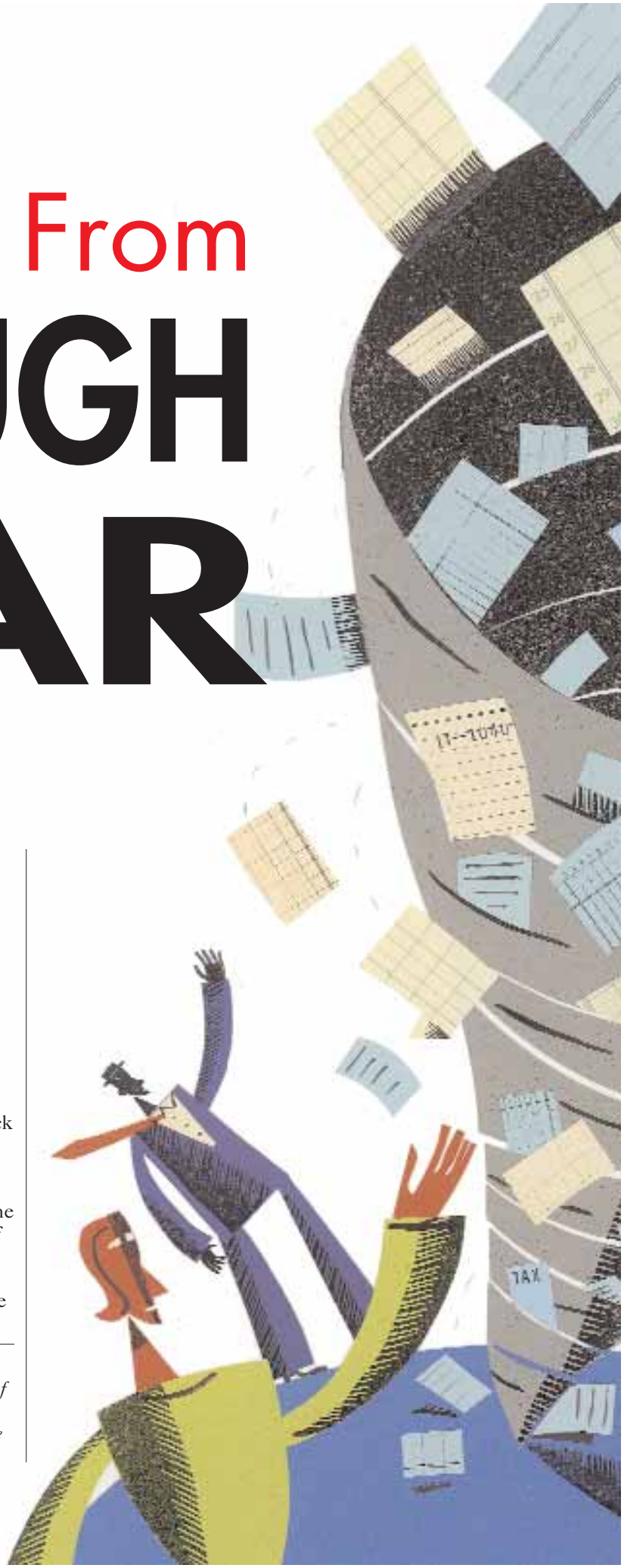
# Tax Issues From A TOUGH YEAR




## Tax Measures Implemented in the Wake of Last Year's Terrorist Attacks Are Likely to Have Widespread Impact

SAMUEL L. BRAUNSTEIN AND CAROL F. BURGER

NOT EVEN TAX LAW WAS IMmune from the troubles of the past year.

Throughout that period, the economic climate has been unstable and the stock market has resembled a roller coaster ride. Making matters worse, the Enron scandal that exploded in the fall of 2001 was merely a precursor to a steady stream of corporate wrongdoing and collapses.

And all of those events have unfolded under the continuing cloud of anxiety and uncertainty triggered by the terrorist attacks on Sept. 11, 2001.

