IRS RELEASES TAX SHELTER AUDIT TECHNIQUE GUIDE

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In May 2005, the IRS released an audit technique guide (ATG) developed to help field personnel identify abusive tax shelters and transactions that it has been using internally for some time. The guide’s goal is to cover all types of transactions and serve as a reference for IRS agents. Based on previous IRS papers, documents, and guides, the authors believe the ATG provides a useful and comprehensive overview of tax shelters, their history, and efforts to combat them. The guide also analyzes the characteristics of listed transactions (transactions that the IRS has determined to be abusive tax shelters) and abusive arrangements that are not listed. The guide discusses relevant judicial doctrines and describes resources that are available to field personnel and investigatory tools that are at their disposal. The guide also sets out what factors should guide IRS agents in developing tax shelter abuse cases and provides a brief overview of various appeals procedures taxpayers may use to resolve disputes.

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Providing an inside look at how the IRS detects and analyzes potentially abusive transactions, the IRS has released an audit technique guide (ATG) to assist agents in identifying abusive tax shelters and transactions.1 The guide covers all types of tax shelter transactions.2 The ATG states that it incorporates other IRS papers, materials, and ATGs; it does not replace them.3 The guide gives taxpayers and practitioners a helpful overview of the Service’s audit technique and previews areas likely to be probed during an examination.

I. Highlights

The ATG:

• Provides an overview of the history of abusive tax shelters and efforts to combat them.
• Discusses characteristics of abusive tax shelters and examines listed transactions and abusive arrangements that are not listed.
• Presents judicial doctrines that may be applied to abusive tax shelters and leading cases that have applied those doctrines.
• Provides an overview of information available to field personnel investigating tax shelters, including information available from the Office of Tax Shelter Abuse (OTSA), technical advisers, tax returns, and a variety of other sources, including many public sources.
• Discusses other investigatory tools available to IRS personnel, such as Information Document Requests (IDRs) and a Corporate Tax Shelter Check Sheet.
• Outlines case management including issues to be considered, penalty development, information collection, and how field personnel can get help.

2 Id.
3 Id.
III. Abusive Tax Shelters

A. Efforts to Curb Abusive Tax Shelters

The ATG’s history of efforts to combat abusive tax shelters may prove useful to those who are unfamiliar with the federal government’s efforts to prevent tax shelter abuse. In the ATG, the IRS encourages agents to refer to other sources, including Tax Notes Today and the OTSA Web site, for updated information.4

The guide details the history of various legislative and regulatory attempts to curb tax shelters from the Tax Reform Act of 19765 through regulatory changes in 2000 and the beginning of listing abusive transactions.6

In 2001 the Service’s Large and Midsize Business Division (LMSB) established a Tax Shelter Committee to lead efforts to combat abusive tax shelters and make strategic decisions related to tax shelters.7 Later that year, the LMSB established a subcommittee charged with approving all LMSB tax shelter promoter activities.8

B. The Hallmarks of Corporate Tax Shelters

According to the ATG, corporate tax shelters are not defined easily, but they do exhibit certain characteristics.9 Those include a lack of meaningful economic risk of loss or potential for gain; inconsistent financial and accounting treatment; presence of tax indifferent parties; complexity; unnecessary steps or novel investments; promotion or marketing; confidentiality; high transaction costs; and risk reduction arrangements.10 The guide discusses those characteristics and provides examples of them.11

C. Listed Abusive Tax Shelters

The guide also gives field personnel guidance on listed transactions. It defines a listed transaction as the same as, or substantially similar to, one of the types of transactions that the IRS has determined to be a tax avoidance transaction for purposes of section 6011 and identified by notice, regulation, or other form of published guidance.12 Notice 2000-51 is the basis for much of the guidance provided.13 In its description of the listed transactions, the guide provides a short description of each transaction, the results, and proper tax treatment.14 A discussion of the code section affected by the transaction’s operation is generally featured.15 An explanation of the transaction’s results focuses on the tax benefits that the parties enjoy because of the transaction.16

The ATG provides agents with information about the IRS’s position on the appropriate tax treatment of the transactions described. Each discussion of proper tax treatment is preceded by a statement that the Service may change its treatment of a transaction, that the facts and circumstances of a case may warrant particular treatment and that a technical adviser should be consulted before the matter is developed.17 The names of, and contact information for, technical advisers assigned to each listed transaction are included in the ATG.18

D. Abusive Transactions, Not Listed

According to the IRS, some transactions show signs that they may be abusive but have not been identified officially as listed transactions.19 OTSA monitors those transactions, which may be subject to review by the Chief Counsel and Treasury if OTSA decides that the transactions may potentially be classified as listed transactions.20

