may impose penalties on participants in these transactions or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

Transactions that are the same as, or substantially similar to, the transaction described in this Notice 2002-xx are identified as "listed transactions" for the purposes of §§ 1.6011-4T(b)(2) of the Temporary Income Tax Regulations and 301.6111-2T(b)(2) of the Temporary Procedure and Administrative Regulations. See also § 301.6112-1T, A-4. It should be noted that, independent of their classification as "listed transactions" for purposes of §§ 1.6011-4T(b)(2) and 301.6111-2T(b)(2), such transactions may already be subject to the tax shelter registration and list maintenance requirements of §§ 6111 and 6112 under the regulations issued in February 2000 (§§ 301.6111-2T and 301.6112-1T, A-4), as well as the regulations issued in 1984 and amended in 1986 (§§ 301.6111-1T and 301.6112-1T, A-3). Persons required to register these tax shelters who have failed to register the shelters may be subject to the penalty under § 6707(a), and to the penalty under § 6708(a) if the requirements of § 6112 are not satisfied.

The Service and the Treasury recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this Notice. These taxpayers are advised to take prompt action to file amended returns.

The principal author of this Notice is Christina A. Morrison of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this Notice, contact Ms. Morrison on (202) 622-3950 (not a toll-free call).

Notice 2002-35

Tax Avoidance Using Notional Principal Contracts

2002 IRB LEXIS 253; 2002-21 I.R.B. 992; Notice 2002-35

May 28, 2002

[*1]

The Internal Revenue Service and the Treasury Department have become aware of a type of transaction, described below, that is used by taxpayers to generate tax losses. This Notice alerts taxpayers and their representatives that the tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. This Notice also alerts taxpayers, their representatives, and promoters of these transactions of certain responsibilities that may arise from participating in these transactions.

FACTS

In general, the transaction involves the use of a notional principal contract ("NPC") to claim current deductions for periodic payments made by a taxpayer ("T") while disregarding the accrual of a right to receive offsetting payments in the future. The NPC has a term of more than one year. Under the NPC, *T* is required to make periodic payments to *CP* at regular intervals of one year or less based on a fixed or floating rate index. In return, *CP* is required to make a single payment at the end of the term of the NPC that consists of a noncontingent component and a contingent component. The noncontingent component, which is relatively large in comparison to **[*2]** the contingent component, may be based upon a fixed or floating interest rate. The contingent component may reflect changes in the value of a stock index or currency.

T may fund its obligation to make periodic payments in whole or in part by borrowing funds from a lender, who may be *CP*. In addition, *T* may engage in other transactions, such as interest rate collars, for purposes of limiting risk with respect to the NPC transaction. *T* may engage in short-term trading activity in securities with a view to establishing a trade or business. *T* may also engage in the transaction through a partnership, in which case instead of *T*, the partnership may engage in some or all of the activities described above. *T* will likely enter into an agreement with *CP* to terminate the NPC prior to the scheduled payment date of *CP*'s payment.

T deducts the ratable daily portion of each periodic payment for the taxable year to which that portion relates. However, *T* does not accrue income with respect to the nonperiodic payment until the year the payment is received. *T* intends to report as capital any gain it realizes upon the termination of the NPC.

ANALYSIS

The **[*3]** requirement of § 1.446-3(f)(2)(i) that a nonperiodic payment must be recognized over the term of a NPC in a manner that reflects the economic substance of the contract must be applied separately to the noncontingent component of the contract, whether that component is based on a fixed or a floating interest rate.

For a discussion of the proper treatment of the periodic and nonperiodic payments made pursuant to the interest rate swap if the noncontingent component is based on a fixed interest rate, *see Rev. Rul. 2002-30 (2002-21 I.R.B. 971).* May 28, 2002 (holding that the nonperiodic payment must be accrued ratably over the term of the NPC). In addition, depending on the facts of the particular case, the Service may challenge the purported tax results of these transactions on other grounds, including by: (i) recharacterizing one or more of the transactions under § § 1.446-3(g)(2) or 1.446-3(i); (ii) determining that the swap expense, if any, was not incurred in the course of a trade or business and was therefore subject to the 2-percent floor limitation in *section 67 of the Internal Revenue Code*; (iii) **[*4]** disregarding the combination of the loans and the periodic payments as circular flows of cash; or (iv) applying other variations of the doctrine of substance-over-form.

The Service may impose penalties on participants in these transactions or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under section 6662, the return preparer penalty under section 6694, the promoter penalty under section 6700, and the aiding and abetting penalty under section 6701.

Transactions that are the same as, or substantially similar to, the transaction described in this Notice 2002-35 are identified as "listed transactions" for purposes of *§ 1.6011-4T(b)(2) of the Temporary Income Tax Regulations* and § 301.6111-2T(b)(2) of the Temporary Procedure and Administrative Regulations. *See also* § 301.6112-1T, A-4. It should be noted that, independent of their classification as "listed transactions" for purposes of § § 1.6011-4T(b)(2) and 301.6111-2T(b)(2), such transactions may already be subject to the tax shelter registration and list maintenance requirements of § § 6111 and 6112 **[*5]** under the regulations issued in February 2000 (§ § 301.6111-2T and 301.6112-1T, A-4), as well as the regulations issued in 1984 and amended in 1986 (§ § 301.6111-1T and 301.6112-1T, A-3). Persons required to register these tax shelters who have failed to register the shelters may be subject to the penalty under section 6707(a), and to the penalty under section 6708(a) if the requirements of section 6112 are not satisfied.

The Service and the Treasury recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this Notice. These taxpayers are advised to take prompt action to file amended returns.

The principal author of this Notice is Elizabeth Handler of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this Notice, contact Ms. Handler at (202) 622-3930 (not a toll-free call).

Internal Revenue Bulletin

Code Section: Section 1362 -- S Corporation Elections; Section 1366 -- S Corp. Passthrough; Section 1367 -- Basis Adjustments; Section 1377 -- S Corporation Special Rules; Section 165 -- Losses; Section 269 -- Acquisitions to Avoid Tax; Section 6111 -- Tax Shelter Registration; Section 6707 -- Tax Shelter Info. Penalty
Author:
Institutional Author: Internal Revenue Service
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PASSTHROUGH ENTITY STRADDLE TAX SHELTER

Part III -- Administrative, Procedural, and Miscellaneous

[1] The Internal Revenue Service and the Treasury Department have become aware of a type of transaction, described below, that is being used by taxpayers for the purpose of generating deductions. This notice alerts taxpayers and their representatives that the tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. This notice also alerts taxpayers, their representatives, and promoters of these transactions of certain responsibilities that may arise from participating in these transactions.

FACTS

[2] This transaction involves a series of preplanned steps. First, Taxpayer and one or more other shareholders form a corporation that elects to be treated as an S corporation under § 1362(a) of the Internal Revenue Code. Taxpayer initially has a minority stock interest in the S corporation.

[3] The S corporation enters into straddles on foreign currencies and may acquire other assets. The S corporation terminates the gain leg of a foreign currency straddle, and allocates the gain to the shareholders pro rata according to their stock ownership. The gain increases each shareholder's basis in the stock of the S corporation under § 1367(a)(1). The S corporation redeems the stock of all of the shareholders other than Taxpayer, and the other shareholders claim a loss as a result of the redemption. The S corporation files an election under § 1377(a)(2) to treat the S corporation's taxable year as though it consists of two separate taxable years, with the first year ending on the date of the redemption.

[4] After the redemption, the S corporation terminates the loss leg of the foreign currency straddle. In order to maximize the allowable loss, Taxpayer also may engage in a transaction that is intended to increase Taxpayer's basis in the S corporation. For example, Taxpayer may make a loan to the S corporation.

[5] The entire loss from the loss leg of the straddle passes through to Taxpayer, the sole remaining shareholder in the S corporation, under § 1366. The loss reduces Taxpayer's basis in the stock (and indebtedness, if any) of the S corporation under § 1367(a)(2). Due to the reduction in Taxpayer's basis in the S corporation's stock (and indebtedness, if any), Taxpayer will recognize gain when the corporation makes additional payments to Taxpayer or Taxpayer disposes of Taxpayer's interest in the S corporation.