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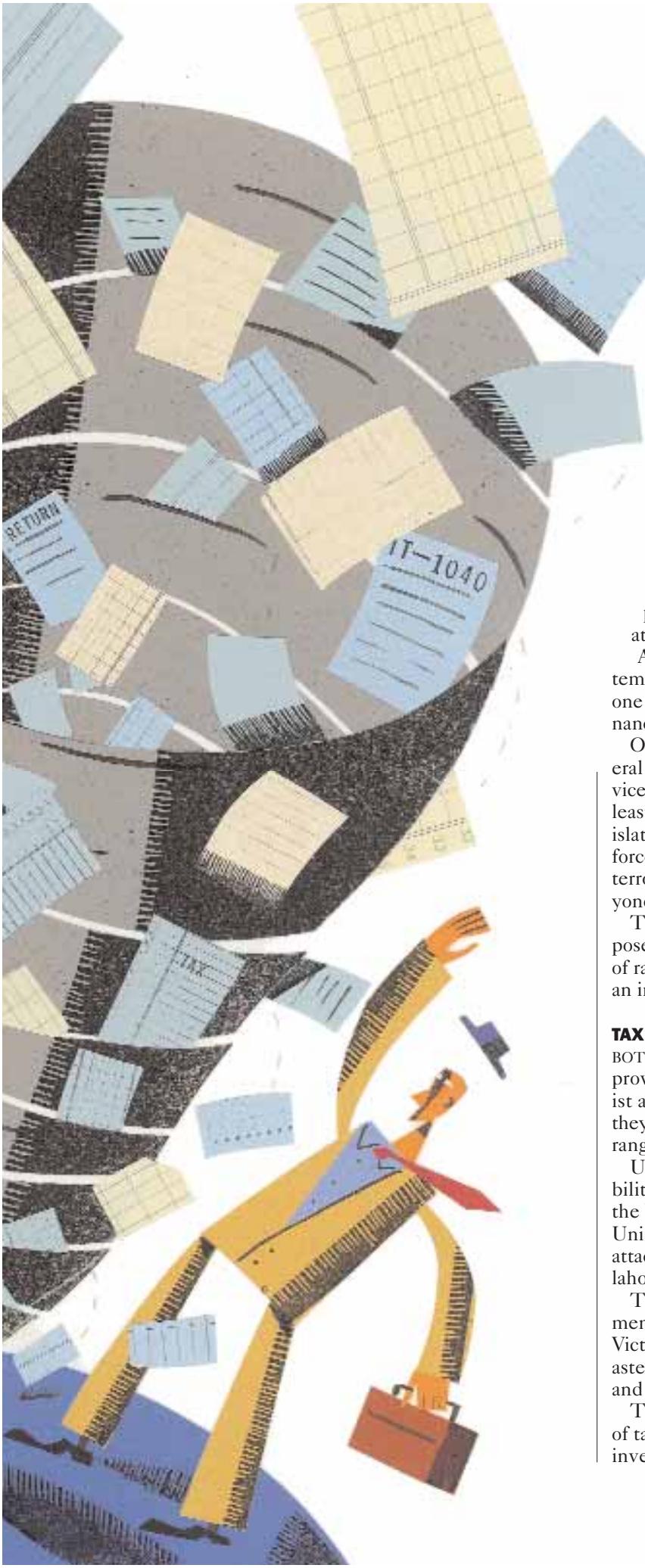


It was impossible for the federal tax system to remain unchanged in light of developments of such magnitude.

Many of these changes reflect an attempt to marshal the power of the tax system, along with other legal mechanisms, in the fight against terrorism. In other cases, changes have been made in the tax laws or regulations to soften the impact on victims of the attacks.

Two of the most significant pieces of tax legislation in the past year or so are the Victims of Terrorism Tax Relief Act of 2001, and the Job Creation and Worker Assistance Act of 2002. Both acts were passed by Congress in direct response to the Sept. 11 attacks.

And the USA Patriot Act of 2001 enlisted the tax system in efforts to combat money laundering, considered one of the primary tools used by terrorist groups to finance their activities.

