An Analysis of New York’s Tax Shelter Legislation

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New York has become the third state to enact legislation aimed at curbing abusive tax transactions. On April 12, Gov. George Pataki (R) signed into law AB 6845, which reflects recent changes to the Internal Revenue Code made as part of the American Jobs Creation Act of 2004 (P.L. 108-357), as well as concepts found in similar legislation enacted by California and Illinois. According to the bill, the New York Legislature expects the legislation to raise $50 million for New York.

Highlights

- Taxpayers must disclose reportable transactions, listed transactions, and New York reportable transactions with their New York state tax returns. The penalty for failure to disclose ranges from $10,000 to $50,000.
- Persons required to register transactions with the IRS must register those transactions with the New York commissioner of taxation and finance if certain nexus filters are met. The earliest date for registration of a transaction with New York is September 9, 2005. The penalty for failure to register ranges from $20,000 to the greater of $50,000 or 75 percent of gross income derived by the material adviser.
- Persons required to maintain investor lists in accordance with Internal Revenue Code section 6112 must maintain a duplicate list for New York purposes if certain nexus filters are met. The list must be provided within 20 days of a written request from the commissioner or a $10,000-per-day penalty will apply.
- A broad range of documents must be maintained for six years and provided to the commissioner in connection with any examination.
- The statute of limitations on deficiencies attributable to “abusive tax shelter transactions” is extended to six years.
- If a taxpayer fails to file a disclosure statement, the statute of limitations on the assessment of items related to the reportable transaction is extended until one year after either the disclosure statement is filed or an investor list containing the taxpayer’s name is provided to the commissioner.
- A reportable transaction understatement penalty of 20 to 30 percent of the understatement attributable to the reportable transaction is added.
- The “aiding or assisting the filing of fraudulent returns” penalty is increased from $1,000 to $5,000.
- The Department of Taxation and Finance will initiate a voluntary compliance program. Eligible taxpayers who do not participate and are assessed a deficiency will have an additional added to tax equal to 100 percent of the interest payable from the payment due date to the date the notice of deficiency is mailed.

I. Information Reporting And Retention Requirements

A. Tax Return Disclosure

Under newly enacted N.Y. Tax Law section 25(a)(1), every person required to file a disclosure statement under Internal Revenue Code section 6011 or regulations promulgated thereunder related to a reportable transaction or a listed transaction must attach a duplicate of that disclosure statement to the tax return required to be filed by that person. The commissioner may require additional information to be provided.

In addition to disclosing participation in a listed transaction or a reportable transaction — as those terms are defined under federal law — every person who has participated in a “New York reportable transaction” must disclose the transaction on a form to be prescribed by the commissioner and must provide information required 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” or a transaction that is the same as or substantially similar to such a transaction. The commissioner may designate a transaction as a New York reportable transaction by notice or other guidance. As of the date of the writing of this article, the commissioner has not designated any transaction as a New York reportable transaction.

1 As defined in IRC section 7701.
2 See Treas. Reg. section 1.6011-4 for rules relating to tax return disclosure of reportable transactions.
3 As defined in IRC section 6011 or the regulations thereunder.
4 As defined in IRC section 6011 or the regulations thereunder.
5 “Participation” is not defined.
B. Reportable Transaction Returns (Known as Registration Statements Under Prior Federal Law)\(^6\)

Like the California and Illinois registration rules, New York’s registration rule has a nexus filter. Under Tax Law section 25(b)(1), a person required to file a registration statement with the IRS must file a duplicate with New York if any one of certain nexus filters is met. The nexus filters are met if the person is:

1. organized in New York;
2. doing business in New York; or
3. deriving income in New York; or
4. the list required to be maintained by that person under IRC section 6112 identifies or is required to identify a taxpayer subject to New York income or franchise tax and that person is a material adviser, who within the state of New York provides any material aid, assistance, or advice regarding organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction.

The New York nexus filters are different from those used in the California and Illinois legislation.\(^5\) The California and Illinois statutes judge nexus based on the connection of the tax shelter to the state, whereas the New York legislation looks to the nexus of the taxpayer/return filer.

