STATEMENT

of

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on behalf of the

SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

before the

SENATE COMMITTEE ON FINANCE

on the subject of

PENALTY AND INTEREST PROVISIONS IN
THE INTERNAL REVENUE CODE

and

CORPORATE TAX SHELTERS

March 9, 2000
Mr. Chairman and Members of the Committee:

My name is Paul J. Sax. I appear before you today in my capacity as Chair of the American Bar Association Section of Taxation. This testimony 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 position of the Association.

The Section of Taxation appreciates the opportunity to appear before the Committee today to discuss the penalty and interest provisions in the Internal Revenue Code and the recommendations contained in the studies prepared by the Staff of the Joint Tax Committee and the Treasury Department. My testimony today will also cover the related subject of corporate tax shelters.

I. PENALTIES AND INTEREST

We believe the recommendations in the penalty and interest studies by the Staff of the Joint Committee on Taxation\(^1\) (hereafter “JCT Study”) and Department of the Treasury’s Office of Tax Policy\(^2\) (hereafter “Treasury Report”) address very important issues. Our testimony today will not include comments on each and every item in the studies. Individual members of the Tax Section would be pleased, however, to provide assistance and comments to members of the Committee and your Staff on any recommendations you might identify.

At the outset, I would like to recognize the time and energy this Committee, the Joint Committee on Taxation, and the Treasury Department’s Office of Tax Policy are devoting and have already devoted to examining the Internal Revenue Code’s penalty and interest provisions. Your thoughtful consideration of this area is important because the law’s approach to penalties and interest affects taxpayers’ views of, and thus their compliance with, our self-assessment tax system.

We have limited our specific comments today to five areas: (1) accuracy-related penalties, (2) preparer penalties, (3) interest, (4) the failure to file penalty, and (5) late payment penalties. The accuracy-related and preparer penalties are important because they set the standards for what taxpayers and preparers are permitted to report on returns. Interest and the filing and payment penalties are important because they are the additions to tax that a taxpayer is

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most likely to encounter and that most commonly create hardship for less well off individual taxpayers. We will address penalties related to corporate tax shelters in the second part of our testimony today.

Before we shift to specific issues, I would like to briefly summarize our views on civil penalties and interest. Penalties should be structured to encourage taxpayers to approach their tax obligations carefully and responsibly, but with due regard for the complexity and sometimes uncertain application of our tax laws. If a penalty is too small, or the taxpayer’s duty is expressed in too vague a way, it is unlikely that a penalty will accomplish this goal. On the other hand, if a penalty is too large, or too much is expected of the taxpayer, the penalty may lead to excessive burdens on taxpayers and perceptions that our tax system is unfair. Accordingly, our comments are guided by the views that penalties should be straightforward enough for taxpayers to understand and for the IRS to efficiently administer. Penalties should penalize similarly situated taxpayers similarly and should impose sanctions proportional to a clearly defined transgression. Penalties should reinforce reasonable expectations of taxpayers and should encourage compliance even if untimely.

A. Accuracy-Related and Preparer Penalties

The accuracy-related and preparer penalties set forth the duties of taxpayers and preparers to prepare returns carefully, taking only realistic positions and disclosing those where the tax treatment is unclear or questionable. We think the current structure of these penalties is reasonably sound, but has features that legislation can improve.

1. Reporting Standards for Taxpayers and Preparers

At present, the two penalties are not completely coordinated, since what is expected of preparers is somewhat less than what is expected of taxpayers. Both the JCT Study and the Treasury Report recommend conforming the reporting standards for taxpayers and preparers. However, the JCT Study would set standards for taxpayers and preparers much higher than the standards of current law, while the Treasury Report would set standards at levels nearer those of current law.

a) Undisclosed Positions

At present, Section 6662 penalizes a taxpayer if a position on a return lacks substantial authority and is not disclosed. Section 6694 penalizes a preparer when a position on a return lacks a realistic possibility of being sustained on its merits and is not disclosed. In general, we think that a “substantial authority” standard for undisclosed positions works best for both taxpayers and preparers. The substantial authority standard has now been in the law for 17 years. The regulations defining the standard do an excellent job of guiding both taxpayers and preparers, and a substantial body of case law is developing that gives both taxpayers and preparers useful guidance. Further, the expectation that an undisclosed position should be supported by substantial authority is intuitively reasonable. The objective nature of the standard,
which turns on whether adequate legal and factual support for a position exists, avoids messy and
difficult inquiries into the taxpayer’s state of mind. Accordingly, we support the Treasury
Report’s recommendation that a “substantial authority” standard be retained in Section 6662 for
undisclosed return positions and that Section 6694 be amended to establish this standard for
preparers as well.

