

September 6, 2001

Mr. John Angell  
Majority Staff Director  
Senate Finance Committee  
United States Senate  
219 Dirksen Senate Office Building  
Washington, DC 20510

Mr. Kolan Davis  
Chief Counsel/Minority Staff Director  
Senate Finance Committee  
United States Senate  
219 Dirksen Senate Office Building  
Washington, DC 20510

**RE: Tax Shelter Disclosure Act**

Gentlemen:

We appreciate the opportunity to comment on the revised bipartisan staff discussion draft of proposed tax shelter legislation that was released on August 3, 2001 by Senate Finance Committee Chair Max Baucus and ranking member Charles Grassley (the "Draft"). We greatly appreciate and support your efforts to develop meaningful tax shelter legislation designed to enhance the integrity of our tax system by encouraging disclosure and deterring abusive conduct.

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 the majority and minority staffs on the Draft and believe that it represents both a substantial improvement to the prior drafts released on May 24, 2000 and October 5, 2000, and a significant contribution to the ongoing process of crafting appropriate measures to halt abusive tax shelters. The Draft includes a number of provisions and revisions that we suggested in our prior comment letters dated June 22, 2000 and February 14, 2001 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 other correspondence with Congress and the Administration.

We particularly welcome the elimination of a strict-liability penalty and its replacement with rules that provide for reduced penalties if disclosure is made. We further welcome 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"). The Tax Section has long viewed disclosure as an appropriate way to attack abusive tax shelters, and the Draft is a helpful step in this direction.

We also applaud the revisions made in the Draft to the understatement penalty structure. We believe this represents a significant simplification of the version that appeared

in the prior draft by providing a single penalty for tax shelter-related understatements. In addition, we support the new requirement that confidential tax shelters be registered regardless of whether there is a direct or indirect corporate participant. Finally, we support the increased penalty on promoters who provide knowingly fraudulent statements with respect to the permissibility of tax benefits.

The remainder of this letter provides our comments on certain specific provisions in the Draft.

I. Section 6662: Penalty for Understatements Attributable to Tax Shelters.

A. The Principal Purpose vs. A Significant Purpose Standard.

We continue to support stringent penalties for participation in abusive tax shelters and stronger incentives for disclosure of those tax shelters. We believe, however, that legislation implementing higher penalties should carefully delineate the types of transactions that might be subject to such penalties in order to avoid inadvertently penalizing transactions that are not abusive. Proposed Code section 6662(i)(4) defines a "tax shelter" as an entity, plan, arrangement, or transaction "a significant purpose" of which is tax avoidance or evasion. We continue to believe that the appropriate standard for application of an enhanced penalty is "the principal purpose," rather than "a significant purpose." While we believe that tax avoidance is the principal purpose of the types of transactions at which the provision is aimed, tax avoidance is a significant purpose of many legitimate business transactions. As a result, we believe that the "a significant purpose" standard is overinclusive. This is particularly troublesome when the penalty is very high.

We understand, however, that there are competing views regarding the appropriate standard. Some people contend that "the principal purpose" standard would fail to capture all transactions that arguably should be disclosed. These people would contend, therefore, that it is better to cover some non-abusive transactions so long as taxpayers have the means to avoid the application of the penalty in such cases through disclosure.

Accordingly, while we continue to believe that "the principal purpose" is the appropriate standard for application of the enhanced penalty, we can appreciate the reasoning behind the "a significant purpose" standard in the Draft. As a result, without retreating from our previously-stated position that "the principal purpose" is the correct test, we are providing below our suggestions for mitigating the overinclusiveness of the "a significant purpose" standard, which include (1) an alternative definition of a tax shelter in which the "a significant purpose" standard is coupled with tax shelter indicators, (2) authorizing and encouraging the Secretary to list transactions that are not "tax shelters" under section 6662(i)(4), (3) providing an exception for non-disclosed transactions if the Internal Revenue Service ("Service") would lack substantial authority to challenge the taxpayer's claimed tax treatment, (4) increasing the \$50,000 minimum tax reduction threshold for the application of the enhanced penalty, and (5) clarifying that, in order to establish reasonable belief, a taxpayer may rely on the opinion of a tax advisor who is engaged in tax planning for a reasonable hourly fee and who has no entrepreneurial stake in

