Dear Senators Baucus and Grassley:

These comments, filed on behalf of the Section of Taxation of the American Bar Association, address the Tax Shelter Transparency Act (the “Act”) which was introduced on May 9, 2002.

We commend you for your introduction of the Act. The Section has long urged Congress to adopt a disclosure-based regime to address the problems posed by tax shelters. The Act is a strong step in that direction. We commend the leadership of the Senate Finance Committee for taking a bipartisan approach to deal with this serious challenge to the integrity of our tax system.

The Section has for many years expressed its concern about the usage of tax shelters by both corporations and individuals. In response to the tax shelters of the late 1990s, the staff of the Senate Finance Committee has made several helpful draft proposals in recent years. In response to each of these proposals, the Section has asserted that tax shelters will better be combated with sunshine than with greater penalties. The Act adopts a disclosure-based approach that we heartily endorse.

Although we support the general approach taken to address tax shelters in the Act, there are some aspects of the bill that give us pause. We applaud particularly (i) the bill’s application to both corporate and noncorporate taxpayers; (ii) the separate nondisclosure penalty for both listed and nonlisted reportable transactions; (iii) the increased accuracy-related penalty and the heightened “reasonable belief” thresholds for certain undisclosed reportable transactions; and (iv) the inability to rely upon certain disqualified advisors and opinions in asserting the “reasonable cause/good faith” exception of section 6664.

Our principal concerns relate to (i) the inability of the IRS to waive, in any case, the nondisclosure and increased accuracy-related penalties; (ii) the substantial complexity that will result from using the overly inclusive “significant purpose of tax avoidance” filter in determining the accuracy-related penalty for nonlisted
reportable transactions; (iii) the use of a “more likely than not” reasonable belief threshold for undisclosed nonreportable transactions, and also for purposes of the increased preparer penalties under section 6694; and (iv) various aspects of the “material advisor” concept, including the potentially overbroad definitional parameters of that term, and the potential intrusion on the attorney-client privilege of the requirement that such advisors furnish “information describing the advice provided.”

Set forth below are more detailed comments concerning the main features of the Act, including suggestions for certain revisions that we urge be considered.

Section 101. The fundamental concept in Section 101 of the Act involves “reportable transactions” for which disclosure is required. The task of defining such transactions is delegated to Treasury, which we believe is appropriate. A legislative definition of such transactions likely would be either over-inclusive or under-inclusive; Treasury is the branch of government best situated to define reportable transactions. Once these transactions are identified by the Treasury, taxpayers may fairly be required to disclose them.

We also support the concept of larger penalties being imposed on taxpayers who fail to disclose listed transactions. If a taxpayer enters into a listed transaction after the transaction has been so identified, the taxpayer does so at its own peril. Disclosure of listed transactions is both fitting and appropriate. The Legislation should also clearly require disclosure if a taxpayer is taking a position contrary to a regulation.

On the other hand, we are concerned about the absence of a grant of authority to the IRS to waive penalties in appropriate circumstances. For example, the proposed legislation would apply the greatest sanctions to the failure to disclose a transaction which is “substantially similar to” or that produces a tax result that is “the same as or similar to” that of a listed transaction. Reasonable people could reasonably disagree whether a transaction is substantially similar to, or produces the same tax results as, a listed transaction. Although the application of penalties to such transactions appears to be appropriate, we believe that it would be fairer if a penalty could be waived by the IRS in its sole discretion. This type of “safety valve” will avoid inappropriate penalties and also prevent situations in which courts will have to choose between applying inappropriate penalties or applying no penalties at all. Sound tax administration requires flexibility; the power to waive penalties would give this flexibility to the IRS. The legislative history should indicate that this authority would be exercised only in rare and unusual circumstances. As a result, a taxpayer who enters into a transaction that is arguably similar to a listed transaction and who fails to disclose would still do so at his or her own risk.

We take no position at this time with respect to any provisions in the Act not mentioned specifically below. We will submit additional comments, if appropriate, as we complete our review of the Act.
Section 102. We agree that failure to disclose a listed or nonlisted reportable transaction should generally result in not only a significant nondisclosure penalty, but also in an increased understatement penalty. Although, as discussed below, we would prefer an alternative approach, the threat of increased penalties relating to any understatement, in addition to the penalty for failure to disclose, should cause most taxpayers to disclose reportable transactions.

We also support the purpose and intent of the proposal in Section 102(c) of the Act that certain opinions may not be relied upon by taxpayers in order to establish reasonable belief. In this regard, the Section recently submitted comments concerning Circular 230 (the rules of practice before the IRS) that propose a significant expansion of what constitutes a suspect fee arrangement, to include any fee arrangement, contingent or otherwise, that deviates substantially from what would be charged for the same work based on reasonable hourly rates. We believe that this approach is preferable to the reliance upon the “contingent fees” criterion referred to in the Act, particularly since certain contingent fee scenarios are expressly sanctioned by Circular 230.