The Joint Committee Staff recommended changing the standard for undisclosed
positions from substantial authority to a reasonable belief that the position taken is “more likely
than not” correct. We do not believe that this proposal is an improvement on the “substantial
authority” standard; it would be less objective, would encourage difficult factual inquiries into
the state of mind of the taxpayer and preparer, could encourage excessive disclosure, and would
fail to give adequate weight to the complexity and uncertainty of existing tax law.

b) Disclosed Positions

At present, Section 6662 imposes a penalty on a return position for which
adequate disclosure has been made only if, in the case of the taxpayer, the position lacks a
reasonable basis. Section 6694 imposes a similar penalty in the case of preparers if the position
is frivolous. Historically, this has been the function of the negligence penalty, and the standard
for disclosed positions in current law in essence defines a negligence standard.

We believe that the Joint Committee Staff recommendation that the standard for
disclosed positions be elevated to “substantial authority” is unwise. We think that it is very
important to preserve the essential nature of this expectation of taxpayers and preparers as a
negligence standard. The vast majority of taxpayers in this country spend a relatively short
period each year preparing and filing their returns. They have a generalized understanding that
they must do so carefully and fairly. However, it is doubtful that they ever would spend the time
and effort necessary to understand the details of a complex penalty standard. We think it
important that the standard for disclosed positions in Section 6662 be viewed as fair and
reasonable, and we think that this requires this standard to reflect taxpayers’ general
understanding that they must be careful and even-handed in preparing their returns. If the
standard were elevated, so that a taxpayer was required to do more than one would expect of a
prudent but relatively unsophisticated individual, then we think penalty impositions would likely
increase because the expectations of our tax system would exceed the behavior that most
taxpayers intuitively think is appropriate. We believe that penalizing taxpayers who have acted
in a reasonably careful way would create anger toward our tax system.

Our understanding of the Treasury Report’s proposal for disclosed positions
(other than those involving a tax shelter) is that Treasury would retain the essential “negligence”
standard of existing law, but conform the definitions in Sections 6662 and 6694 in the language
“realistic possibility of success on the merits.” We support this proposal. For the last several
decades, the overriding debate with respect to the negligence penalty has been to arrive at a
definition of negligence conveying the idea that the conduct expected is more than an empty
appearance of compliance, but rather reflects the serious effort that a careful and prudent person
should make. We think that the language suggested in the Treasury Report for non-tax shelter positions does this. Further, it would conform Section 6694 to existing standards of professional responsibility promulgated by the ABA and the AICPA.

2. Reasonable Cause Exception

Under existing law, the IRS and the courts have the flexibility to waive a Section 6662 penalty to which a taxpayer may become subject. This waiver authority permits IRS and the courts to take into account a person’s education, a personal tragedy, or an isolated failure to identify an issue. We think that this waiver authority is critically important to the smooth functioning of Section 6662. The JCT Study, but not the Treasury Report, recommends repealing the reasonable cause exception for substantial understatement penalties. We oppose repeal of the reasonable cause exception because we think that repeal would result in a penalty that is too rigid and inflexible and would eliminate the discretion of the IRS and courts to waive a penalty even when any reasonable view of the situation would support waiver. Repealing the waiver authority also runs counter to the provisions enacted in the IRS Restructuring and Reform Act that vest IRS with more discretion in administering the interest provisions and collecting late payments.

3. Threshold for Imposing the Substantial Understatement Penalty

At present, the substantial understatement prong of the Section 6662 penalty applies, in the case of corporations, only if the understatement at issue exceeds the greater of $10,000 or 10% of tax liability. The practical effect of this threshold is that, for very large corporations with very large tax liabilities, the substantial understatement penalty is seldom applicable.

The Treasury Report, but not the JCT Study, suggests changing the definition of a substantial understatement in the case of corporations to the lesser of $10 million or 10% of the tax required to be shown on the return. This proposal would have the practical effect of making the substantial understatement penalty potentially applicable to very large corporations for any issue that exceeds $10 million in amount. We think that this proposal provides a reasonable way to encourage disclosure of significant issues by large corporations, and we support it.

A change in threshold would, we believe, also be warranted for individuals. At present, the threshold (the greater of $5,000 or 10% of tax liability) may encompass many very small cases for which a more general negligence penalty is more appropriate. We suggest that the existing “greater of” format for this threshold works well, but that the dollar threshold should be raised and the percentage threshold dropped, so that the minimum size of an issue subject to disclosure is increased and it is less likely that the overall size of the taxpayer’s liability will prevent the application of the penalty. While we do not feel strongly about any specific numbers, a revised individual threshold along the lines of “the greater of $25,000 or 5% of tax liability” would constitute an improvement over existing law.
4. Amount of Penalty

The percentages at which the Section 6662 penalty is applied are a targeted 20% for the negligence and substantial understatement prongs of the penalty and either 20% or 40% for the valuation penalties, depending on the extent to which the taxpayer’s valuation departs from the correct valuation. These are high rates in comparison to the 5% rate at which the negligence penalty was imposed prior to 1989 and the 10% rate at which the substantial understatement penalty was imposed when it was enacted in 1982. The rates were increased in the mid-80’s with little empirical support. We think that penalty rates that are too high are more difficult to administer consistently and may have the paradoxical result of making the penalty less effective because of a reluctance to impose it. A review of case law indicates that very few 40% penalties have been imposed over the years. We encourage repeal of the 40% rate for gross valuation misstatements.