[6] Similar transactions may be structured using a partnership in the place of the S corporation.

ANALYSIS

[7] The transaction described in this notice has been designed to use a straddle, one or more transitory shareholders, and the rules of subchapter S to allow Taxpayer to claim an immediate loss while deferring an offsetting gain in Taxpayer's investment in the S corporation. The Service intends to challenge the purported tax benefits from this transaction on a number of grounds.

First, the Service may disallow Taxpayer's loss under § 165(c)(2) by asserting that the loss was not incurred in a transaction undertaken for profit. See Smith v. Commissioner, 78 T.C. 350 (1982) and Fox v. Commissioner, 82 T.C. 1001 (1984)(disallowing losses from straddle transactions).

Second, the Service may disregard the transitory ownership of the shareholders other than Taxpayer. See Comtel Corporation v. Commissioner, 376 F.2d 791 (2d Cir. 1967) (transitory shareholders' interests not respected). Under this argument, the Service would allocate all of the income and losses from the activities of the S corporation to Taxpayer.

Third, the Service may disallow Taxpayer's loss deduction under § 269 by asserting that Taxpayer acquired control of the S corporation with the principal purpose of avoiding or evading federal income tax. In addition, the Service may challenge the allowance of the loss deduction based on other statutory provisions, including § 988, and judicial doctrines, including the step transaction doctrine and the doctrines of economic substance, business purpose, and substance over form. Transactions that use a partnership instead of an S corporation also will be challenged under the partnership anti-abuse rule contained in § 1.701-2 of the Income Tax Regulations. See § 1.701-2(d) (Ex. 8).

[8] Transactions that are the same as, or substantially similar to, the transaction described in this notice are identified as "listed transactions" for purposes of § 1.6011-4T(b)(2) of the temporary Income Tax Regulations and § 301.6111-2T(b)(2) of the temporary Procedure and Administration Regulations. See also § 301.6112-1T, A-4.

The transaction described in this notice and the transaction described in Notice 2002-50, 2002-28 I.R.B. 98, (Partnership Straddle Tax Shelter) are substantially similar transactions. For purposes of § 1.6011-4T(b)(2) and § 301.6111-2T(b)(2), a transaction will be considered the same as, or substantially similar to, the transaction described in this notice even if the gain and loss legs of the straddle are triggered in separate taxable years, or if, at the time relevant for making such determination, the corporation in the transaction has not elected under § 1377(a)(2) to treat the S corporation's taxable year as though it consisted of two separate taxable years.

Further, it should be noted that, independent of their classification as "listed transactions" for purposes of §§ 1.6011-4T(b)(2) and 301.6111-2T(b)(2), transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the disclosure requirements of § 6011, the tax shelter registration requirements of § 6111 or the list maintenance requirements of § 6112 (§§ 1.6011-4T, 301.6111-1T, 301.6111-2T and 301.6112-1T, A-3 and A-4).

[9] Persons who are required to satisfy the registration requirement of § 6111 with respect to the transaction described in this notice and who fail to do so may be subject to the penalty under § 6707(a). Persons who are required to satisfy the list- keeping requirement of § 6112 with respect to the transaction and who fail to do so may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in this transaction or substantially similar transactions, or, as applicable, on persons who participate in the promotion or reporting of this transaction or substantially similar transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

[10] The principal author of this notice is Demetri Yatrakis of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice contact Mr. Yatrakis at (202) 622-3060 (not a toll-free call).

Internal Revenue Service
United States Department of the Treasury

Internal Revenue Bulletin: 2003-33

August 18, 2003

Notice 2003-54

Common Trust Fund Straddle Tax Shelter

The Internal Revenue Service and the Treasury Department have become aware of a type of transaction, described below, that is being used by taxpayers for the purpose of generating deductions. This notice alerts taxpayers and their representatives that the claimed tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. This notice also alerts parties involved with these transactions of certain responsibilities that may arise from their involvement with these transactions.

FACTS

The transaction involves the use of a common trust fund (CTF) that invests in economically offsetting gain and loss positions in foreign currencies and allocates the gains to one or more tax indifferent parties and the losses to another taxpayer. For example, in the transaction, a bank (Bank) forms a CTF. The CTF's plan provides for monthly valuation dates and for the computation of income and loss on a monthly basis. Two tax indifferent investors, through grantor trusts (Investors' Trusts), each invest money in the CTF. The CTF then invests the money in economically offsetting positions in foreign currencies, which become offsetting gain and loss positions as a result of market price movements. The CTF sells the gain position and allocates the gain proportionately to the Investors' Trusts.

The next month, an investor (Taxpayer) who desires a tax loss uses a grantor trust (Taxpayer's Trust) to invest in the CTF. Taxpayer's Trust makes a large investment for an 80 percent share of the CTF. Consequently, the shares of the CTF's portfolio owned by the Investors' Trusts are diminished to 10 percent each. The CTF then sells the loss position. For tax purposes, the loss is allocated proportionately among Taxpayer's Trust and Investors' Trusts. Taxpayer's Trust is allocated 80 percent of the tax loss and Investors' Trusts are each allocated 10 percent of the tax loss under the accounting rules provided in § 1.584-2(c)(2) of the Income Tax Regulations.

ANALYSIS

The transaction described in this notice has been designed to use economically offsetting positions, one or more tax indifferent parties, and the CTF accounting rules of § 584 of the Internal Revenue Code to allow Taxpayer to claim a noneconomic loss. The Service intends to challenge the purported tax benefits from this transaction on a number of grounds.

The offsetting positions entered into by the CTF did not have any effect on the CTF's net economic position or non-tax objectives and did not serve any non-tax objectives of the CTF or afford it a reasonable prospect for profit. Therefore, the losses purportedly resulting from this transaction are not allowable. *See ACM Partnership v. Commissioner*, 157 F.3d 231, 260 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999). In addition, the Service may disallow the loss of an individual under § 165(c)(2) by asserting that the loss was not incurred in a transaction undertaken for profit. *See Smith v. Commissioner*, 78 T.C. 350 (1982) and *Fox v. Commissioner*, 82 T.C. 1001 (1984) (disallowing losses from straddle transactions). Further, the Service may, under appropriate circumstances, assert that the CTF does not meet the requirements of § 584, including the requirement that it be operated in conformity with the rules and regulations of the Comptroller of the Currency, as set forth in 12 CFR § 9.18 (2003). In that event, the Service will recharacterize such a

CTF as a partnership and reallocate the gains and losses in accordance with the economics of the transaction and the interests of the participants. *See* § 704(b). In addition, the Service may challenge the allowance of the loss deduction based on other statutory provisions, including § 988, and judicial doctrines.

Transactions that are the same as, or substantially similar to, the transaction described in this notice are identified as "listed transactions" for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations. The transaction described in this notice and the transactions described in Notice 2002-50, 2002-28 I.R.B. 98 (Partnership Straddle Tax Shelter), and Notice 2002-65, 2002-41 I.R.B. 690 (Passthrough Entity Straddle Tax Shelter), are substantially similar transactions. For purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2), a transaction will be considered the same as, or substantially similar to, the transaction described in this notice even if the gain and loss legs of the economically offsetting positions are triggered in separate taxable years, or a trust other than a grantor trust is used. Further, it should be noted that, independent of their classification as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2), transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the disclosure requirements of § 6011, the tax shelter registration requirements of § 6111, or the list maintenance requirements of § 6112 (§§ 1.6011-4, 301.6111-1T, 301.6111-2 and 301.6112-1).

