September 9, 2002

Representative William M. Thomas  
Chairman  
Ways and Means Committee  
United States House of Representatives  
1102 Longworth House Office Building  
Washington, DC 20515

Dear Mr. Chairman:

These comments, filed on behalf of the Section of Taxation of the American Bar Association, address the tax shelter-related provisions of the American Competitiveness and Corporate Accountability Act (the “Bill”), which was introduced on July 11, 2002. The comments have not been reviewed or approved by the Board of Governors or House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

We commend you for your introduction of the Bill and for your contribution to the development of meaningful legislation to combat the threat that the proliferation of abusive tax shelters poses to the integrity of our tax system. We also appreciate your release of the Bill at an early stage in the legislative process so that there is a reasonable amount of time for public input. Vetting proposed legislation at a time when public comment can be taken into account is important to the quality and integrity of the legislative product.

The Section has long urged Congress to pursue a disclosure-based approach to address the problems posed by tax shelters. The Bill would take a strong step in that direction and thereby enhance the ability of IRS and Treasury to identify abusive tax shelters. Even more importantly, the disclosure-based approach of the Bill will discourage promoters from developing and marketing such transactions and discourage taxpayers from engaging in them. This is not to say that enactment of the Bill will put an end to abusive tax shelters; but coupled with vigorous IRS enforcement, changes such as those proposed by the Bill would, we believe, alter the environment that has permitted the tax shelter industry to thrive.

We thus support the Bill’s general approach to addressing the tax shelter problem. We specifically support (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” threshold for certain nondisclosed reportable transactions; (iv) the inability to rely upon certain disqualified advisors and opinions in asserting the “reasonable cause/good faith” exception of section 6664(c) of the Internal Revenue Code; and (v) the increase in the penalty for failure to maintain investor lists.
We do have concerns, however, about some aspects of the Bill. Our principal concerns relate to (i) the Bill’s codification of the economic substance doctrine; (ii) the proposed 40% penalty on non-economic substance transactions; (iii) the severe limitations on the ability of IRS to waive the nondisclosure and increased accuracy-related penalties; (iv) the use of the “significant purpose of tax avoidance” filter in determining the accuracy-related penalty for non-listed reportable transactions; (v) the use of a “more likely than not” reasonable belief threshold for undisclosed non-reportable transactions; and (vi) various aspects of the “material advisor” concept.

Our more detailed comments on the tax-shelter-related provisions in the Bill are set forth below. To the extent these provisions are similar to those in the Tax Shelter Transparency Act (S. 2498), our comments here are similar to those we provided to Senators Baucus and Grassley in our letter of June 4, 2002.1

Section 101. We have opposed in the past, and continue to oppose, attempts to statutorily define or otherwise codify the economic substance doctrine. However well-intentioned such attempts may be, we are concerned that the crucial role that the doctrine plays in helping to preserve the integrity of our tax system could be seriously weakened by substituting an explicit and comprehensive statutory test for a broader and more flexible judicial evaluation.

The Bill does represent an improvement over some earlier codification proposals in that it would apparently leave to the courts the determination of whether the economic substance doctrine applies in a particular context (rather than attempting to specify when the doctrine should and should not apply). Our opposition focuses on the attempt to enact a statutory definition of the doctrine which apparently purports to encompass all aspects of the doctrine. As we have previously suggested, however, we do think it appropriate for Congress to clarify that a transaction will in no instance be considered to possess sufficient economic substance unless its non-tax attributes are meaningful when compared to the intended tax benefits. We think that this represents the better view of current law, and that careful tax advisors apply the economic substance doctrine by weighing the potential tax and non-tax consequences of a contemplated transaction. Codifying this view would help prevent promoters of abusive tax-driven transactions from asserting that insignificant non-tax attributes will cause the economic substance doctrine to be satisfied.

Section 102. The fundamental concept in Section 102 of the Bill 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 suited 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. Taxpayers who enter into a listed transaction after the transaction has been so identified, do so at their own peril. We also urge that disclosure be

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1 We are continuing to study and take no position at this time with respect to any provisions in the Bill that are not addressed below.
required of positions that are contrary to a regulation, and that increased penalties be applied for failure to disclose such positions (whether or not in connection with a listed transaction).

We are, however, concerned about the significant constraints that would be placed on the Service’s authority to waive penalties in appropriate circumstances. Congress simply cannot anticipate all situations in which reduction or elimination of a penalty is appropriate. For example, the proposed legislation would apply the stiffest penalties to the failure to disclose a transaction which is “similar to” a listed transaction. Although the application of penalties to such transactions appears to be appropriate as long as the transaction is in fact similar to a listed transaction in relevant respects, we believe that it would be fairer if the IRS were given discretion to waive a penalty without specific statutory constraint. This type of “safety valve” will help avoid inappropriate penalties and also prevent situations in which courts will have to choose between applying such 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 similar to a listed transaction and who fails to disclose would still do so at the fairly certain risk of penalty.