5. Fee-based Preparer Penalties

Both studies recommend a fee-based measure for preparer penalties. The Joint Committee suggests that, instead of the current flat $250 penalty, first-tier violations incur a penalty of the greater of $250 or 50% of the preparer’s fee, and that the penalty for second-tier violations be the greater of $1,000 or 100% of the preparer’s fee rather than a flat $1,000 penalty. Treasury, without recommending specific thresholds, suggests consideration of a fee-based approach because, it contends, current preparer penalties are low compared with the tax liabilities involved and thus discourage IRS assessment on a cost-benefit basis.

Any concern that the preparer penalties are not an effective deterrent to inappropriate conduct should first focus on the effectiveness of the compliance programs for preparers. A review of decided cases suggests that cases involving preparers very rarely arise. A compliance regime that is not effectively policed is unlikely to be improved by increasing sanctions that are infrequently imposed. Tying preparer penalties to a preparer’s fee creates significant complexity and enforcement issues. Perhaps the issue of greatest concern is that it seems likely to increase the costs of return preparation, as preparers seek to protect themselves from large penalties. This problem is likely particularly to affect small taxpayers.

In situations in which the preparer performs a variety of services for the taxpayer, such a penalty would require an analysis of what portion of the fee relates to actual return preparation, in as much as the fee will vary substantially depending on the nature of the client and the extent of the representation. Because the size of the penalty may be substantial but would not vary based on the size of the position in dispute and is calculated on the preparer’s gross (rather than net) fee, it seems likely that those subject to the penalty will think it unfair as actually applied. For these and other reasons, we think that a tying of widely applicable preparer penalties to a percentage of the preparer’s fee is unwise. We express no view on whether the $250 and $1,000 amounts of these penalties are adequate to support expectations of preparers. However, we would note that the primary factors encouraging professional conduct from preparers are probably the professional standards of conduct of the preparer’s chosen profession,
the professional liability that a preparer may face from a client for a job poorly done, and the possibility of referral to the IRS’s Director of Practice. We are convinced that these factors far more strongly encourage professional and careful conduct and that substantial increases in infrequently asserted penalties are unlikely to elevate conduct substantially.

B. Interest and Payment Penalties

The JCT Study and Treasury Report recommend a number of changes to interest provisions and penalties for failure to file, failure to pay, failure to pay estimated tax, and failure to deposit tax.

1. Interest Provisions

The studies suggest various changes for interest, including (1) eliminating the differential between the interest rate the IRS charges on underpayments and the interest rate the IRS pays on overpayments, (2) pegging the interest rate at the applicable federal rate (“AFR”) plus five percent, (3) excluding IRS interest from individuals’ income, (4) providing additional interest abatement rules, and (5) instituting “dispute reserve accounts.”

a) Elimination of Rate Differential

The JCT Study proposes eliminating the differential between the interest rates charged on underpayments and paid on overpayments to make the system simpler and fairer. In contrast, the Treasury Report recommends retaining the interest rate differential for the time being in view of the recent enactment of the global interest netting rules and because retaining the differential mirrors the commercial sector model. We support the Joint Committee’s recommendation to eliminate the rate differential because we believe that a uniform interest rate for under- and overpayments will be perceived as evenhanded, simple and fair, while the rate differential of present law creates significant and unnecessary complexity without any significant compliance benefit.

While we accept as a conceptual matter the Treasury Report’s observation that commercial organizations attempt to achieve a profit on their lending and borrowing activities, we think that this observation has little to do with whether a differential in interest rates has a positive effect on tax compliance. Because the relationship between a taxpayer and the IRS is an involuntary one, because it is not always possible for a taxpayer to know whether at the moment the taxpayer is a borrower or lender from the government, and because different taxpayers are able to borrow money from commercial lenders at rates that differ substantially from the underpayment rate, we think it likely that the existing rate differential is viewed as unfair. For taxpayers with complex affairs, the concurrent accrual of the differential rates is a labyrinth of complexity and time is not needed to prove that one can cope with this complexity when a simple solution is available. We strongly encourage the enactment of uniform over- and underpayment interest rates. This will be a significant simplification in the law and is an opportunity to strengthen the image of the tax system as evenhanded and fair.
b) Interest Rate Increase

Both the Joint Committee and Treasury recommend a higher interest rate: the Joint Committee at the AFR plus 5%, and Treasury at the AFR plus 2-5%. While we have no specific recommendation to make on the most appropriate rate, we note that a significant divergence from market rates, in either direction, may result in taxpayer conduct oriented toward the arbitrage of this differential. Thus, if rates are set too low, taxpayers may be slow to pay their taxes, since the government is a convenient source of cheap borrowings. On the other hand, if rates are set too high, taxpayers may think the tax system unfair or may find an overpayment to be a relatively attractive investment. Accordingly, we encourage the interest rate to be set, as nearly as possible, at a rate that approximates a market rate. We are also concerned that, at AFR plus 5%, the underpayment rate will increase by two percentage points. This increase will make it more difficult for IRS’s Collection Division to resolve the unpaid liabilities of taxpayers who are in financial difficulty.