Persons who are required to satisfy the registration requirement of § 6111 with respect to the transaction described in this notice or substantially similar transactions and who fail to do so may be subject to the penalty under § 6707(a). Persons who are required to satisfy the list-keeping requirement of § 6112 with respect to the transaction or substantially similar transactions and who fail to do so may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in this transaction or substantially similar transactions or, as applicable, on persons who participate in the reporting of this transaction or substantially similar transactions, including the accuracy-related penalty under § 6662 and the return preparer penalty under § 6694.

The principal author of this notice is Tara P. Volungis of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Ms. Volungis at (202) 622-3080 (not a toll-free call).

Internal Revenue Bulletin: 2003-34

August 25, 2003

Notice 2003-55

Accounting for Lease Strips and Other Stripping Transactions

Notice 95-53, 1995-2 C.B. 334, addresses certain tax consequences of lease strips or stripping transactions. Lease strips are transactions in which one participant claims to realize rental or other income from property and another participant claims the deductions related to that income (for example, depreciation or rental expenses). Lease strips may take a variety of forms, including, but not limited to, those in the following examples.

(a) *A lease strip effected through a transferred basis transaction*. In exchange for consideration, one participant sells, assigns, or otherwise transfers ("assigns") the right to receive future payments under a lease of tangible property, and treats the amount realized from the assignment as its current income. The participant later transfers the property (subject to the lease) in a transaction intended to qualify as a transferred basis transaction, such as a transaction described in § 351 of the Internal Revenue Code. The transferee often is not identified until after the transferor has assigned the future payments. Typically, the transferor (or a partner in a partnership that is a transferor) is generally not subject to U.S. federal income tax or has available net operating losses, and the equity of the transferee is owned predominantly by persons other than the transferor.

(b) *A lease strip effected through a transfer of an interest in a partnership (or other pass-through entity)*. In exchange for consideration, the partnership assigns its right to receive future payments under a lease of tangible property and allocates the amount realized from the assignment to its current partners (many of whom are generally not subject to federal income tax or have available net operating losses). The partnership retains the underlying property, and thereafter, there is a transfer or redemption of a partnership interest by one or more partners to whom the partnership allocated the income that it reported from the assignment. The transfer or redemption is structured to avoid a reduction in the basis of partnership property.

(c) *A lease strip effected by a single participant*. A participant assigns its right to receive future payments under a lease of tangible property at a time when that participant is not subject to U.S. federal income tax or in a manner in which the realized amount is not includible in computing the participant's U.S. federal income tax and that same participant or a successor claims deductions related to that income for purposes of U.S. federal income tax.

In addition to transactions described above, this notice applies to lease strips involving licenses of intangible property, service contracts, leaseholds or other non-fee interests in property, and the prepayment, front-loading, or retention (rather than assignment) of rights to receive future payments.

DISCUSSION

The Internal Revenue Service has concluded that lease strips improperly separate income from related deductions and generally do not produce the tax consequences desired by the participants. Depending on the facts of a particular case, the Service may apply one or more Code sections or theories to challenge a lease strip. For example, the Service may apply §§ 165, 269, 382, 446(b), 701, or 704. The Service also may challenge certain assignments or accelerations of future payments as financings. Finally, the Service, as appropriate, may assert that there is no valid partnership or may apply various judicial doctrines, such as the doctrines of assignment-of-income, business purpose, substance-over-form, step transaction, or sham.

Recently, the Court of Appeals for the District of Columbia Circuit held that the partnership used in a lease strip was not a valid partnership because the participants did not join together for a non-tax business purpose. *Andantech L.L.C. v. Commissioner*, Nos. 02-1213; 02-1215, (D.C. Cir. June 17, 2003), 2003 U.S. App. LEXIS 11908, *aff'g in part and remanding for reconsideration of other issues* T.C. Memo 2002-97 (2002). Also, in *Nicole Rose v. Commissioner*, 320 F.3d 282 (2d Cir. 2002), *aff'g per curiam* 117 T.C. 328 (2001), the United States Court of Appeals for the Second Circuit upheld the Tax Court's determination that a lease transfer did not have economic substance.

Transactions that are the same as, or substantially similar to, the lease strips described in this notice are identified as "listed transactions" for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations. Independent of their classification as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2), transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the disclosure requirements of § 6011, the tax shelter registration requirements of § 6111, or the list maintenance requirements of § 6112 (§§ 1.6011-4, 301.6111-1T, 301.6111-2, and 301.6112-1). Persons required to register these tax shelters who have failed to register the shelters may be subject to the penalty under § 6707(a). Persons required to maintain a list of investors under § 6112 may be subject to the penalty under § 6708(a) if the requirements of § 6112 are not satisfied.

Finally, the Service may impose penalties on participants in lease strip transactions or, as applicable, on persons who participate in the promotion or reporting of lease strips, including the accuracy-related penalty under § 6662 and the return preparer penalty under § 6694.

In addition, the Service is currently evaluating other situations in which tax benefits are claimed as a result of transactions in which the ownership of property has been separated from the right to income from the property. For example, the Service is evaluating situations in which, in exchange for consideration, one participant assigns its interest in property but retains the right to income from the property, and, by allocating all of its basis to the transferred property and none to the retained future payments, the transferor claims a loss on the transfer.

This Notice 2003-55 modifies and supersedes Notice 95-53.

Internal Revenue Bulletin: 2003-51

December 22, 2003

Notice 2003-81

Tax Avoidance Using Offsetting Foreign Currency Option Contracts

The Internal Revenue Service and the Treasury Department are aware of a type of transaction, described below, in which a taxpayer claims a loss upon the assignment of a section 1256 contract to a charity but fails to report the recognition of gain when the taxpayer's obligation under an offsetting non-section 1256 contract terminates. This notice alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies these transactions, and those that are substantially similar to these transactions, as listed transactions for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations. This notice also alerts parties involved with these transactions of certain responsibilities that may arise from their involvement with these transactions.

FACTS

A taxpayer pays premiums to purchase a call option and a put option (the purchased options) on a foreign currency. The currency is one in which positions are traded through regulated futures contracts, and the purchased options, therefore, are foreign currency contracts within the meaning of section 1256(g)(2)(A) of the Internal Revenue Code and section 1256 contracts within the meaning of section 1256(b). The purchased options are reasonably expected to move inversely in value to one another over a relevant range, thus ensuring that, as the value of the underlying foreign currency changes, the taxpayer will hold a loss position in one of the two section 1256 contracts. The taxpayer also receives premiums for writing a call option and a put option (the written options) on a different foreign currency in which positions are not traded through regulated futures contracts. Thus, the written options are not foreign currency contracts within the meaning of section 1256(g)(2)(A), nor are they section 1256 contracts within the meaning of section 1256(b). The written options are reasonably expected to move inversely in value to one another over a relevant range, thus ensuring that, as the value of the underlying foreign currency changes, the taxpayer will hold a gain position in one of the two non-section 1256 contracts.

The values of the two currencies underlying the purchased and written options (i) historically have demonstrated a very high positive correlation with one another, or (ii) officially have been linked to one another, such as through the European Exchange Rate Mechanism (ERM II). Thus, as the currencies change in value, the taxpayer reasonably expects to have the following potential gains and losses in substantially offsetting positions: (1) a loss in a purchased option and a gain in a written option; and (2) a gain in a purchased option and a loss in a written option. At any time, the taxpayer's loss in the purchased option position that has declined in value may be more or less than the taxpayer's gain in the offsetting written option position that has appreciated in value. Similarly, the taxpayer's gain in the remaining purchased option position may be more or less than the taxpayer's loss in the remaining written option position. A material pre-tax profit or rate of return, or both, on the transaction is possible but unlikely.

The taxpayer assigns to a charity the purchased option that has a loss. The charity also assumes the taxpayer's obligation under the offsetting written option that has a gain. As with all written options, the amount of gain on the option is limited to the premium received for the option. In the same tax year, the taxpayer may dispose of the remaining purchased option and offsetting written option.

