

February 14, 2001

Mr. Russ Sullivan  
Chief Tax Counsel  
Senate Finance Committee  
United States Senate  
203 Hart Office Building  
Washington, DC 20510

**Revised Corporate Tax Shelter Discussion Draft**

Dear Mr. Sullivan:

We appreciate the opportunity to comment on the bipartisan revised staff discussion draft of proposed tax shelter legislation that was released on October 5, 2000 by the Senate Finance Committee majority and minority staffs (the "Draft"). This letter is presented on behalf of the Section of Taxation. It has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the Association.

We compliment both staffs on the Draft and believe that it represents both a substantial improvement to the prior draft released by the staffs on May 24, 2000 and a significant contribution to the ongoing process of crafting appropriate legislation to halt abusive corporate tax shelters. The Draft includes a number of provisions and revisions that we suggested in our prior comment letter dated June 22, 2000 and a number of provisions that we previously have advocated or supported in testimony before the Senate Finance and House Ways & Means Committees and in correspondence. This letter does not repeat those prior recommendations and supportive comments. We particularly welcome the inclusion in the Draft of a separate penalty for failure to comply with the disclosure requirements under section 6011 of the Internal Revenue Code of 1986, as amended (the "Code"). We also applaud the elimination of the complex penalty structure that appeared in the prior draft. The requirement of a process for approving the assertion of penalties is similarly

welcome. The remainder of this letter provides our comments on provisions in the Draft that either are new or that differ from our prior recommendations.

I. Section 6662A: Penalty for Participation in an Abusive Tax Shelter Device.

A. Definition of Abusive Tax Shelter Device.

We continue to support tougher penalties for corporate tax shelters. We believe, however, that legislation implementing tougher penalties should carefully describe the types of transactions that might be subject to such penalties to avoid inadvertently penalizing transactions that are not abusive tax shelters. Section 6662A of the Draft provides an enhanced 40% penalty for deficiencies resulting from items attributable to an “abusive tax shelter device.” No exceptions (including the reasonable cause exception) are available with respect to the enhanced penalty. Proposed section 6662A(b) defines an abusive tax shelter device as any transaction or other arrangement which does not have a material nontax business purpose or economic substance. It is unclear in the Draft whether a transaction or other arrangement must lack one or both elements to be treated as an abusive tax shelter device.

We applaud the staffs’ decision not to limit application of the tax shelter legislation to transactions in which a “large corporation” participates and to treat corporate and non-corporate (i.e., no large corporation participants) tax shelters in the same manner in proposed section 6662A. We also applaud the abandonment of the subjective “significant purpose” standard. Although we believe that the Draft’s definition of an abusive tax shelter device is on the right track, we recommend the following modifications. We believe that an “abusive tax shelter device” should be defined as follows:

- (1) a “listed transaction” (within the meaning of section 301.6111-2T(b)(2) of the new corporate tax shelter regulations)<sup>1</sup> OR
- (2) a transaction (a) that lacks economic substance within the meaning of the case law, (b) that lacks a material nontax business purpose, and (c) the ultimate tax results of which, taking into account all relevant facts and circumstances, are not clearly contemplated by the applicable statutory and regulatory provisions.

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<sup>1</sup> The inclusion of “listed transactions” in the definition of “abusive tax shelter device” makes it critical that the Internal Revenue Service exercise care in listing transactions under section 301.6111-2T(b)(2) of the temporary Treasury regulations. We note our concern that recently issued Notice 2001-16 is so broadly worded that it may cover some transactions that are not properly characterized as tax shelters, let alone abusive tax shelter devices.