IV. Information to Be Used to Identify Tax Shelters

A. Doctrines

The guide advises field personnel that tax shelter benefits may be denied when a transaction’s facts do not reflect its actual substance.21 The IRS may also invoke judicial doctrines to support its claim that the technical tax results are unreasonable and unwarranted.22 According to the ATG, five judicial doctrines apply to tax shelters: (1) substance-over-form; (2) step transaction; (3) economic substance; (4) sham; and (5) business purpose.23

B. OTSA

OTSA may be able to supply field personnel with valuable information from disclosure statements, registration statements, tax shelter surveys, the tax shelter hotline, informants, and revenue agent audits.24 The ATG discusses those resources, but it does not provide field personnel with much guidance on how to analyze the

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4Id. at I-B, 9.
5Id. at I-B, 1.
6Id. at 4-9.
7Id. at 8.
8Id.
9Id.
10Id. at I-C, 1.
11Id.
12Id. at 2-9.
13Id. at I-D.1. Section references are to the Internal Revenue Code of 1986, as amended, except as otherwise noted.
15E.g., id. at 6.
16E.g., id. at 8.
17E.g., id. at 5.
18See III.B.
19I.D.3, 1.
20Id.
21II.A, 1.
22Id.
23II.A, 2. The JCT’s study on tax shelters, JCX-84-99, Doc 1999-35937, 1999 TNT 218-22, is the basis for the discussion of judicial doctrines. Id.
25Id.
information. The guide stresses that OTSA can provide assistance by providing information, and it instructs agents to contact OSTA, local counsel, and a technical adviser on all emerging tax shelter transactions.26

Information is available to field personnel through disclosure statements filed by certain parties because of participation in "reportable transactions."27 In the ATG, field personnel are provided with an overview of the requisite information and a sample disclosure statement.28 The manual instructs field personnel that OTSA uses disclosure statements to determine if the transaction is a "listed transaction."29 If it is not, the statement is forwarded to Senior Legal Counsel, Corporate Tax Shelters, for review, and may be transmitted to other IRS personnel for further action.30

Surveys also are used by the Service to collect information about tax shelters, and help identify specific instances of noncompliance, determine levels of noncompliance, and track trends.31 The information helps identify shelter types prevalent in the business sector, guides efficient allocation of resources, and is used to make recommendations to Treasury and Congress.32 Agents are required to submit surveys when at least four of the following criteria are present: (1) lack of economic substance; (2) inconsistent financial accounting and tax treatment; (3) complexity; (4) unnecessary steps or novel investments; (5) confidentiality; (6) contingent or refundable fees and recission or insurance agreements; (7) high transaction costs.33

The OTSA tax shelter hotline is another source of information for field service personnel.34

B. Technical Advisers

The guide repeatedly stresses that field personnel should work with technical advisers. Technical advisers act as advisers and consultants to field agents and help to coordinate consistent treatment of tax shelters nationwide.35 To assist field personnel, the guide provides a table with descriptions of listed transactions and contact information for the appropriate adviser.36

C. Tax Return Information

The guide’s discussion of tax return information focuses on Schedule M analysis, flow-through entities, and tax return line items.

In its discussion of Schedule M, the ATG notes that book and tax accounting may vary significantly.37 While variations may be legitimate, they may conceal sham transactions the purpose of which is tax avoidance.38

Those variations should be considered in an audit and examination of a Schedule M-1, and the ATG provides an action list to guide field personnel.39

Flow-through entities are highlighted as something that tax shelters may use to obtain tax benefits.40 The guide provides a brief overview of the entities used, including S corporations, partnerships, TEFRA partnerships, and trusts.41 A brief description of each entity, how it generates tax benefits, and contact information for the appropriate technical adviser is provided.42

The guide points out that tax shelters take various forms, and there are no set line items to alert agents to a tax shelter.43 Field personnel are instructed to look for large, unusual or questionable (LUQ) return items and items that become evident during the examination.44 An agent who reviews a return and identifies a LUQ item should analyze the transaction to determine whether it is a listed transaction or shares characteristics of a tax shelter.45 Agents also should consider accounts with unusual titles or amounts, and some guidance is given about when items may be material, but "judgment and experience" should be used in determining materiality.46

Although no set line items necessarily will disclose a tax shelter, the guide lists 20 tax return items that may signal a tax shelter is being used.47 Those 20 items may represent only part of the transaction, and field personnel must analyze the entire transaction to determine whether there is a tax shelter.48 The agent’s focus should be on whether the transaction, in its entirety, makes economic and business sense when separated from the tax benefits it generates.49 To aid field personnel, the ATG also provides a list of lines on Forms 1040, 1065, 1120S, 1120, and a list of tax forms that may reveal information about tax shelters.50

D. Other Sources of Information

Field personnel should consider various sources of information when investigating abusive tax shelters, including financial statements; board of directors and committee minutes; SEC reports, forms, and descriptions; news and magazine articles; Web sites; and taxpayer profiles.