c) Exclusion of Refund Interest from Income

The JCT Study recommends excluding IRS interest from individuals’ income so that the effective post-tax interest rates on underpayments and overpayments are equivalent. Treasury does not agree with this suggestion. We have reservations about making refund interest tax free for individuals, particularly if the interest rate exceeds that of tax-exempt investments. We understand the Joint Committee Staff’s view that refund and deficiency interest should receive similar treatment. However, we think this objective would be better served by permitting the deduction of deficiency interest than by excluding refund interest from income. We also note that the present regime, which taxes refund interest but provides no deduction for deficiency interest, is consistent with the law’s general treatment of the interest income and the non-business interest expense of individuals.

d) Dispute Reserve Accounts

The JCT Study proposes the establishment of rules for the creation of dispute reserve accounts, which would be special interest-bearing accounts with the Treasury where taxpayers could deposit amounts in dispute. Under present law, a taxpayer can easily recover a disputed amount paid over to the IRS only if the payment was made in the form of a deposit in the nature of a cash bond, and such deposits are returned without interest. We support the Joint Committee Staff’s recommendation because the government has the use of the deposit until such time as it is returned to the taxpayer, and the establishment of the mechanism of a dispute reserve account will simplify taxpayers’ thinking when faced with a potential controversy.

2. Failure to File Penalty

At present, a failure to file a return results in a penalty of 5% of the unpaid amount each month for the first five months of the delinquency. The Treasury Report recommends imposing a lower penalty over a longer period, but with the same maximum
amount. The JCT Study suggests no changes in this area. We support Treasury’s proposal.
Once the failure to file penalty has fully accrued, it ceases to encourage the filing of the return; in
fact, a taxpayer’s inability to pay the penalty along with any tax due may deter the filing of the
return. Further, we think that this penalty, when added to other charges for noncompliance, may
exacerbate delinquent taxpayers’ difficulties in returning to a compliant condition. We believe
that a penalty that accrues more slowly will help to correct these problems within the current
regime.

3. Failure to Pay Penalty

The JCT Study recommends repeal of the failure to pay penalty, replacing it with
a five percent annual service charge if the taxpayer does not enter into, and adhere to, an
installment agreement by the fourth month after assessment. Treasury, on the other hand,
suggests imposing higher penalties, albeit with reductions if the taxpayer makes and follows an
IRS payment plan. We think it important that delinquent taxpayers be subject to some significant
sanctions for their delinquencies. However, we prefer the Joint Committee’s approach, primarily
because, in our view, the totality of interest, failure to file, and failure to pay penalties that
currently apply in many delinquency situations often functions as an impediment to full and
timely resolution of the delinquency, rather than as an incentive to correction.

4. Failure to Pay Estimated Tax

The Joint Committee recommends converting the failure to pay estimated tax
penalty to interest because it is essentially a time-value-of-money computation, and calling it
interest rather than a penalty may enhance taxpayers’ view of the tax system’s fairness. Treasury
does not support this conversion because it would enable corporations to deduct this charge for
the first time. Both studies recommend changes in individuals’ estimated tax thresholds and
various simplifications. We support converting the estimated tax penalty to an interest charge
and endorse measures to simplify the estimated tax rules. We do note that frequent changes in
the safe harbor threshold in Section 6654(d)(1)(C)(i) make compliance with estimated tax rules
more burdensome and cannot be justified on the basis of broad compliance objectives.
Accordingly, we strongly encourage both simplification and permanence in the establishment of
these thresholds.

5. Failure to Deposit Tax

Both the Treasury and Joint Committee studies note that the Internal Revenue
Service Restructuring and Reform Act of 1998 changed rules in this area, so Treasury suggests
just two changes, and the Joint Committee recommends no new legislation be enacted in this
area. We view Treasury’s penalty-reduction proposals as improvements and encourage Congress
to do more to lessen the size of this penalty, which, in our view, is out of proportion to the
conduct that it punishes.

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Mr. Chairman, that concludes the portion of our testimony on interest and penalties. Before discussing corporate tax shelters, I would be happy to respond to questions from the Committee on this portion of our testimony.
II. CORPORATE TAX SHELTERS

I would now like to turn to the very important subject of corporate tax shelters. Our testimony will use the term “corporate tax shelters” in discussing the very aggressive tax transactions currently being marketed. However, the Committee should understand that this phenomenon is not limited to large, multinational corporate taxpayers; indeed, it is not limited to corporations. Increasingly, tax shelter products are also being marketed to unincorporated business taxpayers, including middle market businesses and wealthy individuals.