The third prong that has been added to the non-listed transaction portion of the definition is derived from the partnership anti-abuse regulations. See Treas. Reg. § 1.701-2(e)(2)(ii). The primary purpose of this prong is to assure that transactions involving special tax benefits that are mandated by statute or regulation are not inadvertently treated as abusive tax shelter devices. For example, assume that the owner of a low-income housing project that is supposed to qualify for tax credits under section 42 of the Code is determined on audit not to qualify for such credits because of an inadvertent failure by the owner to satisfy one or more of the qualification requirements under section 42.<sup>2</sup> Ownership of a section 42 qualifying housing project often lacks both economic substance and a material nontax business purpose because the owner is investing in the project to obtain tax benefits without any expectation of deriving a pre-tax economic profit. Nonetheless, a section 42 project that is inadvertently disqualified by its owner should not be treated as an abusive tax shelter device because section 42 is a statutorily mandated tax benefit. Accordingly, we believe that the addition of the third prong to the definition is necessary to prevent the treatment of such transactions as abusive tax shelter devices.<sup>3</sup>

We recommend that the legislative history list specific transactions that will not be abusive tax shelter devices under the three-prong test, such as exchange transactions that meet the test set out in the Cottage Savings decision, partnership redemptions that use property rather than cash, like-kind exchanges that are part of a sale of an asset, certain types of leveraged leases, checking the box, substituting debt for equity, transferring insurance operations to a subsidiary, and tax credit transactions under sections 29 and 42. We also suggest that the legislative history state that the economic substance prong will not be met by the presence of economic attributes that are de minimis when compared to expected tax benefits.

Finally, we recommend that the legislative history state that the “economic substance” prong is based on the case law as it evolves. We believe that the scope of the enhanced penalty should be limited to “listed transactions” and other transactions that would be invalidated under the case law in order to reduce uncertainty both for taxpayers and the Internal Revenue Service (the “Service”) in determining whether a particular transaction should be subject to the enhanced penalty. We believe that there are numerous legitimate business transactions (such as those described in the preceding paragraph) that potentially could be treated as abusive tax shelter devices

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<sup>2</sup> The requirements for qualifying for tax credits under section 42 are numerous and complex. See, e.g., I.R.C. § 42(d)(2)(B)(ii), (6)(a), (e)(3), (g). It is easy to visualize a scenario under which an owner could inadvertently fail to comply with one or more of those requirements.

<sup>3</sup> Although we prefer the three-prong approach, we believe that, at a minimum, the definition should be revised to clarify that an abusive tax shelter device means a transaction that lacks both economic substance and a material nontax business purpose.

under the current Draft. Maximizing the certainty of penalty application is important both in achieving the desired level of deterrence with respect to abusive transactions and in avoiding any adverse impact on legitimate tax planning.

B. Minimum Tax Reduction Thresholds.

As stated above, we applaud the staffs' decision not to limit application of the tax shelter legislation to transactions in which a "large corporation" participates. However, we continue to believe that the threshold for application of the enhanced penalty should be based on the dollar size of the tax benefits produced by the transaction. Specifically, we believe that there should be minimum tax reduction thresholds for the application of the enhanced penalty in the case of an abusive tax shelter device that meets our proposed three-prong test set forth above, as follows:

- Individual taxpayers: \$100,000 tax liability reduction in one year or \$200,000 over multiple years.
- Corporate taxpayers: \$250,000 tax liability reduction in one year or \$500,000 over multiple years.

The staffs could look to the new corporate tax shelter disclosure regulations (Temp. Treas. Reg. § 1.6011-4T(b)(4)) for guidance. We do not, however, believe that minimum tax reduction thresholds are necessary in the case of abusive tax shelter devices that are "listed transactions." In that case, we support the automatic application of the enhanced penalty.

C. Amount of Penalty and Waiver Thereof.

We applaud the elimination of the complex penalty structure that appeared in the prior draft. However, we continue to believe that a 40% penalty is too large, and that a 20% penalty, with a higher degree of certainty of application, would be more appropriate. As we have stated in prior correspondence, in our experience, draconian penalties are administered inconsistently by the Service, because their very size leads to situations in which their application seems inappropriate. In addition, the proposal of an enhanced penalty for abusive tax shelter devices is likely to provide an independent source both of adversarial tension in the audit and of litigation. We also continue to believe that the rules relating to the application of the reasonable cause penalty, if consistently and stringently applied, provide good parameters for determining whether a penalty should apply in a particular case. If the penalty on understatements relating to abusive tax shelter devices were applied at a level of 20% and our other comments relating to proposed section 6662A (i.e., revising the definition of abusive tax shelter device and adding minimum tax reduction thresholds)

were incorporated into the final legislation, we could support the elimination of the reasonable cause exception in connection with the enhanced penalty on abusive tax shelter devices.