On a broader level, these and other changes in the federal tax system suggest that the Internal Revenue Service has entered a new era of stricter enforcement, at least in some areas. And while much of the new tax legislation and regulations are intended to strengthen enforcement efforts against activities that can bolster terrorist groups, their impact is likely to be felt far beyond that realm.

The changes also illustrate the principle that the purpose of the tax system reaches far beyond the simple job of raising money for government. Rather, it also serves as an important tool for carrying out larger policy goals.

## TAX RELIEF FOR VICTIMS

BOTH THE TAX RELIEF ACT AND THE JOB CREATION ACT provide various forms of relief to survivors of the terrorist attacks and the families of those who were killed. But they also contain provisions that will affect a much broader range of taxpayers.

Under the victims tax relief act, federal income-tax liabilities were forgiven for persons killed in the attacks on the World Trade Center and the Pentagon, the crash of United Airlines Flight 93 in Pennsylvania, and the 1995 attack on the Alfred P. Murrah Federal Building in Oklahoma City.

The act addresses several other issues, including treatment—for tax purposes—of payments from the Sept. 11 Victim Compensation Fund of 2001, certain types of disaster relief payments, disability payments, death benefits and estate taxes.

The victims tax relief act also increases the availability of tax return information to police and security agencies investigating terrorist activities.

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were directly affected by the attacks on the World Trade Center. For employers in these areas, the credit is available for wages paid to both new hires and existing employees. Taxpayers in these areas will not be required to provide certification for wages they paid in order to qualify for the credit. The credit is allowed against the alternative minimum tax.

*Specific tax incentives for the New York City area.* Provisions that apply to this specific region include expansion of work opportunity tax credits, special depreciation allowances, authorization to issue special tax-exempt bonds for rebuilding facilities damaged in the terrorist attacks, more liberal treatment of expenses for business property, and extension of time allowed to replace damaged business items.

*Special bonds.* During calendar years 2002, 2003 and 2004, an aggregate amount of $8 billion of tax-exempt private activity bonds is authorized for issuance to finance the construction and rehabilitation of real property in a designated portion of New York City.

*Expensing business property.* The amount a taxpayer can deduct under Section 179 of the IRC for qualifying property is the amount normally allowable, increased by the lesser of 1) $35,000; or 2) the cost of qualifying property purchased and used during the taxable year.

*Involuntary conversions.* The replacement period is extended to five years for a taxpayer to purchase qualifying property to replace property that was destroyed within specific portions of New York City as a result of the terrorist attacks.

In addition to the tax relief provided by the job creation act, the Treasury Department and the IRS have taken positive steps to assure that the spirit of the law as well as the letter will prevail in assessing and rectifying at least a portion of the damage that resulted from the attacks.

On Aug. 22, for instance, the Treasury Department announced in Notice 2002-60 that taxpayers affected by the attacks who sold homes within two years after buying them will still be able to exclude some of their gain from taxable income. "This guidance provides clarification, and reassurance, that those affected by the Sept. 11 terrorist attacks are entitled to exclude the gain from the sale of their principle residence," stated Pamela F. Olson, acting treasury assistant secretary for tax policy, when the notice was issued.

The IRS has issued Publication 3920—Tax Relief for Victims of Terrorist Attacks—which explains in detail many of the provisions of the act.

The job creation act, while providing certain special relief to Sept. 11 victims, is intended primarily to be an economic stimulus package that includes extensions of unemployment benefits and an estimated $43 billion in tax reductions.

These are key provisions in the job creation act:

*Special depreciation.* For certain qualified property defined in the act, there is an additional first-year depreciation deduction equal to 30 percent of the property's adjusted basis. That deduction is allowed in conjunction with the alternative minimum tax as well as regular taxes.

*Net operating losses.* The Internal Revenue Code allows a taxpayer to "carry back" net operating losses from a business from the current year to the immediately preceding years. The job creation act temporarily extends the general net operating-loss carry-back period from two years to five. A taxpayer may elect not to use the carry-back provisions, but that decision is irrevocable. In addition, qualifying net operating-loss deductions involving tax years that end during 2001 and 2002 may be used to offset 100 percent of a taxpayer's income subject to the alternative minimum tax.