The definition of “disqualified opinions” should be expanded to include any tax opinion that is not in compliance with the requirements of Circular 230. We also would disqualify any tax opinion if the practitioner's liability were expressly limited or if the practitioner has agreed to indemnify the taxpayer against the loss of all or any portion of the tax benefits from the transaction. On the other hand, we believe that "contingent fee" arrangements that would not involve the enhanced opinion requirements of Circular 230 should not ipso facto result in disqualification of an advisor or an opinion. For example, a fee based on regular hourly rates but that will not be paid (or will be reduced) if a transaction does not close is technically a "contingent fee" arrangement, yet there is little likelihood of abuse in such situations. The IRS should be authorized to issue regulations addressing situations in which practitioners, whose fee arrangements or opinions would not involve the enhanced opinion requirements of Circular 230, are not automatically disqualified.

Two aspects of Section 102(b) of the Act are somewhat troublesome. First, proposed section 6662(i) would impose a penalty on reportable transaction income with respect to a hypothetical tax liability and without regard to the actual tax liability of the taxpayer involved in the transaction. Because the situation of taxpayers can vary greatly, this could result in penalties in some situations that are completely disproportionate to the amount of the tax benefit, if any, that the taxpayer could have obtained from the transaction. We believe that penalties should be a percentage of the tax savings that the taxpayer would have obtained if the taxpayer's position were sustained, and not a percentage of the highest amount of tax savings that theoretically could have been obtained.

Second, we do not believe that the “a significant purpose” test that is utilized in proposed section 6662(i)(2)(B) is appropriate as a basis for imposing higher penalties for non-disclosed transactions. We have continually commented that this
test is not appropriate because most transactions are structured so as to minimize the
tax liabilities of the parties involved in the transaction. Thus, it may be difficult to
find that any transaction was not structured in a manner that satisfied proposed
Section 6662(i)(2)(B). A test that does not help separate the good from the bad
simply adds complexity to the Code without narrowing the scope of transactions
subject to the increased understatement penalty. This complexity is exacerbated by
the fact that the proposed significant purpose filter would spawn four separate sets of
penalty regimes, each with its own thresholds and conditions.

We believe that an alternative approach would be preferable. The focus of
the Act should be placed on disclosure. In order to encourage disclosure, we would
simply provide in Section 101 of the Act that the penalty for failure to disclose
would be increased by a percentage (10% for listed transactions, 5% for other
reportable transactions) of the understatement resulting from such transactions.
Accordingly, if the taxpayer failed to disclose a reportable transaction and the
taxpayer’s position was sustained, the taxpayer would pay a flat penalty; if the
taxpayer’s position was not sustained, the taxpayer would also pay an increased
reporting penalty.

We believe that this approach is simpler, more accurately reflects the purpose
of the Act and removes the need to have a “second filter” under which a
determination is made concerning whether increased penalties should apply as a
result of a substantial understatement of tax. The substantial understatement of tax
penalties can then be applied completely independently of the disclosure regime,
with failure to disclose being subject to its own penalties.

Finally, as discussed above, we do not believe that non-waivable penalties
are in the best interest of sound tax administration. The IRS should always be given
the discretion to waive penalties in situations in which the IRS, in its sole discretion,
believes it would be advisable to do so. If a waiver feature is not considered
appropriate for the nondisclosure penalty, it should at least exist for purposes of
applying increased accuracy-related penalties to nondisclosed reportable transactions
(whether listed or nonlisted).

**Section 103.** Section 103 of the Act would apply substantial understatement
penalties to any taxpayer who engages in a non-reportable transaction unless the
taxpayer reasonably believed that the proposed tax treatment of any non-disclosed
transaction was more likely than not the proper treatment. This is a significant
change in the law; under present law, a taxpayer who engages in a transaction that is
not a tax shelter would be subject to this penalty only if the taxpayer lacked
substantial authority for its position.

We do not support this proposed change in the law. Although we support the
imposition of increased penalties on taxpayers who fail to disclose reportable
transactions, there does not appear to be any justification to increase penalties on
taxpayers who engage in non-reportable transactions. If a transaction is not
reportable, a taxpayer should be able to take a position on his or her return concerning the transaction without fear of penalties if the taxpayer has substantial authority to support the position.

Moreover, the substantial authority standard may be easier for taxpayers to apply than the more-likely-than-not test proposed in Section 103 of the Act. The presence or absence of substantial authority can be determined by reference to cases, rulings or regulations, whereas the determination whether or not a taxpayer reasonably believed that the proposed treatment was more likely than not correct involves a highly subjective judgment by the court.

Our position on this issue was succinctly stated in our testimony to the Senate Finance Committee in 2000:

"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."

Sections 201 through 204. We support the requirement that material advisors, including lawyers, accountants and other professional advisors, be required to file disclosure returns concerning, and maintain lists of, reportable transactions as required under regulations subject to attorney-client and other relevant privileges. We also support the delegation to the Treasury of authority to promulgate rules concerning which advisors should be treated as “material” to a transaction. Because of the considerable uncertainty as to who would be required to file disclosure returns concerning transactions, it is necessary that the effective date of this requirement be postponed until after regulations that address this issue are promulgated by the IRS. Until such regulations are issued, it will be unclear who is required to file disclosure returns concerning, and maintain lists of, reportable transactions, so that the rules will be unworkable without such guidance.