Because the purchased option assigned to the charity is a section 1256 contract, the taxpayer relies on section 1256(c) and *Greene v. United States*, 79 F.3d 1348 (2d Cir. 1996), to mark to market the purchased option when the option is assigned to the charity and to recognize a loss at that time. In contrast, because the assumed written option is not a section 1256 contract, the taxpayer claims not to recognize gain attributable to the option premium. Specifically, the taxpayer claims that the charity's assumption of the option obligation does not cause the taxpayer to recognize gain and that the taxpayer also does not recognize gain either at the time the option expires or terminates or at any other time.

ANALYSIS

Rev. Rul. 58-234, 1958-1 C.B. 279, *clarified by* Rev. Rul. 68-151, 1968-1 C.B. 363, holds that an option writer does not recognize income or gain with respect to a premium received for writing an option until the option is terminated, without exercise, or otherwise. *Accord* Rev. Rul. 78-182, 1978-1 C.B. 265; *Koch v. Commissioner*, 67 T.C. 71 (1976), *acq.* 1980-2 C.B. 1. Rev. Rul. 58-234 explains that this is the treatment for the option writer because the option writer assumes a burdensome and continuing obligation, and the transaction therefore stays open without any ascertainable income or gain until the writer's obligation is finally terminated. When the option writer's obligation terminates, the transaction closes, and the option writer must recognize any income or gain attributable to the prior receipt of the option premium.

In some cases, the option writer's obligation under the option contract may terminate on the charity's assumption of the written option obligation. In other cases, the writer will have a continuing obligation because the writer may be called upon to perform if the charity fails to perform or to reimburse the charity for any losses or expenses it may incur if called upon to perform. If an assumption terminates the option writer's obligation under the option contract, the option writer must recognize gain when the option obligation is assumed. If the assumption does not terminate the option writer's obligation under the option contract, the option writer must recognize the premium when the option writer's obligation under the option contract terminates (other than through an exercise of the option against, and performance by, the option writer).

These general principles remain applicable even if the assumption of the option writer's obligation is part of what the taxpayer claims is a donative transaction. *Cf. Diedrich v. Commissioner*, 457 U.S. 191 (1982) (noting that if a donee pays a gift tax obligation arising from a donative transfer, the donative nature of the transaction does not preclude income recognition by the donor on the obligation assumed). Here, the taxpayer has made a transfer to the charity of the purchased option, and the charity has assumed the burden of the written option. No aspect of the taxpayer's transfer or the charity's assumption (or their combination) relieves the taxpayer from its duty under the Code to account for the gain attributable to the premium originally received by the taxpayer for assuming the burden of writing the option. *See Lucas v. Earl*, 281 U.S. 111 (1930) (holding that a taxpayer may not avoid inclusion of future earned income by making a gratuitous transfer of the right to receive the income).

Finally, if the taxpayer has any unrecognized gain on the written option at the end of the year in which the assumption occurs (*e.g.*, the assumption did not terminate the option writer's obligation under the option contract), the mark-to-market loss on the offsetting contributed section 1256 contract will be deferred under section 1092.

Transactions that are the same as, or substantially similar to, the transactions described in this notice are identified as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2) effective December 4, 2003, the date this notice was released to the public. Variations on these transactions may include positions in other section 1256 and non-section 1256 contracts. Independent of their classification as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2), transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the disclosure requirements of section 6011 (§ 1.6011-4), the tax shelter registration requirements of section 6111 (§§ 301.6111-1T, 301.6111-2), or the list maintenance requirements of section 6112 (§ 301.6112-1). Persons who are required to register these tax shelters under section 6111 but have failed to do so may be subject to the penalty under section 6707(a). Persons who are required to maintain lists of investors under section 6112 but have failed to do so (or who fail to provide those lists when requested by the Service) may be subject to the penalty under section 6708(a). In addition, the Service may impose penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under § 6662.

The Service and the Treasury recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this notice. These taxpayers should consult with a tax advisor to ensure that their transactions are disclosed properly and to take appropriate corrective action.

The principal author of this notice is Clay Littlefield of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice, contact Mr. Littlefield at (202) 622-3920 (not a toll-free call).

Internal Revenue Bulletin: 2005-9

February 28, 2005

Notice 2005-13

Tax-Exempt Leasing Involving Defeasance

The Internal Revenue Service and the Treasury Department are aware of types of transactions, described below, in which a taxpayer enters into a purported sale-leaseback arrangement with a tax-indifferent person in which substantially all of the tax-indifferent person's payment obligations are economically defeased and the taxpayer's risk of loss from a decline, and opportunity for profit from an increase, in the value of the leased property are limited. This notice alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies these transactions, and substantially similar transactions, as listed transactions for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 6111 and 6112 of the Internal Revenue Code. This notice also alerts parties involved with these transactions of certain responsibilities that may arise from their involvement with these transactions.

FACTS

X is a U.S. taxpayer. FP is a tax-indifferent person that owns and uses certain property.[1] BK1, BK2, BK3, and BK4 are banks. None of these parties is related to any other party, unless otherwise indicated.

Situation 1

On the closing date of January 1, 2003 ("Closing Date"), X and FP enter into a purported sale-leaseback transaction under which FP sells the property to X, and X immediately leases the property back to FP under a lease ("Lease"). The purchase and sale agreement and the Lease are nominally separate legal documents. Both agreements, however, are executed pursuant to a comprehensive participation agreement, which provides that the parties' rights and obligations under any of the agreements are not enforceable before the execution of all transaction documents.

The Lease requires FP to make rental payments over the term of the Lease ("Lease Term"). As described below, the Lease also provides that under certain conditions, X has the option ("Service Contract Option") to require FP to identify a party ("Service Recipient") willing to enter into a contract with X to receive services provided using the leased property ("Service Contract") that commences immediately after the expiration of the Lease Term. The Service Recipient must meet certain financial qualifications, including credit rating and net capital requirements, and provide defeasance or other credit support to satisfy certain of its obligations under the Service Contract. If FP cannot locate a qualified third party to enter into the Service Contract, FP or an affiliate of FP must enter into the Service Contract. The aggregate of the Lease Term plus the term of the Service Contract ("Service Contract Term") is less than 80 percent of the assumed remaining useful life of the property.

On the Closing Date, the property has a fair market value of $105x and X makes a single payment of $105x to FP. To fund the $105x payment, X provides $15x in equity and borrows $81x from BK1 and $9x from BK2. Both loans are nonrecourse and provide for payments during the Lease Term. Accrued but unpaid interest is capitalized as additional principal. As of the Closing Date, the documents reflect that the sum of the outstanding principal on the loans at any given time will be less than the projected fair market value of the property at that time. The amount and timing of the debt service payments closely match the amount and timing of the Lease payments due during the Lease Term.

FP intends to utilize only a small portion of the proceeds of the purported sale-leaseback for operational expenses or to finance or refinance the acquisition of new assets. Upon receiving the $105x purchase price payment, FP sets aside substantially all of the $105x to satisfy its lease obligations. FP deposits $81x with BK3 and $9x with BK4. BK3 may be an affiliate of BK1, and BK4 may be an affiliate of BK2. The deposits with BK3 and BK4 earn interest sufficient to fund FP's rent obligations as described below. BK3 pays annual amounts equal to 90 percent of FP's annual rent obligation under the Lease (that is, amounts sufficient to satisfy X's debt service obligation to BK1). Although FP directs BK3 to pay those amounts to BK1, the parties treat these amounts as having been paid from BK3 to FP, then from FP to X as rental payments, and finally from X to BK1 as debt service payments. In addition, FP pledges the deposit with BK3 to X as security for FP's obligations under the Lease, while X, in turn, pledges its interest in FP's pledge to BK1 as security for X's obligations under the loan from BK1. Similarly, BK4 pays annual amounts equal to 10 percent of FP's rent obligation under the Lease (that is, amounts sufficient to satisfy X's debt service obligation to BK2). Although FP directs BK4 to pay these amounts to BK2, the parties treat these amounts as having been paid from BK4 to FP, then from FP to X as rental payments, and finally from X to BK2 as debt service payments. Although FP's deposit with BK4 is not pledged, the parties expect that the amounts deposited with BK4 will remain available to pay the remaining 10 percent of FP's annual rent obligation under the Lease. FP may incur economic costs, such as an early withdrawal penalty, in accessing the BK4 deposit.

