Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:F:HAR:POSTF-105581-02
CJSantaniello

date: FEB 01 2002

to: [redacted], Team Manager, LMSB, Group [redacted], [redacted]
Attn: [redacted], Team Coordinator

from: Associate Area Counsel, LMSB, Area 1

ubject: **Large Case Advisory Opinion -** [redacted]

This memorandum responds to your January 28, 2002 verbal request for assistance. This memorandum should not be cited as precedent.

On January 28, 2002, Carmino J. Santaniello of this office attended a strategy meeting in [redacted], [redacted] regarding the Lease-In/Lease-Out (LILO) issue in this case. During the meeting, the examination team requested advice regarding whether the Service should assert accuracy-related penalties under I.R.C. § 6662 against the taxpayer attributable to the anticipated LILO adjustments for the years under audit. For the reasons discussed below, the taxpayer does not qualify for the waiver of the penalties pursuant to the tax shelter disclosure initiative appearing in Announcement 2002-2, 2002 I.R.B. 304, because (1) the initiative does not apply to items known to examiners on or before December 21, 2001, and (2), even it did apply, the taxpayer has not satisfied all of the conditions set forth therein. Consequently, any decision by the examination team regarding the application of the accuracy-related penalties under section 6662 must be based on factors typically considered in connection with that issue.

Issue

Whether the taxpayer qualifies for a waiver of the accuracy-related penalties in accordance with Announcement 2002-2, 2002 I.R.B. 304. **U.I.L. Nos. 162.09-10; 6662.00-00**

Facts

The Service is presently examining the taxpayer's [redacted] and [redacted] Forms 1120 as part of its Coordinated Industry Case (CIC) program. At the opening conference held on [redacted], the examination team verbally solicited from the taxpayer a disclosure statement under Rev. Proc. 94-69, 1994-2 C.B. 804. At that time,

the examiners had neither begun to examine the returns in the current cycle nor were they aware of the taxpayer's participation in any tax shelter, including the LILO transactions.

On [redacted], only six days after the opening conference, the taxpayer provided to the examination team a statement captioned "Statement Furnished under Rev. Proc. 94-69 For Year Ended December 31, [redacted]". In the statement, the taxpayer indicated that during [redacted] two of its subsidiaries participated in a total of [redacted] LILO transactions. It also described the material facts relating to the LILOs transactions and the principal tax benefits derived from those transactions.

Thereafter, as a result of the taxpayer's disclosure statement, the examination team began the necessary factual development of the LILO issues. To date, the examiners have issued approximately [redacted] Information Document Requests (IDRs), to which the taxpayer has promptly and completely complied. In response to the IDRs, the taxpayer has identified the names and addresses of the LILO promoters, and has provided all transactional documents, materials received from the promoters, and most internal documents used by the taxpayer in its decision-making process. The taxpayer has, however, refused to provide documents that it claims to be privileged, including the tax opinion.

The examination team expects to complete the examination of the LILO issue in the near future on an unagreed basis. In addition to disallowing the claimed LILO-related expenses, the examination team is also considering whether to assert the accuracy-related penalties under section 6662 for each year under examination. The team has not, however, commenced the mandatory penalty investigation required by LMSB Division Commissioner Larry R. Langdon's memorandum of December 20, 2001. Additionally, to date, no facts have been developed, other than the taxpayer's participation in the LILO transactions and the claimed LILO-related expenses, that would establish that any penalties are warranted.

Discussion

I.R.C. § 6662(a)[1/] imposes a penalty in an amount equal to 20 percent of the underpayment of tax attributable to one or more of the items set forth in section 6662(b). Two of the items appearing under section 6662(b) include (1) negligence or intentional disregard of rules or regulations, and (ii) any substantial understatement of income tax. Sections 6662(b)(1), (b)(2).

[1/] All statutory section references are to the Internal Revenue Code in effect during the years in question.

The term "negligence" includes a failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. Section 6662(c); Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967), aff'g 43 T.C. 168 (1964); Treas. Reg. § 1.6662-3(b)(1). The term "disregard" includes any careless, reckless or intentional disregard. Section 6662(c).

Under section 6662(d), there is a substantial understatement of income tax for any taxable year if the amount of the understatement exceeds the greater of: (i) 10 percent of the tax required to be shown on the return, or (ii) $5,000 (or $10,000 for corporations other than S corporations). Sections 6662(d)(1)(A), (B). The term "understatement means the excess of the amount of tax required to be shown on the return for the taxable year, over the amount of tax imposed shown on the return. Section 6662(d)(2)(A). Under section 6662(d)(2)(B), the amount of an understatement shall be reduced by that portion of the understatement attributable to:

(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

(ii) any item if -

(I) the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and

(II) there is a reasonable basis for the tax treatment of such item by the taxpayer.