The registration statement must be filed with the commissioner within 60 days of the later of:

1. the date required for filing a statement/return with the IRS;
2. the first day any of the nexus filters described above is met;\(^9\) or
3. 90 days within enactment of the section.\(^10\)

C. List Maintenance

New York has enacted a list maintenance provision comparable to IRC section 6112.\(^11\) Any person required to maintain a list of investors under IRC section 6112 must maintain a duplicate list if any of the nexus filters described above are met. The list must be provided within 20 days of a written request from the commissioner.\(^12\)


The new law also provides document-retention provisions for persons required to disclose, register, or maintain investor lists. The law requires that such persons retain for six years all relevant correspondence, memoranda, notes, valuation studies, meeting minutes, spreadsheets, models, opinions, records required to be retained under IRC section 6011, and all records related to the disclosure, registration, and list maintenance obligations.\(^13\) All such information must be made available for inspection in connection with any examination. The legislation does not make any reference to the assertion of privilege.

II. Extended Statutes of Limitations

The legislation provides several extended statute of limitations provisions modeled after IRC section 6501(c)(10). Under new Tax Law sections 683(c)(11) and 1083(c)(11), if a person fails to file a return or provide information regarding a listed transaction, the statute of limitations on assessment is extended to one year after the earlier of:

1. the date on which the required information is provided to the commissioner; or
2. the date that an investor list under Tax Law section 25(c),\(^15\) including the taxpayer’s name, is provided to the commissioner.\(^16\)

Furthermore, a deficiency attributable to an abusive tax shelter transaction may be assessed at any time within six years after the return was filed (assuming the statute of limitations ordinarily would be less than six years).\(^17\) An abusive tax shelter transaction is “a plan or arrangement devised for the principal purpose of avoiding tax.”\(^18\) An abusive tax shelter transaction includes but is not limited to a listed transaction.\(^19\)

III. Penalties

The legislation amends or adds new penalties related to understatements, aiding or assisting the filing of fraudulent returns, failure to disclose a reportable transaction, failure to provide a reportable transaction return, failure to maintain a list of advisees, return preparers who knowingly prepare incorrect tax returns, and promoting tax shelters.

A. Understatement Penalties

1. Substantial Understatement Penalty

Under current law, the substantial understatement penalty is an amount equal to 10 percent of an understatement if the understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $2,000.\(^20\) In determining the amount of an understatement, the amount of the understatement is reduced by the amount attributable to an item for which the taxpayer had substantial authority or for which the relevant facts affecting the item’s tax treatment were adequately disclosed on the return.\(^21\)

The law is now amended to provide that the adequate-disclosure exception does not apply to any item attributable to a “tax shelter.”\(^22\) A tax shelter is a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement “if a significant purpose” of the arrangement “is the

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\(^6\) Although federal and New York law refer to the requirement as “disclosure,” we use the term “registration” to distinguish between tax return disclosure (Treas. Reg. section 1.6011-4) and reportable transaction disclosure (IRC section 6111). California and Illinois use the term “registration.” Cal. Rev. & Tax. Code section 18628; 35 Ill. Comp. Stat. 5/1405.5.

\(^7\) As defined in IRC section 6111.

\(^8\) Cal. Rev. and Tax. Code section 18628(g); 35 Ill. Comp. Stat. 5/1405.5(c).

\(^9\) N.Y. Tax Law section 25(b)(1).

\(^10\) The legislation does not provide any guidance on what standard of care a material adviser must apply to determine whether and when any of the nexus filters is met.

\(^11\) Ninety days from 60 days of enactment is September 9, 2005.

\(^12\) N.Y. Tax Law section 25(c).

\(^13\) Id.

\(^14\) N.Y. Tax Law section 25(d).

\(^15\) The equivalent of IRC section 6112.

\(^16\) N.Y. Tax Law sections 683(c)(11)(A), 1083(c)(11)(A).