## II. Section 6662: Substantial Understatements of Participants in Tax Shelters other than Abusive Tax Shelter Devices.

The Draft replaces the “reasonable cause” exception to the existing 20% substantial understatement penalty in Code section 6662 with a new “reasonable belief” exception that effectively adds a disclosure requirement to the reasonable cause exception. Specifically, the new “reasonable belief” exception allows taxpayers to reduce or avoid the 20% penalty if (1) there was substantial authority for the item, (2) the taxpayer discloses relevant facts about the item on his return, and (3) the taxpayer reasonably believed that the tax treatment claimed by the taxpayer was more likely than not to prevail. Reasonable belief may be based on the opinion of an independent tax advisor, but may not be based on the opinion of a tax advisor who has a financial interest in the transaction or otherwise has a conflict of interest or lack of independence or on a tax opinion that is based on unreasonable facts, assumptions, or representations. We agree with the replacement of the reasonable cause exception with the reasonable belief exception and with the restrictions on reliance on certain tax advisors and opinions, as long as a statutory change is made to clarify that a taxpayer can rely on the opinion of a tax advisor engaged in tax planning for a non-contingent hourly fee where the tax advisor has no entrepreneurial stake in the transaction.

Proposed section 6662(d)(2)(C)(ii) eliminates the threshold of a required minimum amount of an understatement relating to a tax shelter item before the 20% penalty applies. We believe that the elimination of a required minimum amount will force taxpayers to obtain tax opinions on insignificant tax return items. To avoid that result, we suggest that the Draft be amended to add back the requirement of a required minimum amount for an understatement to be treated as a substantial understatement to which the 20% penalty applies.

Proposed section 6662(d)(2)(C)(iii) defines a “tax shelter” as a transaction or other arrangement a significant purpose of which is tax avoidance or evasion. Substantively, we believe that the appropriate test is “the principal purpose,” rather than “a significant purpose,” because we believe that a significant purpose of many legitimate business transactions is tax avoidance. See Treas. Reg. § 1.6662-4(g)(2)(i). However, we understand that, politically, Congress may be hesitant to go back to that standard because it could appear that Congress is being “soft” on tax shelters.

III. Section 6707A: Penalty for Failure to Include Tax Shelter Information with Return.

As stated above, we applaud the staffs for adding a separate penalty for failure to comply with the disclosure requirements under Code section 6011 with respect to a reportable transaction. The amount of the penalty is the greater of (1) 5% (10% for a listed transaction) of any increase in tax resulting from the difference in the taxpayer's treatment of items attributable to the reportable transaction and the proper tax treatment of such items or (2) \$100,000. Although we support a penalty of the greater of 10% or \$100,000 in the case of a listed transaction, we believe that a lower penalty should be imposed in the case of a failure to disclose with respect to a non-listed transaction. We recommend that such lower penalty be the lesser of 5% or \$50,000.

The Draft provides that the penalty for failure to disclose will not apply if the failure is due to reasonable cause and not to willful neglect. In our comments to the Service on the new disclosure regulations, we stated that disclosure of a transaction only should be required if the Service has substantial authority for a contrary position. We believe that the proposed section 6707A penalty for failure to disclose also should apply only if the Service has substantial authority for a contrary position, because the section 6707A penalty may be imposed in addition to the section 6662 and 6662A understatement penalties and may apply even if the taxpayer prevails on audit.

IV. Section 6701(a): Modifications of Penalties for Aiding and Abetting Understatement of Tax Liability Involving Tax Shelters.