The special rules appearing in section 6662(d)(2)(B) (reducing an understatement attributable to items for which there was or is substantial authority or items adequately disclosed on the return) do not apply to items of a corporation attributable to a tax shelter. Section 6662(d)(2)(C)(ii). The term "tax shelter" is defined to include "a partnership or other entity, any investment or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax." Section 6662(D)(2)(C)(iii).

The accuracy-related penalty in section 6662 does not apply with respect to any portion of an understatement if it is shown that there was reasonable cause for such portion of an underpayment and that the taxpayer acted in good faith with respect to such portion. Section 6664(c)(1). The determination of whether the

taxpayer acted with reasonable cause and in good faith depends upon the pertinent facts and circumstances. Treas. Reg. § 1.6664-(b)(1). The most important factor is the extent of the taxpayer's effort to assess the proper tax liability for that year. Id.

In Announcement 2002-2, the Service announced a disclosure initiative to encourage taxpayers to disclose their tax treatment of tax shelters for which the imposition of the accuracy-related penalty may be appropriate if there is an underpayment of tax. Under the initiative, if a taxpayer timely discloses any item, the Service will waive the accuracy-related penalty under section 6662(b)(1), (b)(2), (b)(3), and (b)(4) for any underpayment attributable to that item.

Regarding timeliness of disclosures, Announcement 2002-2 provides that the Service will grant waivers only for those disclosures occurring before the earlier of the date the item or another item arising from the same transaction "is an issue raised during an examination", or April 23, 2002. For purposes of the disclosure initiative, however, an item "is an issue raised during an examination" if (i) the examiner communicates to the taxpayer knowledge about the specific item, or (ii) on or before December 21, 2001, the examiner has made a request to the taxpayer for information, person examining, and the taxpayer could not make a complete response to the request without giving the examiner knowledge of the specific item.

Announcement 2002-2 further provides that to disclose an item under the initiative, the taxpayer must provide the following:

1. a statement describing the material facts of the item;

2. a statement describing the taxpayer's tax treatment of the item;

3. the taxable years affected by the item;

4. if the taxpayer is a CIC taxpayer, a statement that the taxpayer will agree to address the disclosed item under the Accelerated Issue Resolution process described in Rev. Proc. 94-67, 1994-2 C.B. 800, if requested to do so by the Service;[2/]

[2/] The examiners have not requested that the taxpayer agree to address the LILO issue under the Accelerated Issue Resolution process, described in Rev. Proc. 94-67, 1994-2 C.B. 800.

5. the names and addresses of (a) any parties who promoted, solicited, or recommended the taxpayer's participation in the transaction underlying the item and who had a financial interest, including the receipt of fees, in the taxpayer's decision to participate, and (b) if known to the taxpayer, any parties who advised the promoter, solicitor, or recommender with respect to that transaction;

6. a statement agreeing to provide, if requested, copies of all of the following:

   (a) all transactional documents, and, if the taxpayer's participation in the transaction was promoted, solicited, or recommended by any other party, all material received from that other party or that party's advisors;

   (b) all internal documents or memoranda used by the taxpayer in its decision-making process, including, if applicable, information presented to the taxpayer's board of directors; and

   (c) all opinions and memoranda that provide a legal analysis of the item, whether prepared by the taxpayer or a tax professional on behalf of the taxpayer; and

7. a penalty of perjury statement that the person signing the disclosure has examined the disclosure and that to the best of that person's knowledge and belief, the information provided as part of the disclosure contains all relevant facts and is true, correct, and complete.

In this case, the taxpayer is not eligible for the waiver for two reasons. First, although the taxpayer submitted the disclosure statement before the examination team became aware of the items emanating from the LILO transactions, the examiner had already issued IDRs relating to the LILO issue before December 21, 2001. Second, even though the taxpayer has provided the examination team with most of the information required by Announcement 2002-2, it has not fully complied with the announcement's requirements because it continues to withhold the tax opinion and other alleged privileged documents.

We are simultaneously submitting this memorandum to the National Office for post-review and any guidance they may deem appropriate. Consequently, you should not take any action based on the advice contained herein during the 10-day review period. We will inform you of any modification or suggestions, and, if necessary, we will send you a supplemental memorandum incorporating any such recommendation.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

Since there is no further action required by this office, we will close our file in this matter ten days from the issuance of this memorandum or upon our receipt of written advice from the National Office, whichever occurs later. Please call Carmino J. Santaniello at (860) 290-4077 if you have any questions or require further assistance.

BRADFORD A. JOHNSON
Associate Area Counsel
LMSB, Area 1

(Signed) Carmino J. Santaniello

By: _____
CARMINO J. SANTANIELLO
Attorney