\(^17\) N.Y. Tax Law sections 683(c)(11)(B), 1083(c)(11)(B).

\(^18\) N.Y. Tax Law sections 683(c)(11)(C), 1083(c)(11)(C) (emphasis added).

\(^19\) N.Y. Tax Law sections 683(c)(11)(C), 1083(c)(11)(C).

\(^20\) Now renumbered as N.Y. Tax Law section 685(p)(1) and N.Y. Tax Law section 1085(k)(1).

\(^21\) N.Y. Tax Law sections 685(p)(1), 1085(k)(2).

avoidance or evasion of tax." All “reportable transaction understatements” are aggregated to determine whether there is a substantial understatement. The commissioner may waive all or part of the significant understatement penalty if the taxpayer shows reasonable cause for the understatement and shows that it acted in good faith, apparently without regard to whether the understatement is attributable to a tax shelter.

2. Reportable Transaction Understatement Penalty

The legislation imposes a new 20 percent penalty for any reportable transaction understatement. The amount of the reportable transaction understatement penalty is increased to 30 percent if the relevant facts are not disclosed in accordance with Tax Law section 25.

A reportable transaction understatement is the sum of:

- The increase in the applicable tax base resulting from a difference between the proper tax treatment of the item and the taxpayer’s treatment of such item as shown on the tax return.
- The highest rate of tax imposed by Article 22 of the New York Tax Law.
- The decrease in the aggregate amount of credits resulting from a difference between the treatment of the item as shown on the tax return and the proper tax treatment.

Thus, a reportable transaction understatement is calculated as:

\[(I1-I2) \times (R) + (C1-C2)\]

The penalty applies to any item attributable to a listed transaction or a reportable transaction (including a New York reportable transaction) for purposes, for example, of the avoidance or evasion of tax. Unless otherwise provided in regulations, the commissioner will not consider the tax treatment of an item in an amended or supplemental return when determining the amount of the reportable transaction understatement penalty if the amendment or supplemental return is filed after the earlier of the date the commissioner first contacts the taxpayer regarding the examination of the return or such other date prescribed by the commissioner. Presumably, if the IRS first contacts the taxpayer, the taxpayer may still file an amended New York state return and avoid the imposition of the New York reportable transaction understatement penalty.

The reportable transaction understatement penalty may not be imposed if the taxpayer had reasonable cause and acted in good faith. The reasonable cause/proof of good faith exception will not apply unless the relevant facts are disclosed in accordance with Tax Law section 25; there is or was substantial authority for the treatment; and the taxpayer reasonably believed that the treatment was more likely than not the proper treatment.

3. Reliance on Opinions

New York has enacted the equivalent of IRC section 6664(d)(3)(B), regarding which opinions a taxpayer may not rely on to establish reasonable belief to avoid penalties. A taxpayer may not rely on the opinion of a tax adviser if the tax adviser is a material adviser and participates in the organization, management, promotion, or sale of the transaction (or is related to such a person); is compensated directly or indirectly by a material adviser; has a contingent fee arrangement; or has a disqualifying financial interest.

A taxpayer may not rely on an opinion if the opinion is based on unreasonable factual or legal assumptions; unreasonably relies on any representations, statements, findings, or agreements; does not identify and consider all relevant facts; or fails to meet any other requirement prescribed by the commissioner.

4. Increase in Aiding-or-Assisting Penalty

The legislation increases from $1,000 to $5,000 the penalty for aiding or assisting in giving fraudulent returns, reports, statements, or other documents.

5. Penalty for Failure to Disclose Reportable Transaction (Equivalent of IRC Section 6707A)

Any person required to disclose a reportable transaction on its tax return under Tax Law section 25(c) who fails to do so, “shall pay a penalty” of:

1. $10,000 for a reportable transaction, other than a listed transaction, if the person is other than a corporation;
2. $20,000 for a reportable transaction, other than a listed transaction, if the person is a corporation;
3. $25,000 for a listed transaction, if the person is other than a corporation;
4. $50,000 for a listed transaction, if the person is a corporation.