A taxpayer’s financial statements may disclose tax shelters, and field personnel should give special consideration to management discussions, analyses, accounting...
polices, and notes to financial statements. Field personnel are instructed to consider facts that imply a taxpayer needs a tax shelter, financial statements and organizational changes that may indicate that the taxpayer is structuring a shelter, or unaccounted for discrepancies between a financial statement and tax returns.

Field personnel are advised to review complete and unredacted minutes from board of directors and all committee meetings, especially finance committees. Meeting minutes may help to identify unusual transactions or abusive tax shelters, and may include the names of tax shelter promoters.

Field personnel are encouraged to review company organization charts and look for newly formed or dissolved entities, changes in capital structure, or disregarded entities. Tax shelters also may be indicated by consolidated, newly consolidated, or deconsolidated returns, and new activity in a previously dormant company.

Field personnel also should analyze a taxpayer’s business, financial, and tax profiles to isolate transactions that fall outside of the company’s core business operations. Those transactions should be reviewed for abusive tax shelter characteristics. Recognizing that taxpayers are unique and their businesses generate a multitude of tax shelter opportunities, the guide provides a short list of tax shelter opportunities that may appeal to different taxpayers.

An understanding of a taxpayer’s business may be gained by reviewing prior-year tax returns for capital loss, net operating loss, and foreign tax credit carryovers. Agents also should consider the taxpayer’s debt position and its traditional tolerance for risk.

SEC forms are another source of information, and the guide includes a list and description of SEC forms that may disclose information about tax shelters. Field personnel are encouraged to consult newspapers and magazines, such as The Wall Street Journal and Tax Notes Today. The guide lists several websites that may provide useful information about tax shelters.

V. Additional Investigatory Tools

Field personnel have two additional research tools at their disposal: a Corporate Tax Shelter Check Sheet and IDRs.

The ATG advises field personnel to use IDRs to determine if a taxpayer has engaged in listed transactions, or transactions that are the same as, or substantially similar to, listed transactions. In all LMSB cases in which an examination was open as of April 24, 2002, or opened after April 23, 2002, an IDR must be issued. Information about IDRs, their use, and appropriate responses to some taxpayer issues is provided by a list of frequently asked questions issued by LMSB in July 2002.

Field personnel also may use the Corporate Tax Shelter Check Sheet, which provides an overview of areas that agents may want to focus on and related questions. The check sheet lists the following areas: (1) Schedule M-1; (2) section 351 transactions; (3) leasing; (4) subsidiaries; (5) international aspects; (6) financial products; and (7) sales transactions.

VI. Case Development

A. Aspects of Case Development

The guide examines issues that agents should consider when developing tax shelter abuse cases, including the business purpose and economic substance doctrines; transaction costs; exit strategy; and penalties.

When considering a transaction’s economic substance, both the objective economic substance of the transaction and the subjective business motivation must be determined. Analysis should focus on whether the transaction can be respected for tax purposes when considered apart from its tax consequences. The guide remarks that an assessment of a transaction’s substance is a factual determination. Because the IRS’s case may rely on the economic substance doctrine, field personnel should develop facts to establish that a transaction has no business purpose, economic substance, or is essentially a sham transaction. To assist field personnel, the guide describes issues that field personnel should consider, such as circular cash flows.

Transaction costs also are important in tax shelter cases, and courts may consider them when analyzing a transaction’s economic substance. The guide identifies types of transaction costs, advises field personnel to use IDRs to request identification of all transaction costs, and provides a list of documents that should be requested and questions that should be asked of taxpayers. Field personnel are instructed that deductions related to tax shelter transaction costs generally should be disallowed.
The ATG tells agents to consider the taxpayer’s exit strategy when investigating potential tax shelter abuse and evaluating business purpose and economic substance. Field personnel should consider whether those strategies were developed and employed, and facts should be developed regarding the strategies’ use and impact on the economic and tax consequences of the transaction. To guide IRS personnel, the ATG defines exit and exit tax strategies and offers examples of what agents may encounter.

Penalties feature prominently in case management, and the guide suggests audit techniques to ensure proper penalty development. The guide focuses on section 6662, which imposes accuracy-related penalties for negligence or disregard of the rules and regulations; any substantial understatement of income tax; and any substantial valuation misstatement. The ATG also discusses the reasonable cause/good faith exception, and briefly touches on the fraud penalty.