Section 103. We agree that failure to disclose a listed or nonlisted reportable transaction should generally result not only in a significant nondisclosure penalty, but also in an increased understatement penalty. Although, as discussed below, we would prefer an alternative approach to that taken by the Bill, 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 103(c) that certain opinions may not be relied upon by taxpayers in order to establish “reasonable cause.” In this regard, the Section recently submitted comments concerning Circular 230 (the rules of practice before the IRS) in which we proposed a significant expansion of what constitutes a suspect fee arrangement. These should include, we believe, fee arrangements, contingent or otherwise, that deviate substantially from what would be charged for the same work based on reasonable hourly rates. We believe that this approach is preferable to reliance upon the criteria referred to in the Bill, which would disqualify an opinion prepared by a material advisor who participates in organizing or structuring a reportable transaction. If reportable transactions were limited to shelter transactions, such an approach would make sense. However, Treasury has announced that it will adopt objective definitions of reportable transactions, and these definitions will necessarily encompass both objectionable and nonobjectionable transactions. While such over-inclusive standards can be appropriate for disclosure and reporting purposes, they are inappropriately overbroad as a standard for disqualifying material advisors from rendering an opinion on which a taxpayer may rely for penalty purposes. For example, a law firm may advise a taxpayer on the corporate and tax aspects of a merger (or other transaction) that is treated differently for book and tax purposes and is therefore a reportable transaction. Under the Bill, it appears that the firm would be disqualified from giving the reorganization opinion, requiring the taxpayer to obtain an opinion from some other firm. We believe that such a requirement is unnecessary and undesirable, and that disqualification should be limited to situations in which the advisor
is either being compensated by the promoter or has an “entrepreneurial stake” in the transaction. Given the importance of defining the scope of these rules appropriately, it may be preferable to delay the effective date of these provisions until the Treasury Department issues implementing regulations.

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 invoke 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 such situations.

Two other aspects of Section 103 of the Bill are somewhat troublesome. First, proposed section 6662A would impose a penalty based on a hypothetical tax liability and without regard to the actual tax liability of the taxpayer involved in the transaction. Depending upon the tax profile of the particular taxpayer involved, this could result in penalties that are significantly 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 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. Following this approach will also greatly simplify the coordination between this new penalty and the existing understatement penalty under section 6662.

Second, we do not believe that the "a significant purpose" test utilized in proposed section 6662A(b)(2)(B) is appropriate as a basis for imposing higher penalties for non-disclosed transactions. We have consistently espoused this view 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 satisfies proposed section 6662A(b)(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.

We believe that an alternative approach -- focused on disclosure -- would be preferable. In order to encourage disclosure, we would simply provide that the penalty for failure to disclose would be increased by a percentage of the understatement resulting from the transaction. 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 understatement penalty.
We believe that this approach is simpler, more accurately reflects the purpose of the Bill, 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 penalties can then be applied independently of the disclosure regime, with failure to disclose being subject to its own penalties.

Section 104. We believe that a separate penalty scheme tied to satisfaction of the economic substance doctrine would create unnecessary complexity and confusion. The proposed penalty would overlap substantially with existing section 6662 and proposed section 6662A, and the coordination rules with respect to penalties under sections 6662, 6662A and 6662B are unwieldy and confusing. Moreover, we continue to believe that a 40% penalty is too high and is likely to be administered inconsistently by the IRS. The existence of a 40% penalty could also affect a court’s decision as to whether to apply the economic substance doctrine in a given case. Simplicity of penalty structure and certainty of penalty application are more important to safeguarding the integrity of our tax system than the existence of draconian penalties or a variety of overlapping penalties.

The creation of this additional penalty would also create a new set of uncertainties. For example, it is unclear whether the penalty would apply if a taxpayer engages in a transaction that lacks economic substance, but the claimed tax treatment is disallowed on some other basis. In addition, the penalty would apply if a transaction fails to meet the requirements of the economic substance doctrine or “any similar rule of law.” We are uncertain about the potential scope of rules of law that might properly be viewed as “similar to” the economic substance doctrine. The exception for personal transactions of individuals is problematic because the conclusion that a transaction lacks economic substance would seem to imply that the transaction was not entered into in connection with a trade or business or an activity engaged in for production of income. An increased accuracy-related penalty for reportable transactions that are not disclosed should be sufficient to cover transactions that are determined by a court to lack economic substance. Therefore, we reiterate our recommendation that the increased accuracy-related penalties be integrated with the nondisclosure penalty and apply to all reportable transactions.

Section 106. Section 106 of the Bill would prevent the duplication of loss that can occur under some circumstances under current law upon the sale or redemption of an interest in a partnership. For example, if A contributes property with a built-in loss to a partnership and then sells his partnership interest or is redeemed for cash, A may recognize a loss on such sale or redemption. If the partnership does not make an election under section 754, then other partners in the partnership may, in effect, recognize the same loss if the partnership sells the built-in loss property. Ultimately, however, the partners who recognize the second loss will recognize an offsetting amount of gain upon liquidation of the partnership or hold property with reduced adjusted basis, thus preserving the gain for recognition in the future.