the transaction.<sup>1</sup>

B. Refining the Tax Shelter Definition.

As indicated above, we believe that the “a significant purpose” standard is an overinclusive definition of a tax shelter. If a decision is made not to use “the principal purpose” standard (which we believe to be the appropriate one), it is important to couple the “a significant purpose” test with the presence of one or more tax shelter indicators to address this problem. In particular, we recommend that a tax shelter be defined to include only transactions that are described in one or more of the following paragraphs:

(1) Listed transactions. Transactions that are the same as or substantially similar to a transaction that the Internal Revenue Service has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a “listed transaction” within the meaning of Treas. Reg. § 1.6011-4T(b)(2).

(2) Principal purpose of tax avoidance or evasion. A transaction with the principal purpose to avoid or evade Federal income tax. The principal purpose means that purpose exceeds any other purpose. The existence of economic substance does not of itself establish that a transaction does not have the principal purpose of tax avoidance.

(3) Certain transactions having a significant purpose of tax avoidance or evasion. A transaction that has a significant purpose to avoid or evade Federal income tax, provided that the transaction has or involves one or more of the following characteristics:

(i) Confidentiality conditions. The taxpayer has participated in the transaction under conditions of confidentiality (within the meaning of Code section 6111(d)(2)).

(ii) Contractual protection. The taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained, including, but not limited to, rescission rights, the right to a full or partial refund of fees paid to any person, fees that are contingent on the taxpayer’s realization of tax benefits from the transaction, insurance protection with respect to the tax treatment of the transaction, or a tax indemnity or similar agreement (other than a customary indemnity provided by a principal to the transaction that did not participate in the promotion of the transaction to the taxpayer).

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<sup>1</sup> In our letter dated February 14, 2001, commenting on the previous staff draft, we recommended that an “abusive tax shelter device” be defined as: (1) a listed transaction; or (2) a transaction (a) that lacks economic substance within the meaning of the case law, (b) that lacks a material non-tax 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. We continue to believe that this definition represents a viable alternative to the “a significant purpose” test, in that it would reduce considerably the number of non-abusive transactions subject to the enhanced penalty and disclosure. We urge that the staffs continue to consider this proposal.

(iii) Contingent fee. The taxpayer agrees, in connection with the transaction, to pay to a promoter or advisor a fee (other than a fee based on a reasonable stated hourly rate) that is contingent on the taxpayer's participation in the transaction or the realization of the anticipated income tax benefits.

(iv) Certain tax shelter marketing. The taxpayer participates in the transaction as a result of marketing or promotion by any person other than a tax practitioner with whom the taxpayer had a bona fide, pre-existing client relationship (or a member or employee of such practitioner's firm).

There also should be an exception from the foregoing definition for transactions that are structured and effectuated with the objective of claiming exclusions or deferrals of income, tax credits, accelerated deductions, or other tax benefits that are clearly consistent with the purposes of applicable provisions of the Internal Revenue Code (as evidenced by relevant statutory language, legislative history, underlying final or temporary Treasury regulations or other published administrative guidance).

The tax shelter definition outlined above is generally consistent with our supplemental comments on the proposed regulations under Circular 230, which were submitted on August 13, 2001 (a copy of which is attached). Those comments also contain a lengthy list of transactions which we believe are clearly consistent with the Code.

We believe that the foregoing definition of a tax shelter retains the "a significant purpose" standard but limits the scope of the enhanced tax shelter penalty to appropriate situations without forcing disclosure of many legitimate business transactions that involve tax planning.