My testimony today regarding corporate tax shelters contains three parts: (1) a brief discussion of the Tax Section's initial reactions to the administrative actions taken last week by the Treasury Department and the Internal Revenue Service to address the corporate tax shelter problem, (2) a description of the Tax Section’s corporate tax shelter legislative recommendations, and (3) an amplification of certain aspects of our legislative recommendations. But first, I want to say something about the corporate tax shelter problem.

A. The Corporate Tax Shelter Problem

We are aware that you may be told that there is no corporate tax shelter problem and that Congress does not need to take any action. This may be expressed with renewed energy following the administrative actions announced by Treasury and the Internal Revenue Service last week. Mr. Chairman, make no mistake about it. There is a serious problem, and it needs to be dealt with if we are to maintain public confidence in the tax system. Administrative action is very important, but there are limits on what can be accomplished administratively. The magnitude of the problem demands clear and forceful legislative action as well. In the 1970’s and early 1980’s, when individual tax shelters were in vogue, the vast majority of American people justifiably became outraged when they learned through the press that certain high-income taxpayers were eliminating or substantially reducing their tax liabilities by means of uneconomic and frequently artificial transactions. As the nature, scope and duration of the modern tax shelter abuse becomes

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3 The Section of Taxation has testified regarding corporate tax shelters on three prior occasions. On March 10, 1999, the Section testified before the Subcommittee on Oversight, on April 27, 1999 the Section testified before this Committee and on November 10, 1999 the Section testified before the House Ways and Means Committee. Our testimony today is consistent with this prior testimony.

4 We also refer to these shelters as “transactions,” although recognizing that the taxpayer’s investment in a financial or other tax shelter product, or other taxpayer action, may not fit the traditional description of a transaction. We believe all such actions need to be addressed by any legislation.
more widely understood by the taxpaying public, the American people may justifiably ask their elected representatives why action was not taken to stop this tax avoidance activity when the abuses were brought to the Congress’ attention.

Today, transactions that have little or no economic substance, that are designed solely to defer or permanently eliminate tax liability, and that are premised on opinions that either adopt aggressive interpretations of the tax law or are premised on questionable factual assumptions are being marketed to businesses of all sizes and to wealthy individuals. These transactions are not based on Congressionally mandated tax incentives, such as the low-income housing credit, but instead apply aggressive interpretations of the law in situations where the transactions would be dismissed out of hand by the taxpayers if it were not for the tax avoidance benefits of the transactions.

A simple example might illustrate the nature of the abuse with which we are faced. A Fortune 500 company was faced a few years ago with the necessity of paying tax on $445 million of economic gain from a business transaction. An investment bank, on learning of this, approached the company with a tax plan (or "product" in the modern vernacular):

- The company would enter into a partnership with a foreign entity that was not subject to U.S. taxes; the foreign partner would make a large capital contribution and thus initially own a majority of the partnership interests; the partnership would purchase property, then immediately sell it for a large cash down payment plus a five-year note that was indefinite in amount to bring the transaction within the installment sale regulations applicable to contingent payment sales.

- The regulations in question provide that the basis of property sold for a contingent note is spread ratably over the life of the note. This would create a large taxable gain from the down payment received in the year of the sale, almost all of which would be allocated to the tax-exempt foreign partner. The proceeds from the down payment would be distributed to the foreign partner to terminate its interest in the partnership.

- Since a large taxable gain had been realized by the partnership at the front end -- and there was of course no economic gain or loss in the property's value since it had been held only a brief time -- there was a built-in tax loss in the remaining notes receivable. That was left to be enjoyed by the remaining majority partner, the Fortune 500 company.

The result? The company reported a tax loss of $396 million, with no real risk other than transaction costs, and no real opportunity for profit other than the tax benefit. The investment bank was paid a fee of $7 million. We should not underestimate the impact on
voluntary compliance by individual taxpayers if they learn large companies can create tax losses of almost $400 million by paying a fee to an investment bank.

These are the facts of the *ASA Investerings* case in which the Court of Appeals for the D.C. Circuit recently affirmed the Tax Court’s rejection of the claimed tax benefits, *ASA Investerings Pshp. v. Commissioner*, No. 98-1583, 2000 U.S. App. LEXIS 1207 (D.C. Cir. Feb. 1, 2000). It is our belief that these transactions are spreading in the economy to smaller businesses and individual taxpayers, and that without serious government action the level of activity will continue to grow.

We are not in a position to estimate the impact on Federal revenues of the corporate tax shelter activity of the past several years. However, our experience as tax practitioners suggests that the level of tax shelter activity is very substantial. Many of the shelter transactions involve purported tax savings of tens of millions of dollars. Should Congress fail to take appropriate legislative action, taxpayers and their advisors may be emboldened and become even more aggressive.

**B. Treasury/IRS Administrative Actions**

Although we are still analyzing the administrative actions announced by the Treasury Department on February 28, 2000, we want to be on record as welcoming those actions. They appear to be a measured attempt to deal with the problem.

