State Tax Shelter Legislative Update

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Despite California’s phenomenal success in introducing the first state-level tax shelter compliance regime — the state claims to have assessed $1.4 billion in tax, interest and penalties — other states have been slow to follow. Not surprisingly, two other high-tax states, Illinois and New York, were the first to pass similar legislation. Now Connecticut and Minnesota have enacted reporting requirements, Oregon has pending legislation, and the Multistate Tax Commission just approved a disclosure program to deal with abusive tax shelters. No two states have adopted the same approach, leaving taxpayers and their advisers with a hodgepodge of rules that are not only inconsistent with one another but also in some instances internally inconsistent.

I. The Template

California, Illinois, and New York have modeled their legislation in one form or another on the three-part federal system: registration of the transaction by the promoter/material adviser; record-keeping requirements (usually called list maintenance) by the promoter or material adviser, and taxpayer return disclosure. California, Illinois, and New York have somewhat different nexus requirements, but each requires connection of the transaction, the taxpayer, or the promoter to the state, and each state imposes significant penalties for failure to comply.

II. Connecticut

Of all the states, Connecticut has taken the most limited approach. Unlike California, Illinois, New York, and Minnesota (discussed below), Connecticut does not affirmatively require disclosure; instead, Connecticut penalizes nondisclosure on the federal level. Further, Connecticut’s legislation applies only to listed transactions; federal, California, Illinois, and New York law all apply to both listed transactions and reportable transactions. California, New York, and Minnesota also authorize their state tax commissioners to designate additional transactions as abusive.

A. Promoters

Connecticut is the only state to legislate in this area that does not require a promoter to register or retain records for tax shelter transactions. Instead, Connecticut has elected simply to incorporate section 6700(a) of the Internal Revenue Code, which penalizes the making of a false or fraudulent tax statement in connection with the organization or sale of a transaction. Section 6700(a) provides in pertinent part that:

Any person who —

(1)(A) 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

(B) participates (directly or indirectly) in the sale of any interest in any plan or arrangement referred to in subparagraph (A), and


2Several other states, including Arizona, Hawaii, and Montana, have proposed but failed to pass legislation in this area.

3Oregon SB 480.


(2) makes or furnishes or causes another person to make or furnish (in connection with such organization or sale) —

(A) 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 . . .

. . . shall pay [a penalty equal to 50 percent of the gross income derived from the activity giving rise to the penalty].

The same activity generating the federal penalty will subject a promoter to a penalty in Connecticut of “fifty percent of the gross income derived from, or to be derived from, such activities by such person,”7 where such activities affect tax returns required to be filed with the [Connecticut] Commissioner of Revenue Services.8

It is unclear from the face of the statute whether Connecticut will apply the penalty based on 50 percent of gross revenue derived from all such activities by the promoter or only to gross income derived from activities affecting Connecticut tax returns. Because it is a penalty provision, any ambiguity should be resolved in favor of the taxpayer,9 and counsel for a promoter should advocate for a limited penalty base.

Although Connecticut does not require promoters to disclose transactions, the state is allowing promoters to avoid the promoter penalty through disclosure. Until December 31, 2005, Connecticut conducted the Connecticut Abusive Tax Shelter Compliance Initiative (CATSCI).

Under CATSCI, a promoter could avoid the 50 percent promoter penalty by providing “a complete investor list and fee schedule.”10 The CATSCI announcement does not provide information on whether the promoter must include information about non-Connecticut investors or what is meant by the fee schedule. As any reader of Treas. reg. section 301.6112-1(c)(3)(iii) knows, a “fee” can be difficult to quantify. Curiously, Connecticut does not seem to require the promoter to disclose any information about the structure or intended tax benefits of the transaction.

No two states have adopted the same approach to tax shelters, leaving taxpayers and their advisers with a hodgepodge of rules that are not only inconsistent with one another but also in some instances internally inconsistent.

