June 22, 2000

The Honorable Daniel Patrick Moynihan
Ranking Member
Senate Finance Committee
United States Senate
464 Senate Russell Office Building
Washington, DC 20510

Proposed Corporate Tax Shelter Legislation

Dear Senator Moynihan:

We appreciate the opportunity to comment on the bipartisan preliminary staff discussion draft of proposed tax shelter legislation that was released on May 24, 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 a significant contribution to the ongoing process of crafting appropriate legislation to halt abusive corporate tax shelters. The Draft includes a number of provisions that we have previously 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 are particularly encouraged that the Draft includes a requirement that the disclosure statement be signed under penalties of perjury by the chief financial officer or other senior corporate officer with knowledge of the facts. We have consistently advanced this proposition as an important step toward improved corporate tax shelter processes. 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. Definition of corporate tax shelter.

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 penalty scheme for deficiencies resulting from items attributable to a “corporate tax shelter.” Proposed section 6662A(c) defines a corporate tax shelter as any transaction in which a large corporation directly or indirectly participates if a significant purpose of the transaction is the avoidance or evasion of federal income tax. The Draft further provides that a significant avoidance purpose is deemed to exist if one of the tax shelter indicators contained in subparagraphs (B), (C), and (D) of section 6662A(c)(2) is present.

Although we believe that the Draft’s definition of corporate tax shelter is on the right track, we recommend two modifications. First, we believe that the application of section 6662A should be limited to transactions in which one of the tax shelter indicators described in section 6662A(c)(2) is present. The "significant purpose" test is necessarily ambiguous because of its subjective nature. We believe that the scope of the tougher penalty scheme should be limited to situations involving one of the specific tax shelter indicators of section 6662A(c)(2) to reduce uncertainty both for taxpayers and the Internal Revenue Service (the “Service”) in determining whether a particular transaction should be subject to the tougher penalties. 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.

Second, we recommend that the permanent book-tax difference prong of section 6662A(c)(2)(D) be eliminated. There are many ordinary and legitimate business transactions that create permanent book-tax accounting differences. We believe that including this prong in the subparagraph (D) tax shelter indicator may inappropriately inhibit such transactions. In addition, we are studying whether the economic risk test set forth in subdivision (iii) of subparagraph (D) should be limited to the creation of losses, deductions or credits, and thus not be applicable to deferrals, such as deferrals permitted under sections 351 or 721.

II. Absence of separate penalty for failure to comply with disclosure requirements.

The Draft does not provide a separate penalty for failure to comply with the disclosure rules in proposed section 6662A(d)(4). Instead, the incentive to comply with the disclosure rules is built into the deficiency penalties. The penalty applicable to a corporate tax shelter understatement is set at 40% of the deficiency, but may be reduced to 20% or even 0% if the disclosure rules are followed and certain other conditions are met. There is no separate penalty for failing to disclose the existence of the tax shelter transaction if the taxpayer ultimately prevails and there is no deficiency.
The Tax Section has consistently maintained that tax shelter disclosure requirements should be separately codified and that there should be a separate, meaningful penalty for failure to comply with the disclosure requirements, regardless of whether a tax deficiency or a deficiency-related penalty is asserted against the taxpayer. If the law provides an escape hatch for failing to disclose participation in a tax shelter transaction, corporations and their tax advisers will have a significant incentive to find ways to avoid disclosure and thereby diminish the chances that the transaction will be discovered on audit. In the absence of a separate penalty for failure to disclose a corporate tax shelter transaction, we believe that the parties to the transaction—the taxpayer, the promoter and the adviser—will continue to play the audit lottery, or at least to rely on the likelihood that, if the transaction is discovered and a deficiency is asserted, it can be settled without penalties. Accordingly, we recommend that the disclosure rules set out in proposed section 6662A(d)(4) be made mandatory and that a separate, meaningful penalty be established for failure to comply with those rules (regardless of whether a tax deficiency or related penalty is asserted), including the requirement that any disclosure statement be signed under penalties of perjury by a senior corporate officer who has knowledge of the facts. We have previously recommended that the penalty for failure to follow the disclosure rules should be set at $50,000.

We wish to stress that the reporting requirement has an important function quite apart from providing an audit trail for the Service. The knowledge that clear and succinct reporting will be required for transactions that meet certain criteria—cannot be avoided or rationalized away by an adviser who promises a strong likelihood of success—will encourage taxpayers and their advisers to scrutinize the facts and the legal analysis underlying proposed transactions in advance and consider carefully the appropriateness of the transactions under the law. As we have testified before both tax writing committees, we believe that often the facts assumed in analyzing a corporate tax shelter are not the facts that actually occur. Certainty regarding the return disclosure requirement, including most particularly the penalties of perjury

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1 The separate codification of a disclosure requirement is appropriate despite the disclosure rules contained in the recently issued temporary corporate tax shelter regulations because the scope of those regulations is not sufficiently broad. Temp. Treas. Reg. § 1.6011-4T. For example, there is no analogue in the temporary regulations to the subparagraph (B) tax shelter indicator in proposed section 6662A(c)(2). We think, however, there should be a reaffirmation, presumably in legislative history, of the Service's authority to impose reasonable reporting and disclosure requirements generally, and specifically with respect to tax shelters.
statement by a senior corporate officer, will increase the taxpayer's interest in careful due diligence regarding the actual facts of the transaction.

