June 27, 2002

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Mr. B. John Williams
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Re: Treasury Department Tax Shelter Proposals dated March 20, 2002

Dear Ms. Olson, Mr. Rossotti and Mr. Williams:

These comments, filed on behalf of the Section of Taxation of the American Bar Association, address the various proposals (the “Proposals”) made by the Department of the Treasury and the Internal Revenue Service on March 20, 2002, to address tax shelters.

We appreciate the opportunity to comment on the Proposals and commend you for publicizing them in advance of their promulgation as proposed regulations. The Section has long been concerned about tax shelters, both individual and corporate, and the Section has consistently urged both the Administration and Congress to take strong action to address what we believe is a significant threat to the integrity of the tax system. The Proposals represent an appropriate step in the right direction.

The Section has been particularly concerned about the growth of individual tax shelters over the last several years. We have previously stated our view that a disclosure-based system will prevent many Americans from participating in tax shelters of dubious validity. We continue to believe that sunshine may be the best way to address the tax shelter
problem. In this regard, we commend you for the issuance of the amendments to the regulations on June 14, 2002, that extended the disclosure rules to the returns filed by individuals, partnerships, trusts and S corporations. We are currently studying these regulations and will comment on them separately.

As you are aware, we recently commented by letter to Senators Baucus and Grassley on the Tax Shelter Transparency Act (S. 2498), copies of which were sent to each of you. Because of the significant overlap between that bill and the legislative recommendations contained in the Proposals, we have limited our comments in this letter to the suggested regulatory and other administrative changes contained in the Proposals.

We support the general approach taken in the Proposals. In particular, we are pleased that you have recommended: (i) the application of the registration, listing and disclosure rules to both corporate and non-corporate taxpayers, (ii) the implementation of a uniform definition for reportable transactions, and (iii) enactment of legislation to prohibit reliance on certain types of opinions and the opinions from certain disqualified advisors to establish “reasonable belief” for penalty-protection purposes. We also commend the inclusion of proposals for substantive reform of Section 901(k) and the basis allocation rules for income-stripping transactions. We agree that a comprehensive approach to tax shelters should include reform of underlying law to eliminate opportunities for tax shelters as well as strengthening the procedural deterrents.

There are some aspects of the Proposals that give us pause, however. Our principal concern relates to the definition of reportable transactions. Although we believe that over-disclosure would be preferable to under-disclosure, it is equally important that the definition of reportable transactions not be so overly-inclusive that it will result in a deluge of disclosures (particularly from corporate taxpayers) that will make such disclosures ineffective. In this regard, we are particularly concerned that the required disclosure of all transactions which give rise to a book/tax difference over $10 million, and all transactions that result in a loss deductible under Section 165 that exceeds specified thresholds, will result in disclosure of a large number of non-abusive transactions. This is not likely to be helpful to the Service. In addition, although we agree that transactions that are “substantially similar” to listed transactions should be treated as if they were listed transactions, we are concerned about the potential breadth of this rule.

We are also concerned that the Proposals did not include as reportable transactions several areas which we believe are indicative of the presence of a tax shelter. We believe that reportable transactions should include (i) any transaction that is marketed under conditions of confidentiality, (ii) transactions with a tax indemnity or other contractual protection against loss of tax benefits or limitation on liability, (iii) foreign currency losses for individual taxpayers, and (iv) certain substituted-basis transactions.

Set forth below are more detailed comments on certain aspects of the Proposals.

**Definition of Reportable Transactions.** We support the concept of the identification of “reportable transactions” for which disclosure is required. We also agree that such reportable transactions should cover both listed transactions (which have been determined to be potentially abusive by the Service) as well as other situations which may or may not be problematic. On the other hand, if reportable transactions are either too broadly or too narrowly defined, the result may prove to be counter-productive.
We understand that it will not be easy to separate the wheat from the chaff. We suggest that careful consideration be given to the creation of separate rules for individuals and corporations. Transactions that may be suspect for individuals may not be problematical for corporations, and vice versa. Although we understand that the creation of different rules for individuals and corporations adds marginally to the complexity of the tax system, we also are concerned that the application of a single regime to all taxpayers will lead to over-disclosure in many situations.