It also should be noted that the penalty is not limited to tax shelters (that is, reportable transactions11 or listed transactions12). Rather, section 6700 focuses on false tax statements made in connection with the promotion of a transaction of any type. Therefore, promoters who have avoided federal or state tax shelter reporting requirements should consider making a disclosure to Connecticut to avoid potentially significant penalties. A decision to make a protective filing simply to avoid a penalty should be weighed against the likelihood that Connecticut will share information obtained under CATSCI with the IRS, triggering a federal section 6700 examination.

Finally, the penalty effective date says the provision is “effective from passage and applicable to any open tax period.”13 It isn’t clear how far back Connecticut intends the provision to reach. Does the phrase “any open tax period” refer to the Connecticut returns of Connecticut investors reporting tax consequences of the transactions covered by section 6700? Or does it mean some statute of limitations on assessment of the penalty?14 The former is the more logical reading of the statute, but the language is ambiguous.

B. Taxpayers

The Connecticut legislation provides understatement penalties and an extended statute of limitations on assessment of tax liabilities attributable to listed transactions.

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5Sec. 6700(a).
6Id.
7Public Act No. 05-116, sec. 1.
8Id.
9Andersen Consulting LLP v. Gavin, 255 Conn. 498, 511 (2001) (ambiguous tax statutes must be resolved in favor of the taxpayer). (For the Connecticut Supreme Court’s decision, see Doc 2001-8984 or 2001 STT 63-5.)
10State of Connecticut Department of Revenue Services, AN 2005(15) (Sept. 13, 2005).
11Sec. 6707A(c)(1) (defining reportable transactions); IRS Notice 2004-80 (defining reportable transactions to include transactions described in Treas. reg. section 1.6011-4(b)(2)-(7)).
12Sec. 6707A(c)(2) (defining listed transactions); IRS Notice 2004-67 (most updated listing of listed transactions).
13Public Act No. 05-116, sec. 1.
14Under federal law there is no statute of limitations on assessment of the section 6700 penalty. Capozzi v. United States, 989 F.2d 1290 (2d Cir. 1993) (holding that no statute of limitations applies to the assessment of the section 6700 penalty).
1. Penalty

Through a series of amended sections, Connecticut has enacted a penalty for failure to disclose a listed transaction on the taxpayer’s federal income tax return. The penalty is 75 percent of the Connecticut income tax deficiency attributable to the failure to disclose the item on the taxpayer’s federal return. From a policy and legal standpoint, the decision of the state to penalize noncompliance with federal law seems questionable.

While federal law imposes a penalty for failure to disclose a listed transaction on the taxpayer’s return, the penalty is a specific penalty, whereas the Connecticut penalty is an ad valorem penalty. That is, federal law imposes a flat $100,000 or $200,000 penalty (depending on whether the taxpayer is a natural person), while Connecticut imposes the penalty on the deficiency “due to the failure to disclose” the listed transaction. The link between the failure to disclose and the deficiency is imprecise; it is not the failure to file a required disclosure form that causes the deficiency, but rather it is the taxpayer’s incorrect tax position that causes the understatement of tax. The plain language of the Connecticut statute prevents a reading of the statute to simply compute the penalty on the deficiency attributable to the listed transaction. To do so would mean reading the phrase “is due to failure to disclose” out of the statute, in violation of basic statutory interpretation principles. Therefore, it is unclear how the penalty will operate in practice.

2. Statute of Limitations

Connecticut also has adopted an extended statute of limitations on the mailing of a notice of deficiency assessment. Under the new provision, if a taxpayer fails to disclose a listed transaction on the taxpayer’s federal tax return, Connecticut may mail the taxpayer a notice of deficiency assessment “at any time not later than six years after the [Connecticut tax return] was filed.” The Connecticut statute does not make clear whether the extended limitations period applies only to deficiencies attributable to the listed transaction, or whether the statute is extended for all items on that return. Federal law, by contrast, provides that when a listed transaction is not disclosed on the taxpayer’s return the statute of limitations is extended “with respect to such transaction.” The Connecticut statute is sufficiently vague as to permit the taxpayer to argue that the extended limitations period should apply only to the deficiency attributable to the listed transaction.