III. Penalties.

(a) Complexity.

The Draft generally imposes a 40% penalty on a deficiency attributable to a corporate tax shelter. However, if the transaction has a material non-tax business purpose, the penalty is reduced as follows:

- to 20% if the taxpayer (i) reasonably believes that it is “more likely than not” that its tax treatment of the corporate tax shelter will prevail on the merits and (ii) complies with the disclosure requirements;
- to 20% if the taxpayer reasonably believes that it “will” prevail on the merits (even though there is no disclosure); or
- to 0% if the taxpayer (i) reasonably believes that it “should” prevail on the merits and (ii) complies with the disclosure rules.

This scheme is unnecessarily complex. More importantly, it gives far too much weight to the different levels of opinions, as if there were clear lines between “more likely than not,” “should,” and “will” opinions. We believe that this scheme will stimulate opinion shopping by taxpayers, particularly when the 40% penalty can be cut in half without disclosure if a “will” opinion can be obtained. We do not believe the requirement that the transaction must have a material non-tax business purpose will have much impact on taxpayer behavior because that is already a requirement under case law, and taxpayers always seem to think their transaction has sufficient business purpose. Accordingly, we recommend that there be only one level of penalty that applies to corporate tax shelters.

(b) Level of penalty.

We believe that a 40% penalty is too high and that 20% is the appropriate penalty level for corporate tax shelters. 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 a 40% penalty is likely to provide an independent source both of adversarial tension in the audit and of litigation. As presently proposed, whether a penalty is 20% or 40% could turn on a court’s deciding such questions as whether the taxpayer reasonably believed that its tax treatment of the corporate tax shelter transaction “will” prevail on the merits, or only that it “more likely
than not will” prevail. Resolving such fine distinctions does not seem a wise use of judicial resources and will inevitably lead to inconsistent results.

(c) Reasonable cause exception; waivers.

Under present section 6664(c) of the Code, accuracy-related and fraud penalties are not imposed with respect to an underpayment of taxes if it is shown that there was a reasonable cause for such underpayment and the taxpayer acted in good faith with respect to such underpayment. The regulations under section 6664(c) contain detailed rules for applying the reasonable cause exception to understatement penalties attributable to corporate tax shelter items. Under these rules, the minimum requirements for applying the exception include (i) the existence of substantial authority (which is an objective standard) for the taxpayer’s tax treatment of the item and (ii) the taxpayer’s reasonable belief, at the time that the return was filed, that there was a greater than 50-percent likelihood that the treatment of the item would be upheld if challenged. The regulations, however, indicate that meeting these minimum requirements is not dispositive and that all of the facts and circumstances surrounding the transaction must be considered in determining whether the taxpayer acted with reasonable cause and good faith, including the taxpayer's non-tax business purposes (and the relative weight of such purposes) for entering into the transaction and for the particular structure of the transaction. We think that these rules, if consistently and stringently applied, provide good parameters for determining whether a penalty should apply in a particular case. It may be appropriate to consider making certain changes to these rules to make them consistent with the requirements imposed in the Draft. For example, section 6664(c) could be amended to provide that failure to comply with the disclosure rules in the Draft would be an indication of lack of good faith.

We also believe that the Draft’s prohibition of penalty waivers is inadvisable. Congress simply cannot anticipate all situations in which reduction or elimination of a penalty is appropriate. Consequently, we believe that the Service should have the authority to waive the penalty if the taxpayer can show reasonable cause and good faith, as it does in the case of other penalties.

If there is concern that the Service’s field personnel will be too lenient in agreeing to reduction or waiver of penalties, such actions could be subjected to a special review process within the Service.

IV. Economic Substance Doctrine

2 Treas. Reg. §1.6664-4(e).
We commend the staffs for not attempting to codify the economic substance doctrine in the Draft. We consistently have noted the high potential for misuse that could flow from such an amendment, and the potential loss of a valuable body of case law inherent in doing so.

We note the absence of a provision that would make clear that the economic substance test is not met by the presence of economic attributes that are de minimis when compared to intended tax benefits. We continue to believe that such a provision would be a helpful addition to tax shelter legislation, in order to foreclose promoters’ attempts to portray the existence of any nontax benefits as “sufficient.”