Turning to specific suggestions as to what will constitute a reportable transaction, we have several specific observations:

1. **Losses Deductible Under Section 165.** In general, we support the treatment as reportable of all transactions that result in losses deductible under Section 165 in excess of specified threshold amounts; we also support the thresholds suggested in the Proposals. For the most part, these rules should apply equally to corporations, partnerships, trusts and individuals. In the case of individuals, consideration might be given to an exception for losses on marketable securities purchased and sold on a public exchange. In the case of businesses, Section 165 applies to all losses incurred in the ordinary course of a trade or business, including losses on the disposition of inventory and losses on the sale or exchange of property used in a trade or business (and treated as ordinary losses under Section 1231). Consideration should be given to whether the treatment of such losses as reportable transactions is appropriate, particularly if there is no book/tax difference arising as a result of such losses. On the other hand, we also are aware that some abusive transactions involve situations in which a taxpayer obtains property with a substituted basis and then immediately disposes of the property. We suggest that reporting be required for any transaction in which the taxpayer (i) obtains property with a substituted basis, and (ii) disposes of such property at a loss within 1 year of the date of acquisition of the property.

2. **Book/Tax Differences.** The Proposals include as reportable transactions all transactions that result in a book/tax difference in excess of $10 million unless such book/tax difference results from certain to-be-specified tax attributes (such as amortization or depreciation). We question whether a book/tax differential, standing alone, should be the basis for treating a transaction as reportable. If book/tax differences are to be taken into account, then we believe that certain tax benefits provided expressly in the Code should be excluded.

Most large corporations have significant book/tax differences on their returns. These differences are routinely scrutinized as part of the audit of corporate returns. Indeed, the so-called “Schedule M adjustments” are probably the most common source of examination by revenue agents. Requiring large corporate taxpayers to disclose their book/tax differences is unnecessary, because such items are routinely examined in any event. The regulations should seek, instead, to identify through disclosure only those book/tax differences that are indicative of tax shelter activity. For example, we would treat all temporary timing differences of less than 2 years as not reportable. We also would not treat as reportable any book/tax difference attributable to the use of ”purchase accounting” for a tax-free acquisition or that relates to an exclusion of income under Sections 101 through 138, Section 1031 or Section 1033 of the Code.

An alternative that might be considered is that, instead of treating all significant book/tax differences as reportable transactions (unless otherwise expressly excluded), the presumption could be reversed – a book/tax difference does not result in a reportable
transaction unless expressly specified in future regulations or other administrative pronouncements. The Service could specify those book/tax differences about which it is concerned and, over time as additional information emerges, add to the list of book/tax differences that are treated as reportable transactions. Such an approach might be more administrable and might provide more useful information than a system in which every transaction that results in a significant book/tax difference is disclosed unless expressly excluded.

3. **Conditions of Confidentiality.** The Proposals would treat confidentiality as giving rise to a reportable transaction only if the reduction in taxable income exceeds a specified threshold. We would treat any transaction (for either an individual or corporate taxpayer) in which there is a condition of confidentiality as reportable. Confidentiality is the opposite of the “sunshine” that we believe is necessary to curb abusive tax shelters – any confidentiality arrangements should require disclosures. On the other hand, the mere fact that the attorney-client privilege applies to the legal advice provided to the taxpayer should not be treated as a condition of confidentiality.

4. **Tax Indemnification, Protection Against Loss or Limitation on Liability.** If the promoter of a transaction offers a taxpayer (individual or corporate) indemnification or protection against the loss of tax benefits from a transaction, the transaction should be reportable. The transaction should also be reportable if the promoter's liability is limited by agreement. These factors were identified in the existing disclosure regulations and should be contained in the new rules as well.