FP is not legally released from its rent obligations. X's exposure to the risk that FP will not make the rent payments, however, is substantially limited by the arrangements with BK3 and BK4. In the case of the loan from BK1, X's economic risk is remote due to the deposit arrangement with BK3. In the case of the loan from BK2, X's economic risk is substantially reduced through the deposit arrangement with BK4. X's obligation to make debt service payments on the loans from BK1 and BK2 is completely offset by X's right to receive Lease rentals from FP. As a result, neither bank bears a significant risk of nonpayment.[2]

FP has an option ("Purchase Option") to purchase the property from X on the last day of the Lease Term ("Exercise Date"). Exercise of the Purchase Option allows FP to repurchase the property for a fixed exercise price ("Exercise Price") that, on the Closing Date, exceeds the projected fair market value of the property on the Exercise Date. The Purchase Option price is sufficient to repay X's entire loan balances and X's initial equity investment plus provide X with a predetermined after-tax rate of return on its equity investment.

At the inception of the transaction, X requires FP to invest $9x of the $105x payment in highly rated debt securities ("Equity Collateral"), and to pledge the Equity Collateral to X to satisfy a portion of FP's obligations under the lease.[3] Although the Equity Collateral is pledged to X, it is not among the items of collateral pledged to BK1 or BK2 in support of the nonrecourse loans to X. The Equity Collateral upon maturity, when combined with the balance of the deposits made with BK3 and BK4 and the interest on those deposits, fully funds the amount due if FP exercises the Purchase Option. This arrangement ensures that FP is able to make the payment under the Purchase Option without an independent source of funds. Having economically defeased both its rental obligations under the Lease and its payment obligations under the Purchase Option, FP keeps the remaining $6x, subject to its obligation to pay the Termination Value (described below) upon the happening of certain events specified under the Lease.

If FP does not exercise the Purchase Option, X may elect to (1) take back the property, or (2) exercise the Service Contract Option and compel FP either to (a) identify a qualified Service Recipient, or (b) enter (or compel an affiliate of FP to enter) into the Service Contract as the Service Recipient for the Service Contract Term. If X exercises the Service Contract Option, the Service Recipient must pay X predetermined minimum capacity payments sufficient to provide X with a minimum after-tax rate of return on its equity investment. The Service Recipient also must reimburse X for X's operating and maintenance costs for providing the services.

As a practical matter, the Purchase Option and the Service Contract Option collar X's exposure to changes in the value of the property. If the value of the property is at least equal to the Purchase Option Exercise Price, FP likely will exercise the Purchase Option. Likewise, FP likely will exercise the Purchase Option if FP concludes that the costs of the Service Contract Option exceed the costs of the Purchase Option. Moreover, FP may exercise the Purchase Option even if the fair market value of the property is less than the Purchase Option Exercise Price because the Purchase Option is fully funded, and the excess of the Exercise Price over the projected value may not fully reflect the costs to FP of modifying, interrupting, or relocating its operations. If the Purchase Option is exercised, X will recover its equity investment plus a predetermined after-tax rate of return. Conversely, if the Purchase Option is not exercised, X may compel FP to locate a Service Recipient to enter into the Service Contract in return for payments sufficient to provide X with a minimum after-tax rate of return on its equity investment, regardless of the value of the property.

Throughout the Lease Term, X has several remedies in the event of a default by FP, including a right to (1) take possession of the property or (2) cause FP to pay X specified damages ("Termination Value"). Likewise, throughout the Service Contract Term, X has similar remedies in the event of a default by the Service Recipient. On the Closing Date, the amount of the Termination Value is slightly greater than the purchase price of the property. The Termination Value fluctuates over the Lease Term and Service Contract Term, but at all times is sufficient to repay X's entire loan balances and X's initial equity investment plus a predetermined after-tax rate of return. The BK3 deposit, the BK4 deposit and the Equity Collateral are available to satisfy the Termination Value during the Lease Term. If the sum of the deposits plus the Equity Collateral is less than the Termination Value, X may require FP to maintain a letter of credit. During the Service Contract Term, the Service Recipient will be required to provide defeasance or other credit support that would be available to satisfy the Termination Value. As a result, X in almost all events will recover its investment plus a pre-tax rate of return.

For tax purposes, X claims deductions for interest on the loans and for depreciation on the property. X does not include the optional Service Contract Term in the lease term for purposes of calculating the property's recovery period under §§ 168(g)(3)(A) and 168(i)(3). X includes in gross income the rents received on the Lease. If the Purchase Option is exercised, X also includes the Exercise Price in calculating its gain or loss realized on disposition of the property.

The form of the sale from FP to X may be a head lease for a term in excess of the assumed remaining useful life of the property and an option for X to purchase the property for a nominal amount at the conclusion of the head lease term. In some variations of this transaction, the participation agreement provides that if X refinances the nonrecourse loans, FP has a right to participate in the savings attributable to the reduced financing costs by allowing FP to renegotiate certain terms of the transaction, including the Lease rents and the Purchase Option price.

Situation 2

The facts are the same as in Situation 1 except for the following.

The Lease does not provide a Service Contract Option. In lieu of the Purchase Option described in Situation 1, FP has an option ("Early Termination Option") to purchase the property from X on the date ("ETO Exercise Date") that is 30 months before the end of the Lease Term. Exercise of the Early Termination Option allows FP to terminate the Lease and repurchase the property for a fixed exercise price ("ETO Exercise Price") that on the Closing Date, exceeds the projected fair market value of the property on the ETO Exercise Date. The Early Termination Option price is sufficient to repay X's entire loan balances and X's initial equity investment plus a predetermined after-tax rate of return on its equity investment. The balance of the Equity Collateral combined with the balance of the deposits made with BK3 and BK4 and the interest on those deposits fully fund the amount due under the Early Termination Option.

If FP does not exercise the Early Termination Option, FP is required to obtain residual value insurance for the benefit of X, pay rents for the remaining Lease Term, and return the property to X at the end of the Lease Term ("Return Option"). The residual value insurance must be issued by a third party having a specified minimum credit rating and must provide that if the actual residual value of the property is less than a fixed amount ("Residual Value Insurance Amount") at the end of the Lease Term, the insurer will pay X the shortfall. On the Closing Date, the Residual Value Insurance Amount is less than the projected fair market value of the property at the end of the Lease Term. If FP does not maintain the residual value insurance coverage for the entire Lease Term remaining after the ETO Exercise Date, FP will default and be obligated to pay X the Termination Value. If FP does not exercise the Early Termination Option, the rents for the remaining Lease Term plus the Residual Value Insurance Amount are sufficient to provide X with a minimum after-tax rate of return on the property, regardless of the value of the property. As a practical matter, the Early Termination Option and the Return Option collar X's exposure to changes in the value of the property. At the end of the Lease Term, FP also may have the option to purchase the property for the greater of its fair market value or the Residual Value Insurance Amount.

For tax purposes, X claims deductions for interest on the loans and for depreciation on the property. X treats a portion of the property as qualified technological equipment within the meaning of § 168(i)(2). X depreciates that portion of the property over five years under § 168(g)(3)(C). X treats a portion of the property as software. X depreciates that portion of the property over 36 months under § 167(f)(1)(A).

X includes in gross income the rents received on the Lease. If the Early Termination Option is exercised, X also includes the ETO Exercise Price in calculating its gain or loss realized on disposition of the property.

In some variations of this transaction, if the Early Termination Option is not exercised, the Lease rents payable to X may increase for the portion of the Lease Term remaining after the ETO Exercise Date.