III. Minnesota

Minnesota recently enacted tax shelter legislation. Based on the federal model, the Minnesota legislation uses a three-pronged approach to identify potentially abusive transactions: registration, list maintenance, and tax return disclosure.

The general effective date of the legislation is the day following final enactment (effective July 14, 2005). The new rules apply to “tax shelters,” which are defined as “any reportable transaction as defined under section 6707A(c)(1) of the Internal Revenue Code.” The legislation, however, limits the application of the new rules to tax shelters (1) organized, doing business, or deriving income from sources in Minnesota, or (2) having one or more investors that are Minnesota individual income or corporate franchise taxpayers. The Minnesota legislation applies all definitions found in IRC sections 6111, 6112, and 6707A.

A. Promoters

1. Registration

Minnesota law states that “any material advisor required to register a tax shelter under section 6111 of the Internal Revenue Code must register the shelter with the commissioner.” The material adviser must send a duplicate of the federal registration information, in addition to any information required by the Minnesota commissioner of revenue.

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16Section 6707A(a), (b)(2).
20Section 6501(c)(10).

222005 Minn. Laws, 1st Spec. Sess., ch. 3, art. 8, section 2.
23Minn. Stat. section 289A.121, subd. 2(b). Section 6707A defines a reportable transaction as “any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary [of the Treasury] determines as having a potential for tax avoidance or evasion.” IRC section 6707A(c)(1) (2005).
24Minn. Stat. section 289A.121, subd. 1.
25Minn. Stat. section 289A.121, subd. 2(a). Section 6111 defines material advisor, threshold amount, and reportable transaction by cross reference to section 6707A(c). See section 6111(b). Section 6112 does not contain any definitions. Section 6707A defines reportable transaction and listed transaction. See IRC section 6707A(c).
26The reference to section 6111 should be read as a reference to section 6111 as it existed on the date of enactment of the Minnesota legislation. As part of the same piece of legislation, albeit a different section, the Minnesota Legislature defined the term “Internal Revenue Code” to mean “the Internal Revenue Code of 1986, as amended through April 15, 2005.” Minn. Stat. section 289A.02, subd. 7. Therefore, the reference in section 289A.121, subd. 3(a) to “section 6111 of the Internal Revenue Code” should be read to mean section 6111 as amended of April 15, 2005.
27Minn. Stat. section 289A.121, subd. 3(a).
“not later than the day on which interests in that tax shelter are first offered for sale to Minnesota taxpayers.” 28 The Minnesota law also provides that any listed transaction must be registered 29 with the Department of Revenue “by the latest of: (1) 60 days after entering into the transaction; (2) 60 days after the transaction becomes a listed transaction; or (3) October 15, 2005.” 30

2. Failure-to-Register Penalty
The legislation provides a penalty for failure to register a transaction. The law states that “a material adviser who fails to register a tax shelter, including providing all of the required information under section 289A.121, on or before the date prescribed or who files false or incomplete information with respect to the transaction is subject to a penalty of $50,000.” 31 If the transaction is a listed transaction, the penalty increases to the greater of $200,000 or 50 percent (75 percent if the failure to register is intentional) of the gross income the material adviser derived from the transaction. 32 The penalty for failure to register may be abated if the transaction is not a listed transaction and if “abating the penalty would promote compliance” with the tax law. 33 A decision by the commissioner whether or not to abate a penalty “may not be reviewed in any judicial proceeding.” 34

As the legislation is structured, the penalties for failure to register, maintain a list, and make a return disclosure are included in the same section. 35 It “is effective for taxable years beginning after December 31, 2000.” 36 The penalties for failure to register and failure to make a return disclosure “for taxable years beginning before January 1, 2005 . . . apply only if disclosure or registration was not made by October 15, 2005.” 37

The penalty provision related to registration, list maintenance, and return disclosure is effective for tax years beginning after December 31, 2000. It is unclear whether the triggering event must be a transaction entered into after December 31, 2000, a transaction offered to Minnesota taxpayers after 2000, a taxpayer receiving a tax benefit after 2000, or some other event.