C. Level of Penalty and Exceptions Thereto.

Proposed section 6662(a)(2) of the Draft provides an enhanced penalty equal to 40% of the amount of an "applicable tax shelter understatement." Whether or not our proposed definition of a tax shelter is adopted, we applaud the idea of imposing a single penalty for tax shelter-related understatements (with reduction of the penalty in certain appropriate situations, as discussed below). We do, however, wish to reiterate the concern we expressed previously that a 40% penalty may be too high. Our concern with the level of the penalty is purely pragmatic. As we have stated in prior correspondence, in our experience, large penalties are applied inconsistently because the very size of the penalty leads to situations in which application appears inappropriate or unduly punitive. As a result, taxpayers tend to ignore the potential application of such penalties, rendering them ineffective at encouraging disclosure or deterring abusive conduct.

Rather than create a penalty that is no more than a paper tiger, we suggest that a lower penalty would be applied with a higher degree of certainty and consistency which would, in turn, better further the goal of the provision. 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. In our view, the penalty under section 6662(a)(2) should not exceed 25%, but there is no "magic" to this number (or to the 20% rate for substantial understatement); we

urge the staffs to carefully consider setting the penalty at a rate that will lead to certainty of imposition for the intended situations.<sup>2</sup>

We applaud the movement away from the strict liability penalty that appeared in the October 5, 2000 draft of tax shelter legislation. The Draft enables a taxpayer to reduce or avoid the penalty under section 6662(a)(2) if (1) there was substantial authority for the tax treatment of 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 (a) 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 (b) a tax opinion that is based on unreasonable facts, assumptions (including the assumption of a business purpose) or representations, or that doesn't apply the law to the relevant facts. We support the use of the three-prong reasonable belief exception and the restrictions on a taxpayer's reliance on certain tax advisors and opinions. However, we believe that the rules should clarify that a taxpayer may establish reasonable belief by relying on the opinion of a tax advisor who is engaged in tax planning for a reasonable hourly fee and who has no entrepreneurial stake in the transaction.

Proposed section 6662(j) provides that the Treasury Secretary will publish a list of positions for which there is (or is not) substantial authority. We support this provision and encourage the Secretary, upon enactment, to list transactions for which there is substantial authority. This will reduce uncertainty both for taxpayers and the Service in determining whether a particular transaction should be subject to the enhanced penalty. In addition, we believe that the overinclusiveness of the "a significant purpose" standard could be mitigated in part by authorizing and encouraging the Secretary to list transactions that are not "tax shelters" under section 6662(i)(4) because they are clearly consistent with the Code or the related tax benefits are generally accepted. Listing "good" transactions as well as abusive transactions will assure that transactions involving special tax benefits that are authorized by statute or regulation, or that are generally acknowledged to be non-abusive, are not inadvertently treated as tax shelters. Examples of transactions that could be listed as "good" transactions are 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 and tax credit transactions under Code sections 29 and 42. As noted above, we have attached hereto a copy of our supplemental comments on the proposed regulations under Circular 230, which were submitted on August 13, 2001 and which contains a lengthier list of transactions which we believe are clearly consistent with the Code.

Even if the taxpayer has substantial authority for its position, disclosure would still be required under the Draft. If the definition of a tax shelter does not focus on

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<sup>2</sup> In our comments to the October 2000 draft legislation, we advocated a 20% penalty for abusive tax shelter devices. In the October 2000 draft, the penalty was a strict liability penalty with no exceptions. Now that there is an exception to the tax shelter understatement penalty, we believe that the penalty possibly could be higher than the section 6662(1)(1) penalty in order to achieve the desired level of deterrence with respect to abusive transactions, but for the reasons discussed above it should be lower than 40%.