ANALYSIS

The substance of a transaction, not its form, governs its tax treatment. *Gregory v. Helvering*, 293 U.S. 465 (1935). In *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978), the Supreme Court stated that "[i]n applying the doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed." The Court evaluated the substance of the particular transaction in *Frank Lyon* to determine that it should be treated as a sale-leaseback rather than a financing arrangement. The Supreme Court described the transaction in *Frank Lyon* as "a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." *Frank Lyon*, 435 U.S. at 584. The Court subsequently relied on its approach in *Frank Lyon* to recharacterize a sale and repurchase of federal securities as a loan, finding that the economic realities of the transaction did not support the form chosen by the taxpayer. *Nebraska Dep't of Revenue v. Loewenstein*, 513 U.S. 123 (1994).

A sale-leaseback will not be respected unless the owner/lessor acquires and retains "significant and genuine attributes" of a traditional owner, including "the benefits and burdens of ownership." *Coleman v. Commissioner*, 16 F.3d 821, 826 (7th Cir. 1994) (citing *Frank Lyon*, 435 U.S. at 582-84). Considering the totality of the facts and circumstances in the transactions described in Situations 1 and 2, X does not acquire the benefits and burdens of ownership and consequently cannot claim tax benefits as the owner of the property. The transactions described above are, in substance, fundamentally different from the sale-leaseback transaction respected by the Court in *Frank Lyon*.

First, in *Frank Lyon*, the sales proceeds were used to construct the lessee's new headquarters. In contrast, in the transactions described above, substantially all of the $105x sales proceeds are immediately set aside by FP to satisfy its obligations under the Lease and to fund FP's exercise of the Purchase Option or the Early Termination Option. As a condition to engaging in the transactions, FP economically defeases substantially all of its rent payment obligations and the amounts due under the Purchase Option or the Early Termination Option by establishing and pledging the deposit with BK3 and the Equity Collateral. Moreover, even though FP may not pledge the deposit with BK4, FP fully funds its remaining rent obligations with the BK4 deposit and may have limited rights to access the funds held in that deposit. Consequently, the only capital retained by FP is the remaining $6x portion of the sales proceeds that represents FP's fee for engaging in the transaction.

Second, in *Frank Lyon*, the taxpayer bore the risk of the lessee's nonpayment of rent, which could have forced the taxpayer to default on its recourse debt. The Court concluded that the taxpayer exposed its business well-being to a real and substantial risk of nonpayment and that the long-term debt affected its financial position. *Frank Lyon*, 435 U.S. at 577. In contrast, in the transactions described above, economic defeasance renders the risk to X of FP's failure to pay rent remote. Moreover, because of the economic defeasance, X's right to receive the Equity Collateral upon the exercise of the Purchase Option, and FP's obligation with respect to the Termination Value, a failure by FP to satisfy its lease obligations does not leave X at risk for repaying the loan balances or forfeiting its equity investment.

Third, in *Frank Lyon*, the taxpayer's return was dependent on the property's value and the taxpayer's equity investment was at risk if the property declined in value. The economic burden of any decline in the value of the property is integral to the determination of tax ownership. *See*, *e.g.*, *Swift Dodge v. Commissioner*, 692 F.2d 651 (9th Cir. 1982). In the transactions described above, X bears insufficient risk of a decline in the value of the property to be treated as its owner for tax purposes. In Situation 1, regardless of a decline in the value of the property, X can recover its entire investment, repay both loans, and obtain a minimum after-tax rate of return on its equity investment by exercising the Service Contract Option. Similarly, in Situation 2, a decline in the value of the property will not prevent X from recovering its entire investment, repaying both loans and obtaining a minimum after-tax rate of return on its equity investment through the rents for the remaining Lease Term plus the Residual Value Insurance Amount under the Return Option. The failure of FP to satisfy its obligations under the Service Contract Option in Situation 1 or the Return Option in Situation 2 results in default and obligates FP to pay X the Termination Value. In both Situation 1 and Situation 2, the BK3 and BK4 deposits and Equity Collateral are available to fund FP's obligations upon termination of the Lease. Thus, in both situations, X has substantially limited its risk of loss regardless of the value of the property upon termination of the Lease.

Fourth, the combination of FP's Purchase Option and X's Service Contract Option in Situation 1, and FP's Early Termination Option and continued rent and residual value insurance obligations under the Return Option in Situation 2, significantly increase the likelihood that FP will exercise its Purchase Option in Situation 1 and its Early Termination Option in Situation 2 even if the fair market value of the property is less than the Purchase Option Exercise Price or ETO Exercise Price, respectively, because both options are fully funded and the excess of the exercise price over the leased property's fair market value may not fully reflect the costs to FP of modifying, interrupting, or relocating its operations. *See Kwiat v. Commissioner*, T.C. Memo. 1992-433 (ostensible lessor did not possess the benefits and burdens of ownership because reciprocal put and call options limited the risk of economic depreciation and the benefit of possible appreciation); *see also Aderholt Specialty Co. v. Commissioner*, T.C. Memo. 1985-491; Rev. Rul. 72-543, 1972-2 C.B. 87. In contrast, in *Frank Lyon*, the lessee's decision regarding the exercise of its purchase option was not constrained by a lessor's right to exercise a reciprocal option similar to the Service Contract Option or the Return Option described in Situations 1 and 2, respectively. Similarly, X's opportunity to recognize a return through refinancing the BK1 and BK2 loans is also limited in those cases in which FP has a right to participate in any savings attributable to reduced financing costs, such as through renegotiation of the Lease rents and the Purchase Option price. *See Hilton v. Commissioner*, 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982) (arrangement whereby lessor and lessee shared the savings from any refinancing of lessor's nonrecourse debt was a factor supporting holding to disregard form of sale-leaseback transaction).

In the transactions described above, X does not have a meaningful interest in the risks and rewards of the property. Thus, X does not acquire the benefits and burdens of ownership of the property and does not become the owner of the property for U.S. federal income tax purposes. In substance, the transactions described above are merely a transfer of tax benefits to X, coupled with X's investment of the Equity Collateral for a predetermined after-tax rate of return.

Furthermore, in appropriate cases, the Service may challenge the purported tax benefits from these transactions on additional grounds, including (1) that the substance over form doctrine requires recharacterization of the arrangement as a financing arrangement, or (2) that the loans from BK1 and BK2, in substance, do not involve the use or forbearance of money, do not constitute valid indebtedness for tax purposes, and that any interest nominally paid or accrued on the loans is not deductible. *Cf.* Rev. Rul. 2002-69, 2002-2 C.B. 760 (disregarded offsetting obligations in a LILO arrangement gave the taxpayer, at most, a future interest in the property).

The American Jobs Creation Act of 2004, P.L. 108-357, 118 Stat. 1418 (the "Act"), was enacted on October 22, 2004. Section 847 of the Act amended §§ 167 and 168 to provide that service contracts that follow a lease must be included in the lease term and to modify the recovery period for qualified technological equipment and computer software subject to a lease with a tax-exempt entity. Section 848 of the Act added new § 470, which suspends losses for certain leases of property to tax-exempt entities. *See* H.R. Rep. No. 755, 108th Cong., 2d Sess., at 660, 662-663 (2004). These amendments generally are effective for leases entered into after March 12, 2004.[4]

Transactions that are the same as, or substantially similar to, the transactions described in this notice are identified as "listed transactions" for purposes of § 1.6011-4(b)(2) and §§ 6111 and 6112 effective February 11, 2005, the date this notice is released to the public. Independent of their classification as "listed transactions," transactions that are the same as, or substantially similar to, the transactions described in this notice may already be subject to the requirements of § 6011, § 6111, or § 6112, or the regulations thereunder. Persons required to disclose these transactions under § 1.6011-4 who fail to do so may be subject to the penalty under § 6707A.[5] Persons required to disclose or register these transactions under § 6111 who have failed to do so may be subject to the penalty under § 6707(a). Persons required to maintain lists of investors under § 6112 who have failed to do so (or who fail to provide such lists when requested by the Service) may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on parties involved in these transactions or substantially similar transactions, including accuracy-related penalties under § 6662 or § 6662A.