5. **Foreign Currency Losses for Individuals.** Many individual tax shelters attempt to generate ordinary losses by utilizing Section 988, which treats all losses on foreign currency as ordinary. Thus, transactions involving individuals dealing in foreign currencies are disproportionately abusive. We recommend that any transaction in which an individual claims an ordinary loss under Section 988 in excess of $100,000 be treated as a reportable transaction.

6. **Transactions with Brief Asset Holding Periods.** The Proposals would require disclosure for any transaction resulting in a tax credit (including a foreign tax credit) if the underlying asset giving rise to the credit was held by the taxpayer for less than 45 days, and provided that the credits exceed $250,000. To prevent other potential tax avoidance schemes, we would extend this rule to losses (as well as credits) and lower the threshold to $100,000 of credits (or losses of $250,000). In addition, we suggest that Treasury explore whether the "brief holding period" rule should be extended to transactions where the taxpayer’s risk of loss is diminished due to hedging strategies.

**Listed Transactions.** The Section has long supported the concept that certain transactions that are deemed to be potentially abusive by the Service be “listed” so that taxpayers – both individuals and corporations -- are aware that the Service will likely challenge any taxpayer who engages in such a transaction. We also support the application of this concept to transactions that are “substantially similar” to listed transactions. A tax shelter promoter should not be able to change a minor aspect of a proposed transaction and then claim that it is not “listed” because the transaction is not identical to a listed transaction.
The Proposals would extend the definition of listed transactions to include a transaction that has “similar tax results” using the same or similar tax strategy or that is based on the same or similar tax strategy. We are concerned that the phrase “similar tax results” is too vague and subject to inconsistent application. For example, a number of listed transactions that involve basis shifting (such as in Notice 2001-45) produce a capital loss for an individual taxpayer. Would the phrase “similar tax result” require a taxpayer who engages in a transaction that generates a capital loss from owning stock in a foreign corporation to report that transaction because it creates a similar tax result to that of a listed transaction? On the other hand, if a listed transaction generates a loss, and a taxpayer used the same strategy to generate additional basis, it is not clear that the transaction would be treated as “substantially similar” to the listed transaction.

To address this problem, we urge the Treasury to elaborate on what constitutes a “substantially similar” transaction by means of clear examples in the regulations. This will make it easier for practitioners to identify transactions that should and should not be carved out from the “substantially similar” rule without (1) causing many taxpayers to disclose transactions that create a similar tax result but otherwise bear little resemblance to a listed transaction, or (2) allowing some taxpayers to claim that abusive transactions need not be disclosed because they are slightly different than a listed transaction.¹

Strict Liability Penalties. The Section strongly supports penalties that are imposed on taxpayers who fail to meet disclosure requirements. We also support generally the penalty provisions in the Tax Shelter Transparency Act introduced by Senators Baucus and Grassley on May 9, 2002. As set forth in our recently submitted comments on the Act, we believe that it is necessary for the IRS to be granted the authority to waive penalties in rare and unusual circumstances.² It is not clear under the Proposals whether the IRS would retain that right.

Extension of the Disclosure Rules to Cover Partnerships, S Corporations, Trusts, and Some Individuals. The Section applauds the extension of the disclosure requirement to certain “reportable transactions” entered into by partnerships, S corporations, trusts and some individuals.³ In doing so, however, we suggest that the Treasury consider whether or not the strict-liability penalty would be applied at the entity or shareholder/partner level. Minority shareholders/partners may not have any input into the process of deciding whether or not the entity will enter into a tax shelter transaction and may not have full knowledge concerning the facts underlying items reported on their K-1s. As a result, these shareholders/partners could be subject to a strict liability penalty irrespective of their good faith intentions. Application of the penalty at the entity level may be more equitable with respect to minority shareholders/partners.