"the principal purpose" of a transaction, we are concerned that one possible result of the proposed legislation would be to cause taxpayers to feel compelled to disclose virtually every transaction involving tax planning. This would prove to be unduly burdensome for many taxpayers, would generate mounds of paperwork describing perfectly legitimate transactions and would be unlikely to provide much in the way of useful information for the Service. To address this potential problem, we believe that the Draft should also incorporate an exception from disclosure for transactions that have "a significant purpose" of tax avoidance but for which the Service would lack substantial authority (or, in the alternative, a realistic possibility of success on the merits) to challenge the position taken by the taxpayer.<sup>3</sup> In addition, it would be helpful if the statute clearly authorized the Treasury Secretary to provide additional exceptions to the tax shelter definition, and if the legislative history clarified that the Congress expects the Secretary to provide exceptions that are designed to focus the new penalty and disclosure regime on transactions that raise material compliance issues. One example of such an exception is the exception in current Temp. Reg. § 1.6011-4T(b)(3)(ii)(B) for transactions reported consistently with a generally accepted understanding of their correct tax treatment. These exceptions would greatly reduce the number of unnecessary tax return disclosures while encouraging the disclosure of transactions that should be disclosed.

D. Minimum Tax Reduction Thresholds.

Pursuant to proposed section 6662(i)(1)(B) of the Draft, the penalty under section 6662(a)(2) only will apply to a tax shelter understatement that equals or exceeds \$50,000. We support the introduction of a threshold for application of the enhanced penalty that is based on the dollar size of the tax benefits produced by the transaction. However, due to the potentially sweeping nature of the "a significant purpose" standard, we believe that the \$50,000 threshold is too low and will force taxpayers to obtain tax opinions on relatively minor items. We believe that the minimum tax reduction thresholds for the application of the enhanced penalty should be 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 corporate tax shelter disclosure regulations (Temp. Reg. § 1.6011-4T(b)(4)) for guidance.

We do not believe, however, that increased thresholds are necessary in the case of tax shelters that are "listed transactions." These are transactions that the Treasury Department has previously determined to be potentially abusive. While that determination cannot be conclusive, we believe it is sufficient to justify disclosure of all transactions fitting

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<sup>3</sup> The regulations issued by the Service under section 6011 provide that disclosure is not required if the Service would lack a reasonable basis to challenge the taxpayer's claimed treatment of the transaction. We have previously criticized this exception as too narrow, and our proposal reflects the standards which we believe should be adopted for purposes of section 6011 as well.

that description, regardless of the dollar amounts involved.

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

We applaud the staffs for including a separate penalty for failure to comply with the disclosure requirements under Code section 6011 with respect to a reportable transaction. We have consistently advanced this proposition as an important step toward improved tax shelter disclosure. Under the Draft, 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 (\$200,000 for a listed transaction). Standing alone, we believe these penalties are set at appropriate levels. However, because this penalty could be applied in addition to the new understatement penalty under section 6662(a)(2), we recommend that the failure to disclose penalty instead be a flat amount of \$100,000 (\$200,000 for a listed transaction). Under this penalty scheme, a taxpayer who prevails on the merits still will receive a substantial penalty for failing to disclose the transaction, and a taxpayer who loses on the merits and is assessed the penalty under Section 6662(a)(2) will pay a flat penalty for failure to disclose instead of an additional percentage of the taxpayer's understatement of tax.

The Draft provides that the penalty for failure to disclose will not apply if the failure is due to reasonable cause. In our comments to the Service on the tax shelter disclosure regulations, we stated our opinion that disclosure of a transaction under Section 6011 should be required only if the Service has substantial authority for a contrary position (or, in the alternative, a realistic possibility of success on the merits). The Service recently amended the regulations so as to better define when a taxpayer is not required to disclose a transaction, but the Service did not adopt our suggested standard. 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 (or, in the alternative, a realistic possibility of success on the merits), because the section 6707A penalty may be imposed in addition to the understatement penalty under section 6662(a)(2) and may apply even if the taxpayer prevails on audit.

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

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.