The commissioner may rescind all or a portion of the penalty if the violation does not relate to a listed transaction and

**Footnotes:**

23 N.Y. Tax Law sections 685(p)(3), 1085(k)(3)(B) (emphasis added). As can be seen, this is a lower standard than an “abusive tax shelter transaction” for purposes of the extended statute of limitations of N.Y. Tax Law section 683(c)(11)(C) and section 1083(c)(11)(C).
24 N.Y. Tax Law sections 685(p-1)(1), 1085(k-1)(2).
25 N.Y. Tax Law sections 685(p-1)(6)(A), 1085(k-1)(2).
26 N.Y. Tax Law sections 685(p)(1), 1085(k)(1).
27 N.Y. Tax Law sections 685(p-1)(1), 1085(k-1)(1).
28 N.Y. Tax Law sections 685(p-1)(1), 1085(k-1)(1).
29 Section 25 of the Tax Law encompasses disclosure, registration, and list maintenance; it is unclear whether the legislature intended to penalize taxpayers for failures by the material adviser to register a transaction or provide a requested list.
30 N.Y. Tax Law sections 685(p-1)(4), 1085(k-1)(4).
31 N.Y. Tax Law sections 685(p-1)(8), 1085(k-1)(8); see also N.Y. Tax Law sections 685(e), 1085(f) (fraud penalties).
32 N.Y. Tax Law sections 685(p-1)(2), 1085(k-1)(2).
33 N.Y. Tax Law sections 685(p-1)(3), 1085(k-1)(3).
34 N.Y. Tax Law sections 685(p-1)(9), 1085(k-1)(9).
37 As defined in IRC section 6111.
40 N.Y. Tax Law section 685(d); see also N.Y. Tax Law section 1085(l), which was not amended by the new legislation.
41 N.Y. Tax Law sections 685(k)(2)(A).
rescission would promote compliance with the tax law and effective tax administration. The penalty may be imposed in addition to any other penalty.

D. Penalty for Failure to Provide Reportable Transaction Return (Equivalent of IRC Section 6707)

Any person required to file a reportable transaction return under Tax Law section 25(b) who fails to do so shall pay a penalty in the amount of:

1. $20,000 for a reportable transaction, other than a listed transaction; or

2. if the transaction is a listed transaction, the greater of a. $50,000; or
   b. 50 percent of the “gross income that the organizer or material adviser derived with respect to activities that were the basis for the requirement to file, disclose or provide information pursuant to” IRC section 6111 “to the extent such gross income is attributable to the avoidance of personal income tax; the amount is increased to 75 percent in the case of an intentional failure or act.”

As with the failure-to-disclose penalty, the commissioner may rescind all or a portion of the failure-to-register penalty if the violation does not relate to a listed transaction and rescission would promote compliance with the tax law and effective tax administration. The penalty may be imposed in addition to any other penalty.

E. Penalty for Failure to Maintain List of Advisees (Equivalent of IRC Section 6708)

The legislation imposes a penalty for failure to provide the list required to be maintained under Tax Law section 25(c). The penalty is imposed at the rate of $10,000 per day starting on the 21st day after a written request for the list from the commissioner. The penalty shall not be imposed when the failure is due to reasonable cause.

F. Tax Return Preparer Penalty

A new penalty is imposed on a tax return preparer if any part of an understatement of tax or claim for refund is due to a tax position for which there was not a reasonable belief that the tax position was more likely than not the correct tax position; the return preparer knew of that position; and the position was not disclosed or there was no reasonable basis for the tax treatment. The penalty is up to $1,000. The penalty will not be imposed if there is a showing of reasonable cause for the understatement and the return preparer acted in good faith.

The amount of the penalty may be increased up to $5,000 if the understatement or refund claim is due to a willful attempt to understatement the taxpayer’s liability or a reckless or intentional disregard of the rules or regulations by the return preparer.

