Mr. Chairman and Members of the Committee:

My name is Paul J. Sax. I appear before you today in my capacity as Chair of the American Bar Association Section of Taxation. This testimony 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.

The Section of Taxation appreciates the opportunity to appear before the Committee today to discuss the very important subject of corporate tax shelters. Our testimony will use the term "corporate tax shelters" in discussing the very aggressive tax transactions currently being marketed. However, the Committee should understand that this phenomenon is not limited to large, multinational corporate taxpayers; indeed, it is not limited to corporations. Increasingly, tax shelter products are also being marketed to unincorporated business taxpayers, including middle market businesses, and wealthy individuals.

My testimony today contains three parts: (1) a brief reference to Circular 230, (2) a description of the Tax Section’s corporate tax shelter legislative recommendations, and (3) an amplification of certain aspects of our legislative recommendations. But first, I want to say something about the corporate tax shelter problem.

The Corporate Tax Shelter Problem — We are aware that you may be told that there is no corporate tax shelter problem and that Congress does not need to take any action. Mr. Chairman, make no mistake about it. There is a serious problem, and it needs to be dealt with if we are to maintain any semblance of public confidence in the tax system. In the 1970’s and early 1980’s, when individual tax shelters were in vogue, the vast majority of American people justifiably became outraged when they learned through the press that certain high-income taxpayers were eliminating or substantially reducing their tax liabilities by means of uneconomic and frequently artificial transactions.

Today, transactions that have little or no economic substance, that are designed solely to defer or permanently eliminate tax liability, and that are premised on opinions that recite very questionable facts are being marketed to businesses of all sizes and to wealthy individuals. These transactions are not based on Congressionally mandated tax incentives, such as the low-income housing credit, but instead apply aggressive interpretations of the law in situations where the transactions would be dismissed out of hand by the taxpayers if it were not for the tax avoidance benefits of the transactions.

We are not in a position to estimate the impact on Federal revenues of the corporate tax shelter activity of the past several years. However, our experience as tax practitioners suggests that the level of tax shelter activity is very substantial. Many of the shelter transactions involve purported tax savings of tens of millions of dollars. As these transactions spread in the economy to smaller businesses and individual taxpayers, the level of activity will continue to grow. Should Congress fail to take appropriate legislative
action, taxpayers and their advisors will be emboldened and become even more aggressive. At some point, after the inevitable publicity, the American people may justifiably ask their elected representatives why action was not taken to stop this tax avoidance activity when the abuses were brought to the Congress’ attention.

Circular 230 — I would like to refer to what I believe is a very important recent action by the Tax Section in proposing amendments to Circular 230, the rules promulgated by the Treasury Department that seek to regulate the conduct of practitioners who represent taxpayers before the Internal Revenue Service. Less than two weeks ago, on October 29, the Tax Section transmitted to the Treasury Department and the Internal Revenue Service proposed amendments to Circular 230 intended to impose a higher standard of conduct on lawyers and other practitioners who render certain opinions in connection with corporate tax shelters. Copies of our recommendations were sent to you, Mr. Chairman, to Mr. Rangel, and to the appropriate tax staffs, and a copy of our recommendations is attached to this statement.

Our recent action, recommending amendments to Circular 230, reflects a long-standing view of the Tax Section that the professions, including the legal profession, must do what they reasonably can to assure appropriate conduct of their members. We are confident that if the Treasury Department adopts our recommended changes to Circular 230, we will see a higher standard of conduct by all tax practitioners who render corporate tax shelter opinions affected by the recommended amendments.

Legislative Recommendations — Although we consider the revision of Circular 230 to be an important step in addressing the corporate tax shelter problem, it is not the only step. In addition, the Internal Revenue Service must audit these transactions and make clear to taxpayers, tax practitioners, and marketing organizations that it is prepared to assert both civil and criminal penalties where appropriate. We are pleased that Deputy Treasury Secretary Eizenstat and Commissioner Rossoiti recently have stated publicly their concern with corporate tax shelters and their intention to take appropriate actions to curb this potentially harmful activity.