*Discharge of debt.* Income from the discharge of indebtedness of a Subchapter S corporation that is excluded from the corporation's income is not taken into account as an item of income by a stockholder and, accordingly, does not increase the basis of the stock.

*Teachers' expenses.* Qualifying educators are eligible to deduct from their gross income, as opposed to taking as an itemized deduction, up to $250 that they paid or incurred to obtain books, supplies, computer equipment and supplementary materials used in the classroom.

*Work opportunity tax credit.* The work opportunity tax credit will be available to taxpayers with employees that are located specifically in areas of New York City that

## CLEANING UP MONEY LAUNDERING

CONGRESS ALSO IS USING THE TAX SYSTEM AS ONE OF ITS weapons in a stepped-up campaign against money laundering in the wake of the Sept. 11 attacks.

"Money laundering" means different things to different people, depending on the context in which the subject is addressed. The common element of all definitions, however, is the attempt to disguise the illegal ori-

gin of money by processing the funds in a manner whereby criminals are able to enjoy their profits without jeopardizing their source.

The International Monetary Fund estimates that money laundering makes up between 2 percent and 5 percent of the world's gross domestic product—somewhere between $590 billion and $1.5 trillion annually—with up to half of those amounts entering U.S. financial markets.

How to catch a terrorist? How to catch a criminal? No matter whether it is a bin Laden, a phony charity, a mobster or just someone trying to beat an alimony payment, following the money trail often can lead to the perpetrator. Currently, all transfers of more than $10,000 into or out of the United States must be reported to the federal government. In addition, there are many circumstances in which financial institutions are required to report fund deposits and/or transfers.

Now the USA Patriot Act, which President Bush signed into law in October 2001, has broadly expanded the surveillance and investigative powers of law enforcement agencies. (The law's formal title is the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001.) It also creates a new relationship between domestic criminal investigations and foreign intelligence efforts.

Consider these powers along with those created by the tax relief act, which gives law enforcement agencies greater access to tax returns and related information for purposes of investigating terrorist activities. It is evident Congress intends to use these laws to empower the Treasury Department to prevent any party that participates in money laundering, including governments and private institutions, from being a part of the U.S. market.

This new emphasis is likely to help the Treasury continue its string of recent successes in reaching significant tax-information exchange agreements with major offshore financial centers.

One of the difficulties in negotiating with other countries regarding money laundering and information exchange revolves around the question of whether certain types of activities amount to "tax crimes" in both the United States and the other country. Many countries do not have income taxes, for instance, so there can be no evasion.

Moreover, countries do not normally enforce the tax laws of other states unless there is a special agreement between them to do so.

The U.S. government is bringing both political and financial pressure on other countries to change those circumstances. At the same time, the government is seeking to regulate more effectively the activities of domestic financial institutions in dealing with counterparts in such "noncomplying" countries.

While these efforts may produce some positive results, other tools may be necessary, as well. They include legislation making money laundering a crime, authorization of appropriate agencies to trace (and seize) criminally obtained assets, and establishment of an international infrastructure that allows government agencies to freely exchange information among themselves and their foreign counterparts.

There has been substantial publicity in the wake of the terrorist attacks concerning charitable groups in the United States raising millions of dollars annually for various militant movements and organizations. The use of charities as a device to launder money, evade taxes or hide terrorist financing is not new, either in the United States or elsewhere.

In light of that, current negotiations among the United States and other countries regarding money laundering might well include discussions about the evolution of charities as an implementing tool for such activities, as well as how nations should deal with those activities in the future.

## CHASING DOWN TAX SHELTERS

THE INTERNAL REVENUE SERVICE HAS TAKEN A DIM VIEW of tax shelters for some time, and the Tax Reform Act of 1986 put a crimp on them by restricting the way taxpayers may declare losses from them.

The IRS stepped up its attacks on tax shelters—corporate ones in particular—more than two years ago.