We applaud the clear burden the proposals appear to place on the promoters of abusive tax shelters, including the requirements that such shelters be registered with the Internal Revenue Service and that lists be maintained of taxpayers that have entered into such transactions. This should have a definite chilling effect on the eagerness of taxpayers to use abusive tax shelter products. We also support the requirement that corporate taxpayers must disclose certain types of transactions on their tax returns utilizing a "short information statement," but we want to carefully consider the proposed scope and content of such required statements. We are concerned both that such statements not unduly burden taxpayers entering into nonabusive transactions and that they be effective in uncovering abusive transactions.

We applaud the pronouncement by the Treasury Department that the new rules are not intended to require disclosure of customary business transactions or transactions with tax benefits that the Internal Revenue Service has no reasonable basis to challenge. We will closely study the mechanics of the proposed rules to determine if, in our view, they are likely to achieve those goals. We look forward to working closely with the Treasury Department and the IRS on such modifications as may be necessary to achieve these goals.

We are particularly pleased that Secretary Summers has committed that Circular 230 will be amended within six months to address the conduct of tax professionals.
issuing tax opinions that support abusive tax shelter transactions. Our proposal on this topic was submitted to the Treasury Department on October 29, 1999. We understand the role of professionals in these transactions and have evidenced in our proposal our willingness to address it as a part of the problem.

It is important, Mr. Chairman, to recognize that the administrative announcements of February 28, 2000 necessarily are limited to the statutory authority within which the Internal Revenue Service must operate. For example, the tax shelter registration requirement is inapplicable unless the transaction is offered “under conditions of confidentiality.” This requirement of section 6111(d) of the Code may be avoided, some will assert, by informal understandings and subtle economic compulsion that do not rise to the level of “conditions.” In addition, the requirement to maintain investor lists authorized by section 6112 of the Code is supported only by penalties under section 6708, which are limited to $50 per investor left off the list, with an aggregate annual cap of $100,000. Such a penalty structure cannot be expected to deter promoters of tax products expecting annual profits in the millions. Nor does the Code provide any specific penalty for failure to comply with the new tax return disclosure regime proposed in the February 28, 2000 administrative announcements.

C. Legislative Recommendations

Clearly, Mr. Chairman, there is a limit on what the Internal Revenue Service can do under existing law. Under the best of circumstances, it cannot detect all questionable transactions, it cannot devote audit resources to challenge all transactions it does detect, and it cannot litigate all of the cases that should be litigated. If the marketing of aggressive tax shelter transactions is to be constrained, it is vitally important to put added pressure on the marketing process.

The marketing of these transactions is predicated on the odds favoring success. Promoters understand that the IRS may be unable to detect and challenge more than a small fraction of transactions. They also view applicable penalties as relatively minor and probably avoidable. They put these factors together to make a compelling case that the transaction makes economic sense, even though the transaction would not withstand judicial scrutiny. Taxpayers often believe that they have little to lose other than transaction costs by entering into an aggressive tax shelter. Even if the claimed benefits are disallowed, they believe that they will be able to settle out the penalties and will be no worse off (other than transaction costs) than they would have been if they had not entered into the transaction.

Our legislative recommendations are intended to accomplish four objectives. First, to encourage the private sector – taxpayers, tax advisors, and those who market corporate tax shelters – to carefully scrutinize the facts and the legal analysis of proposed transactions and consider carefully the appropriateness of the transactions under the law. Second, to level the audit playing field by assuring that the largest and most aggressive of
these transactions are disclosed to the Internal Revenue Service on the tax return. Third, to make it clear to the Internal Revenue Service that Congress places emphasis on auditing and challenging questionable transactions. Fourth, to legislatively endorse a reasonable interpretation of the economic substance doctrine – an interpretation that we believe constitutes present law. We think these four objectives may be furthered by the following legislative actions.

1. **Require specific, clear reporting for a “large tax shelter”**

   We recommend the enactment of a new Section 6115 of the Internal Revenue Code that would require the following tax return disclosure for a “large tax shelter,” as defined.

   - A detailed description of the facts, assumptions of facts and factual conclusions (including conclusions regarding the business or economic purposes or objectives of the transaction) that are relied upon to support the manner in which the transaction is reported on the tax return;
   
   - A description of the due diligence performed to ascertain the accuracy of such facts, assumptions and factual conclusions;
   
   - A statement signed under penalties of perjury by the taxpayer’s chief financial officer or comparable senior corporate officer with a detailed knowledge of the business or economic purposes or objectives of the transaction that the facts are true and correct as of the date the return is filed, to the best of such person’s knowledge and belief. If the actual facts varied materially from the facts, assumptions or factual conclusions relied upon, the statement would need to describe such variances;
   
   - Copies of any written material provided in connection with the offer of the tax shelter to the taxpayer by a third party;
   
   - A full description of any express or implied agreement or arrangement with any advisor, or with any offeror, that the fee payable to such person would be contingent or subject to possible reimbursement if the anticipated tax benefits are not obtained; and
   
   - A full description of any express or implied warranty from any person with respect to the anticipated tax results from the tax shelter.