The Service and the Treasury Department recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the types of transactions described in this notice. These taxpayers should consult with a tax advisor to ensure that their transactions are disclosed properly and to take appropriate corrective action.

DRAFTING INFORMATION

For further information regarding this notice, contact John Aramburu at (202) 622-4960 (not a toll-free call).

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[1] In some instances, FP meets the definition of a tax-exempt entity under section 168(h)(2). In other instances, FP does not meet that definition but possesses attributes, such as net operating losses, that render FP tax indifferent.

[2] The arrangement by which FP sets aside the funds necessary to meet its obligations under the Lease may take a variety of forms other than a deposit arrangement involving BK3 and BK4. These arrangements include a loan by FP to X, BK1 or BK2; a letter of credit collateralized with cash or cash equivalents; a payment undertaking agreement; prepaid rent (regardless of whether X finances a portion of the purchase price by borrowing from BK1 or BK2); a sinking fund arrangement; a guaranteed investment contract; or financial guaranty insurance.

[3] The arrangement by which the return of X's equity investment plus a predetermined after-tax return on such investment is provided may take a variety of forms other than an investment by FP in highly rated debt securities. For example, FP may be required to obtain a payment undertaking agreement from an entity having a specified minimum credit rating.

[4] Leases or purported leases of Qualified Transportation Property described in section 849(b) of the Act are not identified as listed transactions subject to the terms of this notice.

[5] Section 6707A applies to returns and statements due after October 22, 2004. See Notice 2005-11, 2005-7 I.R.B. 493.

Internal Revenue Bulletin: 2003-49

December 8, 2003

Notice 2003-77

Transfers to Trusts to Provide for the Satisfaction of Contested Liabilities

The Internal Revenue Service and Treasury Department are aware of certain transactions that use contested liability trusts improperly to attempt to accelerate deductions for contested liabilities under § 461 (f) of the Internal Revenue Code. This notice alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies these transactions, and substantially similar transactions, as listed transactions for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations. This notice also alerts parties involved with these transactions of certain responsibilities that may arise from their involvement with these transactions.

LAW

Section 461(f) provides an exception to the general rules of tax accounting by allowing a taxpayer to deduct a contested liability in a year prior to the resolution of the contest if the following conditions are satisfied: (1) the taxpayer contests an asserted liability; (2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability; (3) the contest with respect to the asserted liability exists after the time of transfer; and (4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year) determined after the application of the economic performance rules. If these requirements are satisfied, a taxpayer may deduct the liability in the taxable year of the transfer.

On November 19, 2003, the Service and Treasury Department filed with the Federal Register proposed (REG-136890-02) and temporary (T.D. 9095) regulations under § 461(f). Section 1.461-2T(c)(1) of these temporary regulations, which replaces and restates § 1.461-2(c)(1), provides that a transfer for the satisfaction of an asserted liability is a transfer of money or property beyond the taxpayer's control to: (1) the person asserting the liability; (2) an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) providing that the money or other property be delivered in accordance with the settlement of the contest; (3) an escrowee or trustee pursuant to an order of a court or government entity providing that the money or other property be delivered in accordance with the settlement of the contest; or (4) a court with jurisdiction over the contest. An account is in the taxpayer's control unless the taxpayer has relinquished all authority over the money or other property transferred.

Section 1.461-2T(c)(1)(iii) provides that the following actions are not transfers to provide for the satisfaction of an asserted liability: (1) the purchase of a bond to guarantee payment of the asserted liability; (2) an entry on the taxpayer's books of account; and (3) a transfer to an account in the taxpayer's control. The temporary regulations clarify that a transfer in taxable years beginning after December 31, 1953, and ending after August 16, 1954, of any indebtedness of a taxpayer or any promise by the taxpayer to provide services or property in the future is not a transfer to provide for the satisfaction of an asserted liability. In addition, the temporary regulations provide the express rule that a transfer (other than to the person asserting the liability) of a taxpayer's stock, or the indebtedness or stock of a person related to the taxpayer (as defined in section 267(b)), is not a transfer to provide for the satisfaction of an asserted liability.

Section 461(h)(2)(C) provides that, if a workers compensation or tort liability requires a payment to another person, then economic performance occurs as payments to the person are made. The Conference Report accompanying enactment of § 461(h) states:

> In the case of workers' compensation or tort liabilities of the taxpayer requiring payments to another person, economic performance occurs as payments are made to that person. Since payment to a section 461(f) trust is not a payment to the claimant and does not discharge the taxpayer's liability to the claimant, such payment does not satisfy the economic performance test.

H. R. Rep. No. 861, 98th Cong., 2d Sess. 871, 876 (1984).

Section 461(h)(2)(D) provides that in the case of other liabilities, economic performance occurs at the time determined under regulations prescribed by the Secretary. Section 1.461-4(g)(2) through (7) describes other liabilities for which payment is economic performance.

Section 1.461-4(g)(1)(ii)(A) provides that payment does not include the furnishing of a note or other evidence of indebtedness of the taxpayer.

Section 1.461-4(g)(1)(i) provides that, for certain liabilities for which payment is economic performance, economic performance does not occur as a taxpayer makes payments in connection with the liability to any other person, including a trust, escrow account, court-administered fund, or any similar arrangement, unless the payments constitute payment to the person to which the liability is owed. In *Maxus Energy Corporation and Subsidiaries v. United States*, 31 F.3d 1135, 1144, 1145 (Fed. Cir. 1994), the taxpayer's payment to a settlement fund effectively constituted payment to the person to which the liability was owed because the claimants agreed to look solely to the fund to satisfy their claims and, therefore, the taxpayer's payment to the fund discharged its liability to the claimant.

Section 1.461-2T(e)(2) provides that, except as provided in § 468B or the regulations thereunder, economic performance does not occur when a taxpayer transfers money or other property to a trust, escrow account, or court to provide for the satisfaction of a contested workers compensation, tort, or other liability designated in § 1.461-4(g) unless the trust, escrow account, or court is the claimant or the taxpayer's payment to the trust, escrow account, or court discharges the taxpayer's liability to the claimant.

ANALYSIS

The Service and Treasury Department have become aware of transactions in which taxpayers have established trusts purported to qualify under § 461(f), but that fail to comply with the requirements of § 461(f) or the regulations by reason of: (1) retention of powers over the trust assets (such as the power to substitute assets, to pay the contested liabilities out of assets other than those in the trust, or to limit the trustee's ability to sell the taxpayer's assets that the taxpayer transferred to the trust), contrary to the requirement that the taxpayer relinquish control over the property transferred; (2) transfer to the trust of related party notes under circumstances indicating the liability is not genuine or that there is no intent between the parties to enforce the obligation, which is not a valid transfer to provide for the satisfaction of an asserted liability; or (3) establishment of trusts for contested tort, workers compensation, or other liabilities designated in § 1.461-4(g), for which economic performance requires payment to the claimant.

Transactions that are the same as, or substantially similar to, the following transactions are identified as “listed transactions” for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2):

(1) transactions in which a taxpayer transfers money or other property in taxable years beginning after December 31, 1953, and ending after August 16, 1954, to a trust purported to be established under § 461(f) to provide for the satisfaction of an asserted liability and retains any one or more of the following powers over the money or other property transferred: to pay any liabilities ultimately due to the claimant out of assets other than those transferred to the trust; to substitute money or other property for property transferred to the trust; to prohibit payment to the claimant by the trustee until instructed by the taxpayer; to prohibit notification to the claimant of the trust's establishment; to limit the trustee's ability to sell the property after it is transferred to the trust; and to limit the trustee's ability to enforce notes or rights relating to other property transferred to the trust;

(2) transactions in which a taxpayer transfers any indebtedness of the taxpayer or any promise by the taxpayer to provide services or property in the future in taxable years beginning after December 31, 1953, and ending after August 16, 1954, to a trust purported to be established under § 461(f) to provide for the

satisfaction of an asserted liability;

(3) transactions in which a taxpayer using an accrual method of accounting transfers money or other property after July 18, 1984, to a trust purported to be established under § 461(f) to provide for the satisfaction of a workers compensation or tort liability (unless the trust is the person to which the liability is owed, or payment to the trust discharges the taxpayer's liability to the claimant);

(4) transactions in which a taxpayer using an accrual method of accounting transfers money or other property in taxable years beginning after December 31, 1991, to a trust purported to be established under § 461(f) to provide for the satisfaction of a liability for which payment is economic performance under § 1.461-4(g) (unless the trust is the person to which the liability is owed, or payment to the trust discharges the taxpayer's liability to the claimant), other than a liability for workers compensation or tort; and

(5) transactions in which a taxpayer transfers stock issued by the taxpayer, or indebtedness or stock issued by a party related to the taxpayer (as defined in § 267(b)), on or after November 19, 2003, to a trust purported to be established under § 461(f) to provide for the satisfaction of any asserted liability.