¹ We note that the recently issued regulations, Treas. Reg. Sec. 1.6011-4T(b)(1)(ii), include examples of situations where a transaction is the same as or substantially similar to a listed transaction. These regulations also indicate that the term "substantially similar" must be broadly construed in favor of disclosure. We are currently studying these regulations and will comment on them separately.
² This waiver authority could apply in all situations in which the taxpayer fails to properly disclose or, in the alternative, at least in the context of non-listed reportable transactions.
³ This approach was adopted in the recently issued regulations.
Centralize the Receipt and Review of Disclosures by Partnerships, S Corporations, Trusts and Individuals. The Proposals provide for the centralization of all tax shelter disclosures. We believe that this is a laudable goal. Only by consolidating this function can the Service ever hope to achieve a consistent and well thought-out approach to tax shelters.

Impose Strict Liability for Accuracy-Related Penalties for Undisclosed Transactions Based on the Invalidity of a Regulation. The Proposals could preclude taxpayers from relying on the defenses under Sections 6662(d)(2)(B) (substantial authority), 6664(c) (reasonable cause), or on an opinion regarding the tax consequences of the transaction where the taxpayer failed to disclose that its position was based on the asserted invalidity of a regulation. We strongly support this position. While the taxpayer may be correct in that assertion, we can see no reason why the taxpayer should not disclose that position. Conversely, any failure to do so means that the taxpayer is gambling on the so-called “audit lottery.” This, in our view, is unacceptable and any taxpayer who does so should be subject to strict liability if found in error, but subject to our prior comment that the Service should retain the authority to waive penalties in rare and unusual circumstances. For example, a penalty might be waived if it is not clear that the regulation is contrary to the taxpayer's claimed (and undisclosed) position.

Broaden the Range of Persons Who are Required to Register Reportable Transactions and Maintain Lists of Investors. We recommend that Treasury provide a concise definition of when parties are considered to be “materially involved” with a reportable transaction. Does Treasury intend to rely on the current definition set forth in Treas. Reg. Section 301.6111-IT, or does it intend to create new definitions? Moreover, any definition of “material involvement” with respect to the tax shelter should exclude routine tax planning advice, even though a taxpayer may pay annual fees in excess of the threshold amount. Likewise, the attorney-client privilege must be respected while requiring disclosure of transactions.

A related problem that must be addressed in any regulations concerns the timing of registration and list maintenance by persons materially involved in a transaction. For example, if a transaction is reportable because it results in a large book/tax difference, the attorney who is advising the taxpayer may not be aware of the book/tax difference. In addition, the book/tax difference may not be known until the auditors have completed their review of the corporation's books and records, which may be long after the transaction is consummated. We suggest that parties who are materially involved with a transaction not be required to register or maintain a list with respect to the transaction until such persons have or should have knowledge that the transaction is reportable.

Provide a Consistent Form for Return Disclosures for Listed Transactions. The Section supports the proposal to create a consistent form for tax return disclosures. In that regard, we suggest that the disclosure form for listed transactions require signatures, under penalties of perjury, from the Chief Executive Officer and one Director of the company. With respect to public companies, the form should require the signature of an outside Director. This will ensure that both senior management and the Board of Directors are aware of the listed transactions.
Establish Procedures for Early Examinations of Potential Tax Avoidance Transactions. The Section supports the proposal to establish procedures for the early examination for potential tax avoidance transactions. In that regard, we suggest that the Service develop streamlined audit procedures for purposes of tax shelter investigations. This would include developing tailored audit guidelines and Information Document Requests (“IDR”) for selected tax shelter products. In addition, the IRS should consider assigning senior Revenue Agents to tax shelter audits on a full-time basis.

Again, we appreciate the opportunity to comment on these proposals and look forward to working with you on these issues in the future.

Sincerely,

Richard M. Lipton
Chair, Section of Taxation

cc: Eric Solomon, Deputy Assistant Secretary, Regulatory Affairs, Department of Treasury
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