   The disclosure required by new Section 6115 would impose greater corporate and personal accountability than the reporting required under the new tax return disclosure
regime proposed in the February 28, 2000 administrative announcements. In addition, if a taxpayer fails to satisfy the Section 6115 disclosure requirements for a “large tax shelter,” a new Section 6716 would impose a $50,000 penalty. If the nondisclosure were determined to be willful, criminal penalties also would apply. The penalty should be a no-fault penalty relating solely to the failure to disclose information on the tax return. Neither the amount of the new Section 6716 penalty nor its applicability should be dependent on whether or not the transaction in issue results in a tax deficiency. Moreover, the nondisclosure penalty would be totally unrelated to any penalty to which the taxpayer might be subject under Section 6662.

We believe the proposed Section 6716 penalty should be subject to a reasonable cause exception permitting abatement of the penalty if the taxpayer establishes that it exercised due diligence in attempting to accurately report the relevant information (e.g., that it had appropriate fact-gathering procedures in place and that it did its best to follow them).

2. **Broaden the substantial understatement penalty to cover outside advisors, promoters and “tax indifferent parties”**

In any situation in which the substantial understatement penalty of existing law is imposed on the taxpayer, a penalty also should be imposed on any outside advisors who rendered favorable tax advice or opinions used in the promotion of the tax shelter, and promoters who actively participated in the sale, planning or implementation of the tax shelter. The same type of penalty should also be imposed on any "tax indifferent party," unless any such party can establish that it had no reason to believe the transaction was a tax shelter with respect to the taxpayer. The penalty should not be imposed on advisers who rendered opinions that comply with our proposed Circular 230 amendments.

Such penalties should be set at levels commensurate with the fees or benefits such parties stood to realize if the transaction were successful. In addition, separate procedural rules should be provided to assure such parties of due process, similar to the rules applicable in the case of penalties on tax return preparers.

3. **Define “large tax shelter” for purposes of proposed disclosure requirement**

The definition of “tax shelter” presently contained in section 6662(d)(2)(C)(iii) should be retained. The term “large tax shelter” would be defined as any tax shelter involving more than $10 million of tax benefits in which the potential business or pre-tax economic benefit is immaterial or insignificant in relation to the tax benefit that might result to the taxpayer from entering into the transaction. In addition, if any element of a tax shelter that could be implemented separately would itself be a “large tax shelter” if it were
implemented as a stand-alone event, the entire transaction would constitute a “large tax shelter.”

4. **Clarify that, where the economic substance doctrine applies, the non-tax considerations must be substantial in relation to the potential tax benefits**

Most courts, as well as careful tax advisors, apply the economic substance doctrine by weighing the potential tax and non-tax results of a contemplated transaction. We think this is entirely consistent with long-standing congressional intent, and we recommend that Congress codify the weighing requirement of the better case law. We believe that codification of this rule is desirable to provide a clear statement of the standard generally applied by courts under the economic substance doctrine, and would prevent reliance on unclear or conflicting judicial articulations of that standard in rendering opinions on tax-driven transactions. In this regard, we were pleased to see that the D.C. Circuit’s opinion in *ASA Investerings* rejected arguments that *de minimis* nontax economic attributes are sufficient to sustain a tax-motivated transaction. Any such codification would not, however, displace current law where the business purpose test is currently applied without a weighing of the tax and business objectives, such as the business purpose rules applied in the context of section 355 and in most tax-free corporate acquisitions.

5. **Articulate a clear Congressional policy that existing enforcement tools should be utilized to stop the proliferation of large tax shelters**

Congress should make clear its view that examination of large tax shelter transactions by the Internal Revenue Service should be considered a tax administration priority. This should include the application of both civil and criminal penalties when appropriate.

D. **Amplification of Certain Legislative Recommendations**

1. **Return Disclosure Requirement**

   a) **Rationale**

   We seek to achieve two objectives in proposing enactment of a “large tax shelter” return disclosure requirement. The first objective is to reduce the incentive to engage in transactions that would not withstand scrutiny on the ground that the likelihood of detection is small. Many tax shelter products and transactions are comprised of purportedly separate transactions or steps, often intended to obscure the overall transaction and frequently involving steps both within and outside the United States. As such, these transactions are extremely complex and often impossible to detect through information contained in a tax return, even by an experienced revenue agent. We believe Congress
should mandate specific tax return disclosure obligations that will lessen the significant role that the likelihood of escaping detection currently plays in the corporate tax shelter equation. On the assumption that a return disclosure system is designed to be compliance friendly, as we believe it can be, the argument that legitimate transactions may be affected should be considered with a healthy dose of skepticism. Whether legitimate in the eyes of the taxpayer or not, we would ask what is inappropriate about fair disclosure in a tax return context, even if the transaction is legitimate?