This effective date provision is also curious because the list maintenance and return disclosure rules specifically apply to transactions entered into after December 31, 2001. For a calendar year taxpayer, for example, this would mean that tax year 2002 is the earliest year for which a return disclosure obligation could arise and for which a penalty for failure to do so could apply. Therefore, at least for the list maintenance and return disclosure provisions, it would appear to be a legal impossibility that there could be a penalty for a transaction entered into between December 31, 2000, and December 31, 2001.

3. List Maintenance
As noted above, Minnesota has enacted list maintenance provisions similar to those enacted by California and Illinois, modeled at least in part on section 6112. The first Minnesota list maintenance provision states that “any person required to maintain a list under section 6112 of the Internal Revenue Code with respect to any reportable transaction must furnish the list to the commissioner not later than when required under federal law.” 38 The second section provides a specific rule for listed transactions:

For transactions entered into on or after December 31, 2001, that become listed transactions at any time, the list must be furnished to the commissioner by the latest of:

1. 60 days after entering into the transaction;
2. 60 days after the transaction becomes a listed transaction; or
3. October 15, 2005. 39

The language of the Minnesota statute is almost identical to the California and Illinois list maintenance statutes. 40

4. List Maintenance Penalty
Although the Minnesota statute purports to require production of an investor list on the happening of a certain event (such as entering into the transaction or the transaction becoming a listed transaction), the state does not impose a penalty for failure to comply with the “spontaneous” list production

38Minn. Stat. section 289A.121, subd. 6(a).
39Minn. Stat. section 289A.121, subd. 6(b) (2005).
40Cal. Rev. & Tax. Code section 18648(c)(3) (“For transactions entered into on or after February 28, 2000, that become listed transactions . . . at any time, the lists shall be provided to the Franchise Tax Board by the later of: (A) Sixty days after entering into the transaction; (B) Sixty days after the transaction becomes a listed transaction; (C) April 30, 2004”; 35 Ill. Comp. Stat. 5/1405.6(b) (“For transactions entered into on or after February 28, 2000 that become listed transactions . . . at any time, the list shall be furnished to the Department by the later of (i) 60 days after entering into the transaction, (ii) 60 days after the transaction becomes a listed transaction, or (iii) December 31, 2004”).
requirement. The only penalty in the Minnesota legislation related to list maintenance states:

A material advisor required to maintain or provide a list under section 289A.121, subdivision 6, is subject to a penalty equal to $10,000 for each day after the 20th day that the material advisor failed to make the list available to the commissioner after written request for that list was made. No penalty applies for a failure on any day if the failure is due to reasonable cause.\(^{41}\)

Further, as indicated above, the effective date provision of the penalty provision is inconsistent with the list maintenance provision.

5. Enhanced Promoter Penalty

Minnesota has imposed a penalty for promoting abusive tax shelters based on section 6700 since 1991, although there are no reported cases imposing the penalty. Minnesota now has enhanced the penalty for false or fraudulent statements in promotion of a transaction, if the false or fraudulent statement is made by a material adviser.\(^{42}\) Under prior law, the penalty was the greater of $1,000 or 20 percent of the gross income derived by the promoter.\(^{43}\) Now material advisers will be penalized the greater of $1,000 or 50 percent of the gross income derived from the promotional activity.\(^{44}\)