In March 2000, the Treasury issued temporary regulations requiring corporate taxpayers that participate in tax-shelter transactions to attach a disclosure statement to their tax returns.

The first category of tax-shelter transaction for which reporting was required encompassed transactions that the IRS listed as tax shelters (by notice, regulation or other published guidance), though reporting was only required if the expected tax benefit exceeded $1 million in any year or $2 million over a number of years.

New regulations issued in June 2002 expanded this disclosure requirement to include noncorporate taxpayers, and the dollar threshold for these "listed transactions" was eliminated.

The second category of tax-shelter transaction requiring reporting applies only to corporations. A corporate taxpayer must attach a disclosure statement if it participates in a transaction that has certain specified characteristics of a tax shelter (even though it's not listed by the IRS).

However, reporting is required only if the expected tax benefit from the transaction exceeds $5 million in any taxable year or $10 million over a number of years.

Promoters of listed tax shelters and other confidential tax shelters must register them with the IRS prior to sale and must maintain lists of all persons who acquire interests in each shelter. The IRS has been adding tax shelters to its listed transactions as it becomes aware of them. Certain transactions that do not technically qualify as tax shelters also have been attacked, including one involving split-dollar insurance that was designed to avoid estate


and gift taxes rather than income taxes.

In Announcement 2002-2, issued last December, the IRS provided a 120-day opportunity for taxpayers to voluntarily come forward and disclose tax shelters and other questionable items reported on their returns, thus becoming eligible for penalty waivers. The IRS reported that it received some 1,600 disclosures under this initiative, far more than expected and involving billions of dollars in reported losses and deductions.

The IRS also is cracking down on taxpayers who maintain unreported offshore accounts and in many cases access those accounts using credit or debit cards.

As part of its effort, the IRS has issued John Doe summonses on MasterCard, Visa and American Express to obtain records of U.S. taxpayers with offshore accounts, particularly those held in tax-haven countries.

Most recently, the IRS successfully petitioned a federal court in August for approval to serve its second John Doe summons on MasterCard International, covering records for the years 1999-2001 on cards issued in more than 30 tax-haven countries. This action follows a successful petition in March for a similar John Doe summons on VISA International.

Based on data obtained from earlier summoned information, the IRS has estimated that between 1 million and 2 million U.S. citizens may have debit or credit card accounts with offshore banks, whereas only 170,000 taxpayers reported foreign bank accounts on their tax returns for 2000.

Credit card companies are not the only ones being summoned. In July, the IRS filed suit against two accounting firms—KPMG and BDO Seidman—to enforce summonses seeking information relating to tax shelters marketed by the firms. According to IRS chief counsel B. John Williams, this was the first time that any tax-shelter enforcement action was brought against a large accounting firm. He indicated in an interview with the Bureau of National Affairs that the lawsuits were intended to send a message that the IRS is serious about tax-shelter enforcement. 132 Daily Tax Report GG-6 (July 10, 2002).

The IRS took another step earlier this year in its efforts to attack tax shelters more effectively when it announced that it would begin exercising a long-unused power to seek certain work materials from accountants.

Eighteen years ago, the U.S. Supreme Court affirmed in *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984), the IRS' right to obtain accountants' tax-accrual workpapers in the course of an audit.

Tax-accrual workpapers are not the same as tax-return workpapers. Rather, they represent an accountant's determination of the risk of a successful challenge to a reported position, and they can give the IRS a blueprint to the accountant's thinking regarding the client's position on a particular tax issue.

Say, for example, that a taxpayer reports a tax loss of $1 million on the return. The accountant concludes that the tax position underlying the loss deduction has only a 50 percent chance of being sustained, and may require the taxpayer to set up (accrue) a $500,000 reserve on its balance sheet. The materials used by the accountant to reach that conclusion are the tax-accrual workpapers.

## IRS STEPS LIGHTLY

DESPITE ITS SUPREME COURT VICTORY, THE IRS—RECOGnizing that this was a sensitive issue—imposed its own restrictions on requesting audit and tax-accrual workpapers. Under Internal Revenue Manual procedures, accountants' workpapers were not to be requested as standard procedure; they were only to be requested when the factual data supporting a return could not be obtained from the taxpayer's records.

