January 4, 2006

The Honorable Charles E. Grassley
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Max S. Baucus
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable William M. Thomas
Chairman
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Charles B. Rangel
Ranking Member
House Committee on Ways and Means
1106 Longworth House Office Building
Washington, DC 20515

Re: S. 2020

Gentlemen:

I am writing on behalf of the Section of Taxation of the American Bar Association concerning several revenue proposals included in S. 2020, the Tax Relief Act of 2005, as passed by the Senate on November 18. The views expressed herein represent the position of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Specifically, I write with respect to three revenue offset provisions in S. 2020 (the “Bill”) that have also been contained in previous legislation passed by the Senate, including the Senate version of H.R. 3, the Safe, Accountable, Flexible, Efficient Transportation Equity Act of 2005. These three provisions would (i) codify the “economic substance” doctrine and create a 40% penalty for “noneconomic substance” transactions, (ii) require a 20%, nonrefundable down payment for certain offers in compromise, and (iii) create increased penalties and restrict access to judicial review in an attempt to reduce frivolous tax submissions.

We have previously written to express our opposition to these provisions. The purpose of this letter is to reiterate our opposition.

**Economic substance doctrine.** Section 511 of the Bill would attempt to codify the economic substance doctrine, and section 512 would add a penalty for understatements attributable to transactions lacking economic substance. However well intended, these provisions may have significant ramifications for bona fide business transactions that are far removed from the tax shelter transactions that are the intended target of the legislation. Moreover, the concerns that underlie this legislation were recently addressed by the tax shelter provisions enacted in October 2004 as part of the American Jobs Creation Act of 2004. As we have previously stated, we support legislation clarifying that when a court determines that 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. We have similarly supported legislative clarification that in evaluating the potential economic profits of a transaction, all costs associated with the transaction, including fees paid to promoters and advisers, should be taken into account. To the extent that the legislation incorporates these concepts, we believe it will improve the state of the law. In other respects, however, as we have previously written, we continue to oppose codification of the economic substance doctrine.

We further believe that enactment of the 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 recently enacted section 6662A, and the coordination rules with respect to penalties under sections 6662, 6662A and 6662B are unwieldy and confusing. In addition, we continue to believe that a 40-percent penalty is too high, is likely to be administered inconsistently by the IRS and may affect a court’s decision as to whether to apply the economic substance doctrine in a given case.

We also urge that the Congress not adopt some new and unvetted variation of economic substance codification. This would include the “option” proposed by the staff of the Joint Tax Committee in early 2005, which would introduce new concepts and formulations. Given the high level of uncertainty and potential for disruption of transactions that are commonly viewed as acceptable, both by taxpayers and the IRS, we believe it would be inadvisable to enact any proposal that has not been the subject of hearings by the tax-writing committees with an opportunity for comment by interested parties.

Offers in compromise. Section 523 of the Bill proposes adding a 20-percent down payment requirement to lump-sum offers-in-compromise. It is apparently intended that the lump-sum down payment would be nonrefundable and retained by the IRS if the offer is rejected. We have serious concerns about this proposal. A successful offer-in-compromise program raises revenue both from the offer and by bringing taxpayers back into the system. Because the 20 percent nonrefundable down payment requirement could dramatically reduce available outside funding for potential offers, there is a significant risk that the proposal could decrease the number of legitimate offers submitted, the number of offers accepted and the number of individuals reentering the tax system. The provision also marks a change in direction from the 1998 Taxpayer Bill of Rights. Accordingly, we recommend that the proposal not be adopted or, at a minimum, that it be deferred for further consideration.

Frivolous tax submissions. Section 523 of the Bill would revise sections 6702, 6320, 6330, and 7122 of the Code in an effort to restrict “frivolous” submissions of requests for collection due process (“CDP”) hearings, applications for installment agreements and offers in compromise (“OICs”), and requests for taxpayer assistance orders (“TAOs”). The proposal would create two different categories of “specified frivolous submissions”: those based upon positions the IRS has identified as frivolous and those that reflect a desire to delay or impede the administration of federal tax laws. In addition to increasing the penalty for filing frivolous returns from $500 to $5,000, it would apply the penalty to any specified frivolous submission, and would allow the IRS to disregard specified frivolous submissions. The revisions also allow the IRS to block court review of its decisions regarding frivolous submissions. As we have previously written, frivolous conduct penalties should be imposed upon taxpayers requesting CDP hearings only (i) where the request is based on arguments or positions the IRS has identified as frivolous in published pronouncements and (ii) after the taxpayer has been afforded the opportunity to withdraw the request or supplement it with information that would render the relevant published pronouncement inapplicable. By authorizing the IRS both to assess a substantial penalty and to disregard requests for CDP hearings, the proposal may eliminate one of the most important innovations of the 1998 Taxpayer Bill of Rights: the ability to petition the Tax Court where the IRS has failed to follow proper collections procedures. Low income taxpayers would be at particular risk, as the mere threat of the $5,000 penalty would be sufficient to effectively force the withdrawal of a submission (even if the IRS did not have the ability unilaterally to block access to the Tax Court). The proposal threatens what have become accepted as basic rights of taxpayers - to request installment agreements of OICs, to request TAOs, and to obtain administrative and judicial review of collections activity - without a showing that a large number of taxpayers are abusing these rights or that the proposed changes will result in increased collections. Moreover, we believe that the Code currently affords the government adequate protection in preventing delaying tactics by taxpayers. We, therefore, recommend that section 5502 of the bill be deferred, and that the Treasury Inspector General for Tax Administration be asked to evaluate the prevalence of frivolous submissions, and the presence or lack of existing laws and procedures to deal with these submissions.

In addition to the foregoing, we are preparing comments on certain provisions in S. 2020 affecting charities and other tax-exempt organizations. We will submit these comments as soon as possible.
We appreciate your consideration of the foregoing comments. Representatives of the Section would be pleased to discuss them in further detail with you or members of your respective staffs. Please contact William Paul, the Section’s Vice-Chair for Government Relations, at (202) 662-5300 if that would be helpful.

Sincerely,

Dennis B. Drapkin
Chair, Section of Taxation

cc: Hon. John Snow, Secretary of the Treasury
    Eric Solomon, Acting Assistant Secretary of the Treasury (Tax Policy)
    Thomas Barthold, Acting Chief of Staff, Joint Committee on Taxation
    Kolan Davis, Republican Staff Director and Chief Counsel, Senate Finance Committee
    Russell Sullivan, Democratic Staff Director, Senate Finance Committee
    Robert Winters, Republican Chief Tax Counsel, House Ways and Means Committee
    John Buckley, Democratic Chief Tax Counsel, House Ways and Means Committee