6. Aiding-and-Aiding Liability

Minnesota has added a penalty for aiding and abetting understatement of tax based on section 6701.\(^{45}\) The penalty is imposed on any person who aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim or other document if that person knows or has reason to believe that the document will be used in connection with any matter under Minnesota individual income or corporate franchise tax and will result in understatement of tax for another person.\(^{46}\) The penalty will apply whether or not the taxpayer is aware of or consented to the understatement.\(^{47}\)

The penalty is $1,000 if the understatement relates to an individual, and $10,000 if the understatement relates to a corporation.\(^{48}\) The burden of proving that a person is liable for the penalty is on the commissioner.\(^{49}\) The aiding-and-abetting penalty is in addition to any other penalty, except that it will not apply if the penalty for promoting abusive tax shelters applies.\(^{50}\)

B. Taxpayers

The legislation requires taxpayers to fulfill disclosure obligations, imposes penalties for failure to comply with those obligations, and provides for extended statutes of limitations on assessments on tax shelter-related liabilities.

1. Disclosure

Minnesota also imposes return disclosure requirements on Minnesota return filers. Under the new law, a taxpayer must file a copy of its federal reportable transaction disclosure statement with its Minnesota return.\(^{51}\) Similarly, any taxpayer\(^{52}\) that is a member of a unitary business group that must make a disclosure to the IRS must file a disclosure with Minnesota.\(^{53}\)

The statute provides several different timing provisions for disclosure. For transactions in which the taxpayer participated during tax years ending on or after December 31, 2005, the disclosure statement must be filed in the time and manner provided under federal regulations. Generally speaking, that means the disclosure statement must be attached to the tax return for each tax year in which the taxpayer participates in a transaction. Moreover, if a taxpayer entered into a transaction at any time after December 31, 2001, and the transaction subsequently becomes a listed transaction, the taxpayer must attach a disclosure statement to its next filed return, even if it did not participate in the transaction during that tax year.\(^{54}\) For transactions in which the taxpayer participated in a tax year ending before December 31, 2005, the taxpayer’s disclosure “must be made by the due date of the first return required [under Minnesota law] that occurs” after September 13, 2005.\(^{55}\)

The legislation also provides exceptions to the general disclosure rule for certain transactions entered into between January 1, 2002, and December

\(^{41}\)Minn. Stat. section 289A.60, subd. 26(e).

\(^{42}\)Minn. Stat. section 289A.60, subd. 20(b).

\(^{43}\)Minn. Stat. section 289A.60, subd. 20(a)(2).

\(^{44}\)Minn. Stat. section 289A.60, subd. 20(b).

\(^{45}\)Minn. Stat. section 189A.60, subd. 20a.

\(^{46}\)Minn. Stat. section 189A.60, subd. 20a(a).

\(^{47}\)Minn. Stat. section 189A.60, subd. 20a(d).

\(^{48}\)Minn. Stat. section 189A.60, subd. 20(a).

\(^{49}\)Minn. Stat. section 189A.60, subd. 20(a).

\(^{50}\)Minn. Stat. section 189A.60, subd. 20a(f).

\(^{51}\)Minn. Stat. section 289A.121, subd. 5(a).

\(^{52}\)Minnesota law defines a taxpayer as “a person subject to, or liable for, a tax or fee imposed by a law administered by the [Minnesota Commissioner of Revenue (“commissioner”)]; a person required to file a return, information return, or report, with respect to, or to pay, or withhold or collect and remit, a tax or fee imposed by a law administered by the commissioner; a person required to obtain a license or a permit under a law administered by the commissioner; or a person required to keep records regarding a tax or fee imposed by a law administered by the commissioner.” Minn. Stat. section 270C.01.

\(^{53}\)Minn. Stat. section 289A.121, subd. 5(b).

\(^{54}\)Minn. Stat. section 289A.121, subd. 5(c) (referred to Treas. reg. section 1.6011-4(e)).