The second objective of the proposed return disclosure requirement is to encourage taxpayers and their advisors to pay careful attention to the actual facts underlying the proposed transaction prior to its consummation. We remain concerned, as we have previously testified, that often the facts assumed in analyzing the tax shelter are not the facts that actually occur. We believe the return disclosure requirement will underscore the importance of the actual facts of the transaction and encourage the taxpayer and its advisors to more carefully scrutinize the transaction in advance.

b) Certification by a senior officer

We believe the proposed senior officer certification is an extremely important component of the return disclosure requirement for two reasons. First, the senior business people within the organization who likely were involved in implementing the transaction, and, thus, who likely are most familiar with the actual facts, will be involved in preparation of the certification. It will be in the direct interest of the senior officer to assure such involvement, and there will be much less risk that the taxpayer’s return position will be based on other than the actual facts.

Second, because these transactions by definition are large (we suggest a $10 million reporting threshold) and because they are very aggressive, we think it is appropriate to encourage the taxpayer’s senior management to personally consider the proposed transaction. If the chief financial officer or a comparable senior officer knows that he or she will be required to execute the certification, we expect the officer will be much more interested in being personally advised of the transaction and of its risks before it is consummated.

Because of the potentially serious civil and criminal penalties that could result to a corporate officer who commits perjury by executing an inaccurate certificate, the

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5 Some unincorporated businesses that will be subject to the reporting requirement may not have officers. Thus, it will be important for the legislation, or the legislative history, to make it clear that in such circumstances the certification must be executed by the person with responsibilities comparable to those of a senior corporate officer.
legislation should provide appropriate separate administrative and judicial procedures that will accord the officer full due process. To this end, procedures should be established for reviewing officer certification issues that are independent of the audit process.

Mr. Chairman, the Tax Section attaches particular importance to the proposed large tax shelter return disclosure requirement because we believe it has the potential to accomplish two important objectives: (1) reduce the incentive to rely on nondiscovery by the IRS and (2) encourage a more careful factual and legal analysis of the transaction on the front end, before the transaction is consummated. A disclosure requirement which has this effect will make a significant contribution to tax administration and the American people’s confidence in the tax system.

2. Affirmation of Economic Substance Standard

We are aware that certain advisors have taken the position that any amount, even a de minimis amount, of risk, profit or other economic return is sufficient to satisfy the judicial economic substance doctrine. While we are confident that this view does not reflect present law, it is important to foreclose such assertions. It is for this reason that we make the relatively modest suggestion that Congress legislatively affirm that when a court determines the economic substance doctrine applies, the taxpayer must establish that the non-tax considerations in the transaction were substantial in relation to the potential tax benefits.

Our recommendation does not require the Congress to adopt a definition of economic substance or specify the particular circumstances in which the doctrine is relevant. We think both of these matters are best left to the courts where judicial discretion can be applied on a case-by-case basis. However, we think it is appropriate and important for the Congress to affirm what we believe to be current law, namely, that the non-tax considerations in the transaction must be substantial in relation to the potential tax benefits. It would also be helpful if Congress would make it clear that in evaluating the non-tax aspects of a transaction, such as potential economic profit, all of the costs associated with the transaction, including fees paid to promoters and advisors, should be taken into account.

To be clear, we do not support codification of any particular formulation of the economic substance doctrine. We believe it would be prohibitively difficult to codify the doctrine without creating untold and unintended effects to ordinary business transactions and possibly even missing transactions that ought to be covered. Rather, we propose to leave to the courts when and how to apply the doctrine. Our narrow proposal is simply that Congress confirm that de minimis non-tax benefits will not sustain a tax motivated transaction and instead that economic attributes must be substantial in relation to tax benefits, as ASA Investerings decided.

* * *
One of the arguments that we expect the Committee will continue to hear from opponents of corporate tax shelter legislation is that the Internal Revenue Service already has the tools to deal with corporate tax shelters on its own, without legislation. Last week's administrative steps by the Treasury Department and the Internal Revenue Service will be cited as examples of action that could have been taken long ago; the argument will be made that no legislation is appropriate at least until the effectiveness of such administrative attempts can be gauged. Recent court decisions in the Commissioner’s favor may be cited as additional proof to support this point of view.

We urge the Committee not to accept these assertions. The administrative actions are important and they should be welcomed by the Committee. But legislation is needed to fill in the gaps that are beyond the power of the Treasury and IRS. Ours is a self-assessment system. It works best when taxpayers are motivated to take their return reporting obligations seriously. We think it is important to modify the behavior of taxpayers, their tax advisors and those involved in the marketing of tax shelters through an improved self-policing system. Changes to Circular 230 will help. Increased reporting requirements and audit activity by the Internal Revenue Service is very important. But, Congress also has a responsibility. We urge the Committee to take the lead by adopting legislation along the lines we recommend. As you proceed in your deliberations, please know that members of the Tax Section are prepared to lend a helping hand.

CONCLUSION

Mr. Chairman, thank you for the opportunity to appear before the Committee today. I will be pleased to respond to any questions.