The regulations will need to provide concrete and specific guidance as to who is a "material advisor" to a taxpayer. For example, we believe that a person who provides advice to the taxpayer after the completion of a transaction should not be treated as a “material advisor.” Therefore, a tax return preparer who was not involved in the transaction, or a lawyer who analyzes the transaction after it has been implemented, would not be required to make a disclosure. Likewise, lower-level employees of a law or accounting firm might not be included within the definition of a "material advisor," although the regulations could clarify that a partner or shareholder in a law or accounting firm would be so treated. Such regulations are necessary because of the potentially broad meaning of the words “implementing” or “carrying out” of a reportable transaction.
A related issue concerns the timing of the filing of any disclosure. The proposed statutory language would require a disclosure return to be filed “on the first business day following the earliest date on which such advisor provides any material aid, assistance or advice with respect to organizing, selling, implementing or carrying out the transaction (or such later date as the Secretary may prescribe).” Unless regulations are issued that permit a delay in filing, a practitioner would be required to file a return when a client merely asks a preliminary question concerning the feasibility of a reportable transaction, even if the transaction is not implemented. This would result in needless and excessive filings. The effective date of this provision should be deferred until regulations are issued that set forth clear and concise rules concerning when practitioners are required to file disclosure returns with respect to reportable transactions that their clients have implemented.

Finally, we believe that the language proposed for new section 6111(a)(2) should be considered for possible deletion. This language calls for the material advisor’s return to include “information describing the advice provided by such advisor, including any tax benefits represented to result from the transaction.” We believe that this language will present significant problems in the development and application of new section 6111 regulations, and that its deletion would not undermine any of the policy goals of the legislation. The subsection (2) language may, for example, force the regulation writers to seek privileged information when it is not clear that such information is material to tax shelter administration. In addition, subsection (2) appears to require that, where there are multiple advisors, the material advisor filing the report include its own advice (and potentially its own representations concerning tax benefits, depending on the reading of the “represented” language) but not the advice and representations of other advisors (which the reporting advisor may not be aware of in any event). This would create unwanted pressures on the regulatory determination of who is a material advisor, and on the identification of the one material advisor who is required to report when there are multiple material advisors in a transaction. We believe that the other language, referring to identification, description, and “such other information as the Secretary may prescribe” is sufficient to permit the requirement of the material that the IRS needs to understand and analyze reportable transactions.

Section 211. This provision of the Act would apply the return preparer penalty under Section 6694(a) to any preparer who did not reasonably believe that the proposed treatment was more likely than not correct. We do not support this proposal.

Section 211 would impose on return preparers the difficult task of making a determination whether the proposed treatment of each item on a return is more likely than not correct. For reasons similar to those discussed above with respect to Section 103 of the Act, we believe that this change will impose a significant cost on
the millions and millions of taxpayers who utilize return preparers, but it will likely
not have any significant impact on tax shelters or abusive or fraudulent transactions.

We would not change current law. However, if Congress is concerned that
the “realistic possibility of success on the merits” standard of existing Section 6694
is too lenient, we could support a change under which return preparers would be held
to the “substantial authority” standard. This standard is a relatively objective one
and would be preferable to the proposed “more likely than not” standard.

We generally support the proposal concerning frivolous submissions.
However, because many of the taxpayers who make such submissions will likely be
either poorly-advised or poorly-educated, we suggest that subsection (b)(3) be made
mandatory rather than optional, i.e., the Service must provide the taxpayer with an
opportunity to withdraw the frivolous submission and a suitable period (e.g., 30
days) to do so before imposing a penalty. If the taxpayer fails to take advantage of
this withdrawal opportunity, then penalties should be imposed (subject to the IRS’
ability, in its sole discretion, to subsequently waive the penalty).

Section 214. We support this proposal, which appears to reflect our prior
comments on the proposed revisions to Circular 230.

* * * * * * *

We appreciate the opportunity to provide this input and would be pleased to
discuss this important legislative initiative further with either of you or with your
staffs. Please contact Bill Wilkins, our Vice Chair for Government Relations (at
202-663-6204) if you have any questions regarding these comments or if we can be
of any further assistance in any way.

Sincerely,

Richard M. Lipton
Chair, Section of Taxation

cc: Russell Sullivan, Democratic Chief Tax Counsel, Senate Finance Committee
    Staff
Mark Prater, Republican Chief Tax Counsel, Senate Finance Committee
    Staff
Lindy Paull, Chief of Staff, Joint Committee on Taxation
Pamela F. Olson, Acting Assistant Secretary, Tax Policy, Department of
    Treasury
Eric Solomon, Deputy Assistant Secretary, Regulatory Affairs, Department
    of Treasury