Independent of their classification as “listed transactions,” transactions that are the same as, or substantially similar to, the transactions described in this notice may already be subject to the disclosure requirements of § 6011 (§ 1.6011-4), the tax shelter registration requirements of § 6111 (§§ 301.6111-1T, 301.6111-2), or the list maintenance requirements of § 6112 (§ 301.6112-1). Persons required to register these tax shelters under § 6111 who have failed to do so may be subject to the penalty under § 6707(a). Persons required to maintain lists of investors under § 6112 who have failed to do so (or who fail to provide such lists when requested by the Service) may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under § 6662.

Transactions that are the same as, or substantially similar to, the transactions described in this notice are identified as “listed transactions” for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2) effective November 19, 2003, the date this notice is released to the public. The references to specific taxable years and dates in the description of transactions covered by this notice are intended to provide consistency with the temporary and proposed regulations under § 461(f) filed with the Federal Register on November 19, 2003. Only those transactions covered by the provisions (including the effective date provisions) of the disclosure, tax shelter registration, and list maintenance requirements under §§ 6011, 6111, and 6112 and the regulations thereunder will be subject to those requirements.

DRAFTING INFORMATION

The principal author of this notice is Norma Rotunno of the Office of the Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice, contact Ms. Rotunno at (202) 622-7900 (not a toll-free number).

Internal Revenue Service
United States Department of the Treasury

Internal Revenue Bulletin: 2004-17

April 26, 2004

Notice 2004-30

S Corporation Tax Shelter

The Internal Revenue Service and the Treasury Department are aware of a type of transaction, described below, in which S corporation shareholders attempt to transfer the incidence of taxation on S corporation income by purportedly donating S corporation nonvoting stock to an exempt organization, while retaining the economic benefits associated with that stock. This notice alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies these transactions, and substantially similar transactions, as listed transactions for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations. This notice also alerts parties involved with these transactions to certain responsibilities that may arise from their involvement with these transactions.

FACTS

In a typical transaction, an S corporation, its shareholders, and an organization exempt from tax under § 501(a) and described in either § 501(c)(3) or § 401(a) of the Internal Revenue Code (such as a tax-qualified retirement plan maintained by a state or local government) (the exempt party) undertake the following steps. An S corporation issues, *pro rata* to each of its shareholders (the original shareholders), nonvoting stock and warrants that are exercisable into nonvoting stock. For example, the S corporation issues nonvoting stock in a ratio of 9 shares for every share of voting stock and warrants in a ratio of 10 warrants for every share of nonvoting stock. Thus, if the S corporation has 1,000 shares of voting stock outstanding, the S corporation would issue 9,000 shares of nonvoting stock and warrants exercisable into 90,000 shares of nonvoting stock to the original shareholders. The warrants may be exercised at any time over a period of years. The strike price on the warrants is set at a price that is at least equal to 90 percent of the purported fair market value of the newly issued nonvoting stock on the date the warrants are granted. For this purpose, the fair market value of the nonvoting stock is claimed to be substantially reduced because of the existence of the warrants.

Shortly after the issuance of the nonvoting stock and the warrants, the original shareholders donate the nonvoting stock to the exempt party. The parties to the transaction claim that, after the donation of the nonvoting stock, the exempt party owns 90 percent of the stock of the S corporation. The parties further claim that any taxable income allocated on the nonvoting stock to the exempt party is not subject to tax on unrelated business income (UBIT) under §§ 511 through 514 (or the exempt party has offsetting UBIT net operating losses). The original shareholders might also claim a charitable contribution deduction under § 170 for the donation of the nonvoting stock to the exempt party. In some variations of this transaction, the S corporation may issue nonvoting stock directly to the exempt party.

Pursuant to one or more agreements (typically redemption agreements, rights of first refusal, put agreements, or pledge agreements) entered into as part of the transaction, the exempt party can require the S corporation or the original shareholders to purchase the exempt party's nonvoting stock for an amount equal to the fair market value of the stock as of the date the shares are presented for repurchase. In some cases, the S corporation or the original shareholders guarantee that the exempt party will receive the fair market value of the nonvoting stock as of the date the stock was given to the exempt party if that amount is greater than the fair market value on the repurchase date.

Because they own 100 percent of the voting stock of the S corporation, the original shareholders have the power to determine the amount and timing of any distributions made with respect to the voting and nonvoting stock. The original shareholders exercise that power to cause the S corporation to limit or suspend distributions to its shareholders while the exempt party purportedly owns the nonvoting stock. For tax purposes, however, during that period, 90 percent of the S corporation's income is allocated to the exempt party and 10 percent of the S corporation's income is allocated to the original shareholders. The transaction is structured for the original shareholders to exercise the warrants and dilute the shares of nonvoting stock held by the exempt party, or for the S corporation or the original shareholders to purchase the nonvoting stock from the exempt party at a value that is substantially reduced by reason of the existence of the warrants. In either event, the exempt party will receive a share of the total economic benefit of stock ownership that is substantially lower than the share of the S corporation income allocated to the exempt party.

DISCUSSION

The transaction described in this notice is designed to artificially shift the incidence of taxation on S corporation income away from taxable shareholders to the exempt party. In this manner, the original shareholders attempt to avoid paying income tax on most of the S corporation's income over a period of time.

The Service intends to challenge the purported tax benefits from this transaction based on the application of various theories, including judicial doctrines such as substance over form. Under appropriate facts and circumstances, the Service also may argue that the existence of the warrants results in a violation of the single class of stock requirement of § 1361(b)(1)(D), thus terminating the corporation's status as an S corporation. *See, e.g.*, §§ 1.1361-1(l)(4)(ii) and (iii).

Transactions that are the same as, or substantially similar to, the transaction described in this notice are identified as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2) effective April 1, 2004, the date this notice was released to the public. Independent of their classification as listed transactions, transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the disclosure requirements of § 6011 (§ 1.6011-4), the tax shelter registration requirements of § 6111 (§ 301.6111-1T and § 301.6111-2), or the list maintenance requirements of § 6112 (§ 301.6112-1). Under the authority of §1.6011-4(c)(3)(i)(A), the exempt party in the listed transaction described in this notice will also be treated as a participant in the transaction (whether or not otherwise a participant). The exempt party will be treated as participating in the transaction for the taxable year of the purported donation, the taxable year of the reacquisition, and all intervening taxable years. Pending further review and possible additional guidance, this notice does not apply to any investment in employer securities, as defined in § 409(l), by an employee stock ownership plan subject to the requirements of § 409(p).

Persons who are required to register these tax shelters under § 6111 but have failed to do so may be subject to the penalty under § 6707(a). Persons who are required to maintain lists of investors under § 6112 but have failed to do so (or who fail to provide those lists when requested by the Service) may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under § 6662.

The Service and the Treasury Department recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this notice. These taxpayers should take appropriate corrective action and ensure that their transactions are disclosed properly.

The principal author of this notice is Tara P. Volungis of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this notice, contact Ms. Volungis at (202) 622-3070 (not a toll-free call).

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