The Draft increases the current aiding and abetting penalty to 50% of the gross proceeds derived by the person aiding and abetting from the tax shelter if the penalty involves a tax shelter or abusive tax shelter device. In addition, the Draft adds a separate penalty on any person who (1) aids or assists in, procures, or advises with respect to the creation, organization, sale, implementation, management, or reporting of a tax shelter or an abusive tax shelter device and (2) opines, advises, represents, or otherwise indicates (directly or indirectly) that the taxpayer's tax treatment of items attributable to such tax shelter or abusive tax shelter device and giving rise to an understatement of tax liability would more likely than not prevail or not give rise to a penalty, if such opinion, advice, representation, or indication is unreasonable. We assume that the "unreasonable" standard in the new penalty is a negligence standard. The Draft also provide that, if a standard higher than "more likely than not" was used in any such opinion, advice, representation, or indication, then the test will be applied as if such standard were substituted for the more likely than not standard.

We have consistently supported extension of the aiding and abetting penalties

to reach promoters, their advisors, and other participants in the transaction. We applaud the broadening of the aiding and abetting penalty and agree with public disclosure of the penalties. However, we believe that the standard for imposing the aiding and abetting penalty should be negligence in the case of both listed and non-listed transactions. We suggest that a clarification be made in the legislative history to final legislation.

In addition, we do not support an aiding and abetting penalty if a tax advisor gives a “should” opinion and the appropriate level was “more likely than not.” The difference between the two is a fine line and not one on which it is appropriate to base penalties. We support imposition of the penalty if a tax advisor gives a more likely than not (or higher) opinion, and it was negligent to give a more likely than not opinion. We believe that the Draft should be amended accordingly.

V. Section 6708(a): Failure to Maintain Lists.

The Draft increases the penalty imposed on persons who fail to maintain lists of investors in tax shelters and abusive tax shelter devices to 50% of the gross proceeds derived from each person with respect to whom there is a failure. The \$100,000 maximum limit on the penalty is not applicable in the case of a failure to maintain a list of investors in tax shelters and abusive tax shelter devices. We support the broadening of the penalty on failure to maintain investor lists. However, we believe that a statutory change to the investor list maintenance requirement in Code section 6112 is necessary to clarify that a tax advisor who is engaged in tax planning for a non-contingent hourly fee and who has no entrepreneurial stake in the transaction is not required to maintain investor lists.

VI. Section 330(b): Regulation of Individuals Practicing before the Department of Treasury.

The Draft authorizes the Treasury Secretary to impose a monetary penalty on any representative described in existing Section 330(b) (31 U.S.C. § 330) (i.e., a representative who is incompetent or disreputable, violates regulations prescribed under section 330, or, with intent to defraud, willfully and knowingly misleads or threatens the person being represented or a prospective person to be represented). While we support the addition of monetary penalties to the punishment of suspension or disbarment, we believe that section 330(b) monetary penalties should be limited to tax shelter-related conduct. In addition, we believe that the section 330(b) monetary penalties should not be duplicative of the aiding and abetting penalty.

VII. No Penalty on Tax-Indifferent Parties.

We previously have recommended and continue to believe that, if a tax shelter penalty is imposed on the taxpayer, the other parties who participate in the transaction should have “some skin in the game” and, therefore, should be subject to separate penalties (and should be granted separate appellate rights to assure them due process). In the case of a tax-indifferent party, the “penalty” for participating in an abusive tax shelter device could take the form of simply being subject to tax on the income allocated to it as part of the shelter scheme. The Draft does not penalize or create any disincentive to participation in an abusive tax shelter device by a tax indifferent party. We reiterate our prior recommendation that such a penalty or other disincentive be included in tax shelter legislation.

We look forward to working with the staffs on these and any other issues related to the Draft.

Sincerely,

Richard M. Lipton  
Chair, Section of Taxation

cc: Mark Prater, Chief Tax Counsel, Senate Finance Committee  
Lindy L. Paull, Chief of Staff, Joint Committee on Taxation