G. Penalty for Promoting Abusive Tax Shelters (Equivalent of IRC Section 6700)

The legislation adds a new penalty for promoting abusive tax shelters akin to IRC section 6700. The penalty is imposed on any person:

1. who organizes or participates in the sale of an interest in a partnership, entity, or other plan or arrangement; and
2. who makes or causes another person to make a falsa or fraudulent statement with respect to the securing of a tax benefit, or a gross valuation misstatement as to any material matter,
3. and who is a. organized in New York; b. doing business in New York; c. deriving income in New York; or d. conducts any of the activities described in paragraphs 1 and 2 within New York.

The amount of the penalty is the lesser of $1,000 or 100 percent of the gross income derived by the person from the activity. However, if the person’s activity involves making a false or fraudulent statement regarding the securing of a tax benefit, the penalty is 50 percent of the gross income derived from that activity. The penalty may be imposed in addition to any other penalty.

The commissioner may waive all or part of the penalty for a gross valuation misstatement if there is evidence of a reasonable basis for the valuation and the valuation was made in good faith.

IV. Voluntary Disclosure Initiative

Like California and Illinois, New York will have a voluntary compliance initiative. New York’s voluntary compliance initiative provides penalty relief and other types of relief to certain taxpayers owing taxes attributable to a tax avoidance transaction for tax periods before January 1, 2005. The relief is available provided the taxpayer complies with three requirements: submission of an application for relief; filing of amended returns without regard to the tax avoidance transaction; and absent an agreed-upon installment agreement, the immediate payment of the resulting tax and interest. The requirements to participate in the New York voluntary compl-

N.Y. Tax Law sections 685(x)(5), 1085(p)(5).
N.Y. Tax Law sections 685(y)(5), 1085(q)(5).
N.Y. Tax Law sections 685(z)(2), 1085(r)(2).
N.Y. Tax Law sections 685(aa)(1), 1085(o)(1).
54 N.Y. Tax Law sections 685(bb), 1085(t).
55 Defined as the value of property or services if the stated value exceeds 200 percent of the correct value and the value of the property or services is directly related to the amount of any deduction or credit. N.Y. Tax Law sections 685(bb)(2)(A), 1085(u)(2)(A).
57 For purposes of the voluntary compliance initiative, a tax avoidance transaction is “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.” 2005 N.Y. Laws ch. 61, part N, sec. 11(b).
pliance initiative and the taxpayer participation options are described in more detail below.

A. Application to Designated Taxes

New York’s voluntary compliance initiative applies to designated taxes. Designated taxes are tax liabilities attributable to the use of a tax avoidance transaction for years before January 1, 2005, and relating to: corporation tax, franchise tax on business corporations, personal income tax, and franchise tax on insurance corporations.

B. Participation Limited to Eligible Taxpayers

A taxpayer must qualify as an eligible taxpayer to participate in New York’s voluntary compliance initiative. 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 relating to a designated tax as discussed above.

An otherwise eligible taxpayer will be prohibited from participating in the voluntary compliance initiative if:

1. the taxpayer is a party to any federal or state criminal investigation for underreporting or underpayment of tax;
2. as of the taxpayer’s application date under the voluntary compliance initiative, the taxpayer is a party to any pending administrative proceeding or civil or criminal litigation relating to the designated taxes under the voluntary compliance initiative (an administrative proceeding or civil litigation shall be deemed not to be pending on the application date if the taxpayer withdraws from that proceeding or litigation before the commissioner’s penalty waiver under the voluntary compliance initiative);
3. the taxpayer has a criminal conviction concerning the tax on which penalty relief is sought;
4. the taxpayer was eligible to participate in the New York Offshore Voluntary Compliance Initiative of 2003, and the tax avoidance transaction now at issue is a financial arrangement or payment card transaction described in the New York Offshore Voluntary Compliance Initiative or the IRS’s Offshore Voluntary Compliance Initiative set forth in Rev. Proc. 2003-11.

C. Time Period and the Commissioner’s Authority

The voluntary compliance program shall begin no later than October 1, 2005, and shall end on March 1, 2006. Participation in the initiative will be administered by the commissioner who has authority to adopt rules, issue forms and instructions, and determine the start date of the voluntary compliance initiative. Thus, taxpayers will have at a minimum a five-month period to participate in the voluntary compliance initiative.