\(^{55}\)Minn. Stat. section 289A.121, subd. 5(c).
31, 2005, for which amended returns have been filed. Disclosure will not be required, if “the taxpayer has filed an amended income tax return which reverses the tax benefits of the tax shelter transaction.” Disclosure also is not required if “as a result of a federal audit the [IRS] has determined the tax treatment of the transaction and an amended return has been filed to reflect the federal treatment.”

2. Penalties

Minnesota now imposes the same penalties as federal law for failure to disclose reportable transactions; these penalties are the highest in any state. An individual who fails to disclose a reportable transaction must pay $10,000; the penalty climbs to $100,000 if the transaction is a listed transaction. The penalty is imposed without regard to the size of the tax benefit received by the taxpayer. For any other taxpayer, the penalty ranges from $50,000 for a reportable transaction to $200,000 for a listed transaction.

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The legislation provides special rules limiting penalties on unitary businesses. If one or more members of a unitary business fail to make a required tax shelter disclosure, they will be assessed the “regular” penalty ($50,000 to $200,000), plus an additional $500 for each member, up to a maximum additional penalty of $25,000. Therefore, the maximum penalty for a unitary business’s failure to make a required disclosure to Minnesota is $225,000, assuming the transaction is a listed transaction.

3. Extended Statute of Limitations

Minnesota law now provides extended statutes of limitations on assessment of tax arising from items related to undisclosed reportable and listed transactions. If a taxpayer fails to file a required disclosure statement related to a reportable transaction, Minnesota law now provides that the commissioner may recompute the tax for items associated with that transaction within six years after the return was filed.

The law provides what amounts to a tolling provision for listed transactions. If the transaction is a listed transaction and the taxpayer fails to disclose it, the commissioner may recompute tax associated with that transaction. If the commissioner determines the transaction and an amended return has been filed to reflect the federal treatment.

It is clear that multistate taxpayers and material advisers can’t take a one-size-fits-all approach to complying with state tax shelter rules.

Minnesota courts will look to similar federal or other state legislation in interpreting Minnesota law and will assume that those statutes “were available as models to [the Minnesota] legislature when it drafted” the statute in question. If the

56 Minn. Stat. section 289A.60, subd. 26(d)(1).
57 Id.
58 Minn. Stat. section 289A.60, subd. 26(d)(2).
59 Id.
60 Minn. Stat. section 289A.121, subd. 5(d).
61 Minn. Stat. section 289A.38, subd. 16(a)(1), (b).
62 Minn. Stat. section 289A.38, subd. 16(a)(2), (b).
language of the Minnesota statute materially differs from a previously enacted statute of another jurisdiction that the Legislature appears to have considered, the court may conclude that the Legislature intended to reject the standards in the other jurisdiction's statute.64

Applying those principles suggests two possible interpretations of the Minnesota provision. First, Minnesota could intend that tolling ceases when the material adviser registers, maintains a list, or produces a list to the commissioner. Second, the statute could be read to require registration, list maintenance, and list production. When a tax statute is subject to two interpretations, any doubt must be resolved in favor of the taxpayer, suggesting that the former interpretation is correct.65

IV. Conclusion

It is clear that multistate taxpayers and material advisers can’t take a one-size-fits-all approach to complying with state tax shelter rules. Each state has taken a somewhat different approach, and there is little guidance available to interpret sometimes confusing statutes. Because the penalties for non-compliance are so high, taxpayers and material advisers must carefully evaluate their reporting obligations and monitor developments, since other states are likely to develop similar reporting regimes.

65 See, e.g., BCBSM Inc. v. Comm’r, 663 N.W.2d 531, 533 (Minn. 2003); Apple Valley Red-E-Mix Inc. v. State, 352 N.W.2d 402, 406 (Minn. 1984); and Benda v. Girard, 585 N.W.2d 422, 425 (Minn. Ct. App. 1998). (For the Minnesota Court of Appeals’ decision in Benda v. Girard, see Doc 98-31897 or 98 STN 211-14.)