On a technical level, the proposed amendment to section 704(c) appears largely duplicative in its effect with the proposed amendments to sections 743 and 734. That is, in cases where the potential duplicated loss exceeds the de minimis threshold set forth in the
proposed amendments to sections 734 and 743, we cannot think of any case where a duplicated loss would be allowed under those proposed changes but would be precluded by the proposed change to section 704(c).

More fundamentally, we are concerned that the proposed amendments will add substantial complexity to the Code that may not be necessary to prevent abuse. The elective nature of section 734 and 743 exists precisely to minimize the administrative burden on partnerships by not requiring basis adjustments following distributions to partners or sales of partnership interests. Such simplification should be retained if possible. In addition, the proposed provisions contemplate the issuance of regulations to address related partnerships and to provide anti-stuffing rules; those regulations would undoubtedly add further complexity.

With respect to the need for the proposed changes to prevent abuse, we note that the partnership anti-abuse regulation specifically addresses and precludes the inappropriate duplication of loss that potentially could arise because of the elective nature of the basis adjustments under sections 743 and 734. See Treas. Reg. § 1.701-2(d) (Examples 8 and 9). We believe that this regulation should adequately address the inappropriate loss duplication that is the apparent target of Section 104 of the Bill. If there is any concern as to the validity of the regulation, Congress could act to eliminate such concern.

Section 107. Section 107 of the Bill 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 (and that is not adequately disclosed) would be subject to this penalty only if the taxpayer lacked substantial authority for its position.

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 raise the threshold that taxpayers currently must meet to avoid penalties with respect to 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 such position is supported by substantial authority.

Moreover, the substantial authority standard may be easier for taxpayers to apply than the more likely than not test proposed in Section 107 of the Bill. 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 may often entail a more subjective inquiry.

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.”

Section 111. We support the requirement that, subject to attorney-client and other relevant privileges, 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. 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, and maintain lists, concerning transactions, it is necessary that the effective date of this requirement be postponed until after regulations that address these issues are promulgated.

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.” A tax return preparer who was not involved in the transaction, or a lawyer who analyzes the transaction after it has been implemented, should 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.

Section 117. We support this proposal, which appears to reflect our prior comments on the proposed revisions to Circular 230.

Section 121. A number of aggressive transactions entail separating rights to future income from other property rights (sometimes referred to as “income-stripping” transactions). After the income rights have been separated, the property may be sold for an amount less than the taxpayer’s basis in the property. Some taxpayers have taken the position that such sales give rise to losses for tax purposes. Other transactions are structured so that taxpayers who buy property from which income rights have been stripped can avoid current taxation on ordinary income and claim a capital gain when the property is later sold.

To address income-stripping transactions involving debt instruments, section 1232B was added to the Code in 1982 (later renumbered section 1286). Section 305(e) was added to the Code in 1993 to deal with certain aspects of income-stripping transactions involving preferred stock, but did not address the basis allocation problem. No Code provision
expressly addresses income-stripping transactions on property other than debt instruments or preferred stock, although the IRS has invoked a number of existing Code provisions as potentially applicable. See Notice 95-53; Prop. Reg. § 1.7701(l)-2.

The proposed grant of regulatory authority under section 1286 would authorize Treasury to address some, but not all, of the stripping transactions not currently covered by section 1286 or section 305(e). While expanding the scope of section 1286 to include strips of accounts or entities holding bonds or preferred stock will address some of the existing abuses (once regulations are issued), we think a more comprehensive grant of regulatory authority is appropriate to deal with these types of problems, especially in view of the ease by which new financial products can be created to avoid narrowly crafted rules. Accordingly, we suggest that Treasury be given regulatory authority (i) under section 1011 to require the allocation of basis in an income-stripping transaction between the property and/or income rights sold and the property and/or income rights retained; (ii) under section 446 to require the accrual of income on certain stripped financial instruments based on the principles of section 1272; and (iii) under section 1001, to treat other income-stripping transactions as secured borrowings. Because some income-stripping transactions present difficult issues (for example, strips of income where the amount of income to be received in the future is not fixed), we think that regulations under each of these provisions is the best way to deal with problems in this area.

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We appreciate the opportunity to provide this input and would be pleased to discuss this important legislative initiative further with you or with your staff. 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.

Very truly yours,

Herbert N. Beller
Chair, Section of Taxation

cc: Honorable Charles B. Rangel, Ranking Member, House Ways & Means Committee
James D. Clark, Republican Chief Tax Counsel, House Ways & Means Committee Staff
John Buckley, Democratic Chief Tax Counsel, House Ways & Means Committee Staff
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