D. Preliminary Requirements to Participate

To participate in the voluntary compliance initiative, in addition to complying with any rules adopted by the commissioner, the taxpayer must file an application; file an amended return for the year in which the tax avoidance transaction was used without taking the position identified as incorrect by the IRS; and absent an installment agreement, make full payment of taxes and interest attributable to the avoidance transaction. A taxpayer’s failure to comply with an installment agreement entered into in connection with the voluntary compliance initiative will cause any waiver of penalties to be null and void, and make related tax, interest, and penalties immediately due and payable. A taxpayer’s participation in the voluntary compliance initiative “shall not be considered evidence that the taxpayer in fact engaged in a tax avoidance transaction.”

E. Participation Options

Eligible taxpayers may participate in New York’s voluntary compliance initiative under one of two methods for each tax year at issue: voluntary compliance without appeal, or voluntary compliance with appeal. The election of a method is irrevocable. Each method is discussed below.

1. Voluntary Compliance Without Appeal

If the taxpayer elects the “voluntary compliance without appeal” method, the following will apply:

a. The commissioner shall waive any applicable penalties regarding the tax avoidance transaction unless the penalty imposed is attributable to a tax assessment finalized before the start date of the voluntary compliance initiative.

b. Except as otherwise provided under the voluntary compliance initiative, the commissioner shall not bring or seek civil, administrative, or criminal action against the taxpayer for the relevant tax year concerning the use of any tax avoidance transactions.

c. The taxpayer may not file a credit or refund claim concerning the tax avoidance transaction.

2. Voluntary Compliance With Appeal

If the taxpayer elects the voluntary compliance with appeal method, the following will apply:

...
a. The commissioner shall waive any applicable penalties, except for certain negligence and substantial understatement penalties in effect as of December 31, 2004, unless the penalty imposed is attributable to a tax assessment finalized before the start date of the voluntary compliance initiative.

b. Except as otherwise provided under the voluntary compliance initiative, the commissioner shall not bring or seek civil, administrative, or criminal action against the taxpayer for the relevant tax year concerning the use of any tax avoidance transactions.

c. The taxpayer may file a credit or refund claim concerning the tax avoidance transaction.

d. Despite Tax Law sections 689(c)(3)(A) and 1089(c)(3)(A), the taxpayer will be able to file a petition with the Division of Tax Appeals only after either of the following occurrences:

i. the commissioner takes action on the refund claim and notifies the taxpayer of such action, or

ii. the earlier of 180 days after the IRS's final determination concerning the tax avoidance transaction, or three years after the claim filing date, or two years after full payment of all tax, including penalty and interest, was made.

F. Failure to Participate

Taxpayers eligible to participate in the voluntary compliance initiative that do not participate will suffer an additional penalty. Specifically, eligible taxpayers with designated transactions that fail to participate shall have an amount added to any related deficiencies equal to 100 percent of the interest payable from the payment due date (without regard to extensions) to the date the notice of deficiency is mailed to the taxpayer.

V. Effective Dates

The legislation generally is effective as of April 12, 2005, but contains specific effective-date provisions.

A. Tax Return Disclosure

The tax return disclosure provision of Tax Law section 25(a) applies to all disclosure statements that were required to be provided to the IRS “at any time with respect to ‘listed transactions.’” The new law also applies to any disclosure to the IRS of any reportable transaction, other than a listed transaction “in which a taxpayer participated during any taxable year for which the statute of limitations for assessment had not expired” as of the date of enactment, and applies to disclosure statements required to be filed with the commissioner within 60 days of enactment.

B. Other Provisions

The amendments regarding extended statutes of limitations, substantial understatement penalties, and reportable transaction understatements apply to any tax liability for which the statute of limitations on assessment had not expired as of April 12, 2005.

C. Expiration

The provisions in the legislation expire on July 1, 2007.