These restrictions reflected an IRS concern that both the client's openness in communicating with its accountant and the accountant's obligation to act in accordance with conservative accounting principles might be jeopardized if these workpapers were routinely requested.

Earlier this year, however, in Announcement 2002-63, the IRS stated that for returns filed on or after July 1, 2002, it will routinely request the tax-accrual workpapers for any "listed transaction" (as described above) that is properly disclosed on a return. If the taxpayer fails to disclose a listed transaction, the IRS will routinely request all tax-accrual workpapers.

In addition, as a discretionary matter, the IRS will request all tax-accrual workpapers if tax benefits are claimed from multiple listed transactions. This will be done regardless of whether the tax benefits are disclosed or whether there are reported financial-accounting irregularities—such as those requiring a restatement of earnings—in connection with the examination of a return claiming benefits from a disclosed listed transaction.

For returns filed prior to July 1, the IRS may at its discretion request tax-accrual workpapers pertaining to a listed transaction that a taxpayer failed to disclose.

After several years of criticizing the IRS for overzeal-

ousness in its enforcement efforts, Congress now seems to have switched gears. Legislators have criticized corporations that take advantage of loopholes to reduce taxes, calling them "corporate traitors" and arguing that in the current wartime atmosphere it is unpatriotic for corporations to avoid paying their fair share in taxes. Congressional interest in the corporate tax-shelter area seems to have been piqued by the spate of publicity given to a maneuver known as the "Bermuda inversion."

Under this transaction a U.S. company reincorporates as a foreign corporation (Bermuda is often selected because of its favorable tax laws), with its U.S. operations held in a subsidiary. The parent corporation is able to avoid U.S. taxes on its non-U.S. income and, by making tax-deductible ("earnings stripping") payments to its foreign parent, the U.S. subsidiary can reduce its own taxes.

**PUBLIC DISCLOSURE**

Although U.S. corporations have been reincorporating in Bermuda and other low-tax jurisdictions for some time, these transactions have only now been brought to the attention of the general public. The negative publicity, combined with proposed legislation aimed at restricting the practice, seems to have stopped some of these transactions. Stanley Works Corp. recently abandoned its plans to reincorporate in Bermuda, and the consulting unit of PricewaterhouseCoopers agreed to be acquired by IBM, thus canceling its plans to operate as a Bermuda corporation named Monday Ltd.

Several anti-tax-shelter bills are now making their way through Congress. Certain bills would deny the intended tax benefits of inversion transactions by treating the top-tier foreign corporation as if it were a U.S. company under the Internal Revenue Code. Other bills would make it more difficult to "earnings strip" by denying or deferring deductions and additions to basis on payments by the U.S. subsidiary to its foreign related parties.

Yet other bills would go outside the IRC to deter inversion transactions through such steps as denying certain federal contracts to expatriated companies. Expatriated companies that received millions of dollars in federal contracts during fiscal 2001 include Foster-Wheeler, Accenture Consulting, Tyco and Ingersoll-Rand. See 145 DTR G-4 (July 29, 2002).

Accenture (formerly part of Arthur Andersen) in particular has been reported in the press to have been lobbying heavily against the proposed legislation—at least to the extent that the legislation would apply to it—on grounds that it was not an American company, but rather a global company with a presence in 47 countries long before it incorporated in Bermuda.

Some of the proposed anti-tax-shelter bills would go beyond just shutting down Bermuda inversion transactions. The Tax Shelter Transparency Act (S. 2498), for instance, would strengthen the IRC's disclosure regime and impose new sanctions on noncompliance. The American Competitiveness Act of 2002 (H.R. 5095) contains similar provisions in addition to others intended to reduce the incentive for U.S. companies to incorporate overseas.

While it is far from certain which, if any, of these bills will ultimately become law, it is clear that combating tax shelters has moved to the front burner. Both Congress and the IRS can be expected to make this a priority in the months, if not years, to come. ■