

TAX AVOIDANCE TRANSACTIONS AND REPORTING REQUIREMENTS IN NEW YORK

December 27, 2006

The New York State Department of Taxation and Finance (the “Department”) recently adopted a new regulation regarding various tax avoidance transactions. The New York State Legislature amended the Tax Law in 2005 to impose reporting requirements on taxpayers engaged in potential tax avoidance schemes (See N.Y. Tax Law § 25). Most of these reporting requirements piggyback off of federal reporting requirements (i.e., if a taxpayer must report a transaction to the IRS, then they must also report it to the Department). However, the Tax Law also imposes reporting requirements that are specific to New York. If a taxpayer participates in a targeted tax avoidance transaction, the regulation requires the taxpayer to file a disclosure form highlighting such participation.

New York Reportable Transactions

The regulation defines the term “New York Reportable Transaction” (“NYRT”) as a transaction that has the potential to be a tax avoidance transaction under Articles 9, 9-A, 22, 32 and 33 of the Tax Law. Taxpayers who engage in NYRTs must report the transaction to the Department for its review. The new regulation requires a taxpayer to disclose its participation in an NYRT with its tax return for the taxable year it has participated in such NYRT. This rule is designed to help the Department curtail the use of allegedly abusive tax shelters.

The regulation establishes three broad categories of NYRTs:

1. New York Listed Transactions;
2. New York Confidential Transactions;
3. New York Transactions with Contractual Protection.

New York Listed Transactions

A “New York Listed Transaction” is a transaction that is the same or substantially similar to one of the transactions that the Commissioner of Taxation and Finance (the “Commissioner”) has determined to be a tax avoidance transaction and identified by notice or other form of published guidance as a New York Listed Transaction. When determining whether a transaction is a tax avoidance transaction, the Commissioner is required to find that one of the following

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conditions are met:

- the transaction is not done for a valid business purpose; or
- the transaction does not have economic substance apart from its tax benefits; or
- the tax treatment of the transaction is based upon an elevation of form over substance.

It does not appear that the Commissioner has designated any transactions as New York Listed Transactions yet. In fact, the Tax Law requires that regulations be established regarding NYRTs prior to the designation of any specific transactions as tax avoidance transactions (See N.Y. Tax Law § 25(a)(4); TSB-M-05(4)I). The regulation became effective on December 27, 2006. It is likely that the Commissioner will soon designate specific transactions as New York Listed Transactions.

New York Confidential Transactions

A “New York Confidential Transaction” is a transaction that is offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a fee. A transaction is “under conditions of confidentiality” if the advisor, who is paid the fee, places a “limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor’s tax strategies.” It is important to note that a transaction can be treated as confidential even if the conditions of confidentiality are not legally binding on the taxpayer.

The regulation also clarifies the fee requirement. The term “fee” includes consideration, in whatever form, for services to analyze the transaction, for services to implement the transaction, for services to document the transaction, and for services to prepare tax returns to the extent that the fees exceed the fees customary for return preparation. Finally, a taxpayer is treated as paying fees to an advisor if the taxpayer knows or should know that the amount it pays will be paid indirectly to the advisor, such as through a referral fee or fee-sharing arrangement.

New York Transactions with Contractual Protection

A “New York Transaction with Contractual Protection” is a transaction for which the taxpayer or a related party has the right to a full or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained. Moreover, a Transaction with Contractual Protection is a transaction for which fees are contingent on the taxpayer’s realization of the tax benefits from the transaction. A transaction is not considered to have contractual protection solely because a party to the transaction has the right to terminate the transaction upon the happening of an event affecting the taxation of one or more parties to the transaction.

General Provisions

The regulation’s reporting requirement applies to any person/entity that is required to file a return or report under articles 9, 9-A, 22, 32 or 33 of the Tax Law. This includes individuals, sole proprietorships, corporations, partnerships, limited liability companies, estates and trusts, partners, shareholders of an S corporation, beneficiaries of an estate or trust, banking corporations, insurance corporations and captive insurance companies and each member of a combined group.

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A taxpayer is deemed to have participated in an NYRT if its tax return reflects a tax benefit deriving from one of the three transaction categories detailed above. The term “tax benefit” is defined to include:

deductions, exclusions, and modifications included in gross receipts, gross earnings, income (including entire net income, gross income, New York source income, New York adjusted gross income), gain, loss, assets, liabilities, total capital, capital stock, tax credits, nonrecognition of gain, status as an entity exempt from New York State taxation, and any other tax consequences that may reduce a taxpayer's New York State tax liability by affecting the amount, timing, character, or source of any such item, amount or activity.

This regulation is applicable to taxable years beginning on or after January 1, 2006. Thus, the first possible disclosure of an NYRT would be by a 2006 calendar year taxpayer with their 2006 tax return due on March 15, 2007. The regulation allows the Commissioner to prescribe the forms and manner in which a taxpayer must disclose an NYRT. The NYRT requirements largely conform to the federal provisions relating to reportable transactions. The structure and content of the regulation is analogous to Treasury Regulation § 1.6011-4. According to the Department, taxpayers will benefit from this parallel design since they are already familiar with the requirements of the federal provisions. The Tax Law imposes potentially significant penalties for nondisclosure (See N.Y. Tax Law § 25(f)(1)).

For the text of the regulation, visit the Department’s website at:

<http://www.tax.state.ny.us/rulemaker/propprocadmin.htm>