The ATG reminds agents to determine what efforts a taxpayer made to assess the return position’s accuracy. The goal is to assess accountability for the return position and determine whether documentation corroborates the taxpayer’s position. To help field personnel determine whether the taxpayer has a reasonable cause/good faith defense, the guide provides a list of questions that documentation should address. However, the ATG does not provide much guidance on what types of documents should be consulted. The ATG also provides field personnel with guidance on determining whether a taxpayer has relied on tax advice in good faith or with reasonable cause. Service personnel are directed to seek out documents that indicate whether the taxpayer sought independent legal advice; whether the taxpayer scrutinized the advice before it was adopted; how compensation was provided for the outside advice; and what facts and assumptions the taxpayer made available to the adviser.

B. Collecting Information

To collect information, IRS personnel can use formal document requests (FDRs) and summonses. The guide remarks, however, that taxpayers may invoke privilege doctrines and withhold documents. The guide focuses on the use of FDRs to collect foreign information, an important consideration because abusive tax shelters often involve foreign aspects. Ideally, a taxpayer will provide written authorization for foreign third parties’ disclosure. If not, field personnel should consider using an FDR, but a request can be made only for documents previously requested by an IDR. The ATG offers guidance on how an IDR should be used to obtain information, and it cautions that an FDR should not be used for routine information gathering.

Summonses also may be used to collect information. The guide instructs field personnel that the commissioner may examine any books and records that may be relevant or material and may summon any person to produce records or testify about relevant or material issues. The guide provides an overview of when a summons should be used, the required procedure, how a summons should be drafted, and what is required for enforcement. The guide also discusses issuing summonses that reach U.S. citizens residing abroad or to toll the statute of limitations, and when to summons tax accrual workpapers.

C. Assistance

The guide discusses the role of the following field specialists: international examiners; financial products specialists; economists; engineers; and computer audit specialists. Training for each specialist is discussed, and the guide advises field personnel when a particular specialist should be used.

Field personnel are strongly encouraged to consult counsel when an examination begins. The guide lists examples of the support that counsel can offer, including identifying and evaluating legal positions, identifying facts for further development and helping draft documents. The ATG advises agents that counsel can help collect information, and may be helpful when dealing with taxpayers or when liaising with the National Office and the Treasury Department. The guide remarks that working with the National Office is important because it

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78IV.A.4, 1.
79Id.
80Id. at 2-3
81IV.A.5, 2.
82Id. at 3. That section of the code also penalizes taxpayers for any substantial overstatement of pension liabilities and any substantial estate or gift tax valuation understatement. Those are not discussed by the ATG, because the other penalties are applicable in most tax shelter examinations. Id. The American Jobs Creation Act amended section 6662.
83Examination Guide — Abusive Tax Shelters and Transactions, IV.A.5 at 4. It bears noting that another Audit Technique Guide entitled Accuracy-Related Penalties for Taxpayers Involved in Tax Shelter Transactions, Doc 2005-6893, 2005 TNT 64-21, misstated the requirements for the substantial authority exception under section 6662(d)(2)(B). That same misstatement does not appear in this ATG.
85Id. at 14.
86Id.
87Id.
88Id. at 15.
89Id.

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90IV.B.3, 1.
91IV.B.1, 1.
92Id.
93Id. at 1-2.
94Id. at 2.
95IV.B.2, 1.
96Id. at 2-4.
97Id. at 5-7.
98IV.C.1, 1-5. For example, international examiners are trained to identify situations in which income and expense have been shifted to or from a foreign entity or affiliate or in which there is a deviation from arm’s-length dealing. The guide instructs field personnel to consult an international specialist when such a situation arises or when the taxpayer has significant foreign transactions. Id. at 1.
99IV.C.2, 1.
100Id.
101Id. at 2-3.
ensures that the projected legal positions accord with IRS policy and can be supported, and the National Office can advise whether additional positions should be developed.102

The ATG also discusses the role of outside consultants. Outside experts also can assist with case development. They can provide consulting services, valuation, actuarial, economic analysis, software analysis, and financial analysis services, among others.103 The use of experts is justified in special situations and when there are important precedential issues at stake.104

D. Appeals

1. Appeals Coordinated Issue Program. The Appeals Coordinated Issue Program (ACI) coordinates cases that have not been formally coordinated, meaning there is no coordinated issue paper and no written appeals settlement guidelines.105 The guide lists ACI issues that relate to tax shelters and provides a list of ACI coordinators and the transactions for which they are responsible.106

2. Fast Track Dispute Resolution Program. The guide discusses the Fast Track Dispute Resolution Program, which has been made permanent by a revenue procedure and renamed the Fast Track Settlement (FTS) Program.107 The FTS is optional for the taxpayer and it does not replace existing dispute resolution mechanisms. Matters may be rejected by Appeals or the LMSB if they do not appear suitable for resolution under FTS.108

102Id. at 3.
103IV.C.3, 1.
104Id.
105IV.D.1, 1.
106Id. at 1-2.
108Id.