V. Limits on the applicability of the tax shelter rules.

The provisions of the Draft generally would apply only if a “large corporation” engages in a tax shelter transaction. While that approach might be politically attractive, our members have seen tax shelter promoters begin to market tax shelters more broadly to smaller corporations, partnerships, and wealthy individuals. Consequently, we believe that the threshold for application of the provisions of the Draft should be based on the dollar size of the tax benefits produced by the transaction, not the size or type of the taxpayer. If the dollar threshold for tax shelter transactions that are subject to the new legislation is set at an appropriately high level (for example, $5 million in tax benefits), there is no discernible policy reason for not applying the same rules without regard to the type or size of the taxpayer engaging in the abusive tax shelter. Accordingly, we recommend that you consider extending the application of the Draft to taxpayers other than large corporations, but applying a reasonably high dollar threshold.

We note that the definition of “large corporation” includes those having average annual gross receipts of $10 million over a three-year period. This definition will reach many corporations not commonly regarded as large. Consequently, if this definition is to be used in the Draft, the gross receipts threshold should be raised to a higher level (for example, $100 million).

VI. No tax or penalty on tax indifferent parties.

The Tax Section previously has recommended 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 unsuccessful corporate tax shelter 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 a corporate 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.

VII. Aiding and abetting penalties.

The Draft extends the application of the aiding and abetting penalty in section 6701 to any person who (i) aids or assists in, procures, or advises with respect to the creation, organization, sale, implementation, management, or reporting of a corporate tax shelter, (ii) knows (or has reason to believe) that the corporate tax shelter (or any portion thereof) could result in an understatement of tax liability of a large corporation, and (iii) opines, advises, represents, or otherwise indicates (directly or indirectly) that it was reasonable to believe that the tax treatment “should prevail or not give rise to a penalty,” if a reasonable tax adviser would not have so believed. Accordingly, a tax adviser who renders a tax shelter opinion that it was reasonable to believe that the tax treatment “should prevail or not give rise to a penalty” would be subject to penalty if a reasonable tax adviser would not have so believed.

We have consistently supported extension of the aiding and abetting penalties to reach promoters, their advisers and other participants in the transaction. At the same time, we urge that great care be taken not to deter taxpayers from obtaining independent advice on transactions. It would be contrary to the apparent intent of the legislation to deter taxpayers from seeking such advice. For this reason, we believe that there should be a specific exemption from the aiding and abetting penalty for independent advisers, that is, those who (i) are not involved in the creation, promotion, or sale of the corporate tax shelter, (ii) are not described in the Draft’s list of advisers whose opinions may not be relied upon (i.e., advisers who are promoters, compensated by promoters, have contingent fee arrangements, or have referral agreements with a promoters), and (iii) comply with the standards for tax shelter opinions advanced in our October 1999 proposal for amendment of Circular 230.

VIII. Limitations on opinions of professionals to assure independence.

The Draft provides that a tax adviser’s opinion may not be relied upon to establish the reasonable belief of a taxpayer if the adviser is a promoter, is compensated by a promoter, has a contingent fee arrangement, or has a referral agreement with a promoter. The Draft also precludes reliance on an opinion if it fails to meet certain standards. While we generally agree that such restrictions are appropriate if a reasonable belief approach is to be adopted, we believe that the rule regarding failure to meet “any other applicable professional ethics or practice standard” in proposed section 6662A(d)(5)(B)(ii)(I) is too vague a test for precluding reliance on a tax adviser’s opinion. There are many potential state and local issuers of such statements, and they may not be in complete agreement.
on every point. Consequently, we recommend removal of that language from the Draft.

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

Sincerely,

Paul J. Sax
Chair

cc: Members, Senate Finance Committee
The Honorable Bill Archer, Chair, Committee on House Ways and Means
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John L. Buckley, Minority Chief Tax Counsel, House Ways and Means Committee
Lindy L. Paull, Chief of Staff, Joint Committee on Taxation
Jonathan Talisman, Acting Assistant Secretary (Tax Policy), Department of the Treasury
The Honorable William V. Roth  
Chair  
Senate Finance Committee  
United States Senate  
104 Hart Senate Office Building  
Washington, DC 20510

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to avoid inadvertently penalizing transactions that are not abusive tax shelters. Section 6662A of the Draft provides an enhanced penalty scheme for deficiencies resulting from items attributable to a “corporate tax shelter.” Proposed section 6662A(c) defines a corporate tax shelter as any transaction in which a large corporation directly or indirectly participates if a significant purpose of the transaction is the avoidance or evasion of federal income tax. The Draft further provides that a significant avoidance purpose is deemed to exist if one of the tax shelter indicators contained in subparagraphs (B), (C), and (D) of section 6662A(c)(2) is present.

Although we believe that the Draft’s definition of corporate tax shelter is on the right track, we recommend two modifications. First, we believe that the application of section 6662A should be limited to transactions in which one of the tax shelter indicators described in section 6662A(c)(2) is present. The "significant purpose" test is necessarily ambiguous because of its subjective nature. We believe that the scope of the tougher penalty scheme should be limited to situations involving one of the specific tax shelter indicators of section 6662A(c)(2) to reduce uncertainty both for taxpayers and the Internal Revenue Service (the “Service”) in determining whether a particular transaction should be subject to the tougher penalties. 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.

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in a corporate 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.

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