The Draft increases the current aiding and abetting penalty to 50% of the gross income derived from the tax shelter by a person who aids and abets with respect to the tax shelter. 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 and (2) opines, advises, represents, or otherwise indicates (directly or indirectly) that the taxpayer's tax treatment of items attributable to such tax shelter and which gives 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. The Draft also provides 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 assume that the “unreasonable” standard in the new penalty is a negligence standard. However, we believe that this must be clarified. We suggest, therefore, that the legislative history to final legislation provide that negligence is the standard for application of the penalty. In addition, we do not believe it is appropriate to impose an aiding and abetting penalty if a tax advisor gives a “should” opinion and the appropriate level is later determined to be “more likely than not.” The difference between the two is a fine line and not one on which it is appropriate to base penalties. Instead, 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.

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

The Draft increases the penalty imposed on persons who fail to maintain lists of tax shelter investors to 50% of the gross income derived from each person with respect to whom there is a failure, reduced by any failure to register penalty imposed with respect to such income under section 6707(a)(3). The \$100,000 maximum limit on the penalty is not applicable in the case of a failure to maintain a list of tax shelter investors. We support the broadening of the penalty for failure to maintain investor lists. However, the definition of a tax shelter promoter in the Treasury regulations is overly broad and could cover practitioners who are engaged in routine tax planning for a reasonable hourly fee. 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 reasonable hourly fee and who has no entrepreneurial stake in the transaction is not required to maintain investor lists.

In addition, we would support changes to the penalty that cause the application and/or the amount of the penalty to be time sensitive. For example, if a promoter makes an investor list available for inspection by the Service within 10 days after the Service’s request, as provided in the Temp. Reg. § 301.6112-1T, no penalty is imposed. The penalty on a taxpayer who makes an investor list available within 30 days after the Service’s request could be lower than the penalty on a taxpayer who makes an investor list available within 90 days after the Service’s request, and so on.

V. 31 U.S.C. § 330(b): Regulation of Individuals Practicing Before the Department of Treasury.

The Draft authorizes the Treasury Secretary to censure or impose a monetary penalty on any representative described in existing Section 330(b) (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). We strongly support the addition of statutory support for a censure sanction under Section 330(b). While we support the addition of monetary penalties to the existing penalties of suspension or disbarment, we believe that section 330(b) monetary penalties should be limited to tax shelter-related

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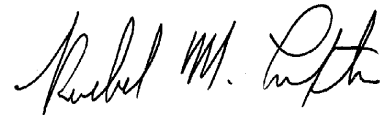
conduct. In addition, as drafted, the section 330(b) monetary penalty could be an amount up to 100% of the representative's gross income from the transaction and could be imposed in addition to the aiding and abetting penalty and the section 6700 penalty on promoting abusive tax shelters. As a result, the combination of those penalties could exceed 100% of a representative's gross income from the transaction. We believe that the Draft should be amended to prevent the aggregate amount of the penalties imposed on a representative from exceeding 100% of the representative's gross income from the transaction.

VI. Treatment of Tax-Indifferent Parties.

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

Again, we thank you for your efforts on this issue. We look forward to working with the staffs on this important matter.

Sincerely,



Richard M. Lipton  
Chair, Section of Taxation

Enclosure

cc: Lindy L. Paull, Chief of Staff  
Joint Committee on Taxation  
John L. Buckley, Democratic Chief Tax Counsel  
House Ways & Means Committee Staff  
James D. Clark, Tax Counsel  
House Ways & Means Committee Staff  
Mark A. Weinberger, Assistant Secretary, Tax Policy  
Department of Treasury  
Pamela F. Olson, Deputy Assistant Secretary, Tax Policy  
Department of Treasury  
Eric Solomon, Deputy Assistant Secretary, Regulatory Affairs  
Department of Treasury  
Richard W. Skillman, Acting Chief Counsel  
Internal Revenue Service  
Larry R. Langdon, Commissioner, Large & Mid-Size Business Division  
Internal Revenue Service