But, Mr. Chairman, there is a limit on what the Internal Revenue Service can do. Under the best of circumstances, it cannot detect all questionable transactions, it cannot devote audit resources to challenge all transactions it does detect, and it cannot litigate all of the cases that should be litigated. If the marketing of aggressive tax shelter transactions is to be constrained, it is vitally important to put added pressure on the marketing process.

The marketing of these transactions is predicated on the odds favoring success. Promoters understand that the IRS is unlikely to detect and challenge more than a small fraction of transactions. They also view applicable penalties as relatively minor and usually avoidable. They put these factors together to make a compelling case that the transaction makes economic sense, even though the transaction would not withstand judicial scrutiny. Corporate tax managers often believe that they have nothing to lose by entering into an aggressive tax shelter. Even if the claimed benefits are disallowed, they believe that they will be able to settle out the penalties and will be no worse off than they would have been if they had not entered into the transaction.

Our legislative recommendations are intended to accomplish four objectives. First, to encourage the private sector – taxpayers, tax advisors, and those who market corporate tax shelters – to carefully scrutinize the facts and the legal analysis of proposed transactions and consider carefully the appropriateness of the transactions under the law. Second, to level the audit playing field by assuring that the largest and most aggressive of these transactions are disclosed to the Internal Revenue Service on the tax return. Third, to make it clear to the Internal Revenue Service that Congress places emphasis on the audit of and challenge to questionable transactions. Fourth, to legislatively endorse a reasonable
interpretation of the economic substance doctrine – an interpretation that we believe constitutes present law. We think these four objectives may be furthered by the following legislative actions.

1. Require specific, clear reporting for a "large tax shelter".

2. We recommend the enactment of a new Section 6115 of the Internal Revenue Code that would require the following tax return disclosure for a "large tax shelter," as defined.

   1. A detailed description of the facts, assumptions of facts and factual conclusions (including conclusions regarding the business or economic purposes or objectives of the transaction) that are relied upon to support the manner in which the transaction is reported on the tax return;
   2. A description of the due diligence performed to ascertain the accuracy of such facts, assumptions and factual conclusions;
   3. A statement signed under penalties of perjury by the taxpayer’s chief financial officer or comparable senior corporate officer with a detailed knowledge of the business or economic purposes or objectives of the transaction that the facts are true and correct as of the date the return is filed, to the best of such person’s knowledge and belief. If the actual facts varied materially from the facts, assumptions or factual conclusions relied upon, the statement would need to describe such variances;
   4. Copies of any written material provided in connection with the offer of the tax shelter to the taxpayer by a third party;
   5. A full description of any express or implied agreement or arrangement with any advisor, or with any offeror, that the fee payable to such person would be contingent or subject to possible reimbursement if the anticipated tax benefits are not obtained; and
   6. A full description of any express or implied warranty from any person with respect to the anticipated tax results from the tax shelter.

In the event a taxpayer fails to satisfy the Section 6115 disclosure requirements for a "large tax shelter," a new Section 6716 would impose a $50,000 penalty. If the nondisclosure were determined to be willful, criminal penalties also would apply. The penalty should be a no-fault penalty relating solely to the failure to disclose information on the tax return. Neither the amount of the new Section 6716 penalty nor its applicability should be dependent on whether or not the transaction in issue results in a tax deficiency. Moreover, the nondisclosure penalty would be totally unrelated to any penalty to which the taxpayer might be subject under Section 6662.

We believe the proposed Section 6716 penalty should be subject to a reasonable cause exception permitting abatement of the penalty if the taxpayer establishes that it exercised due diligence in attempting to accurately report the relevant information (e.g., that it had appropriate fact-gathering procedures in place and that it did its best to follow them).

3. Broaden the substantial understatement penalty to cover outside advisors, promoters and "tax indifferent parties."

4. In any situation in which the substantial understatement penalty of existing law is imposed on the taxpayer, a penalty also should be imposed on any outside advisors who rendered favorable tax advice or opinions used in the promotion of the tax shelter, and promoters who actively participated in the sale, planning or implementation of the tax shelter. The same type of penalty should also be imposed on any "tax indifferent party," unless any such party can establish that it had no reason to believe the transaction was a tax shelter with respect to the taxpayer. The penalty should not be imposed on advisers who rendered opinions that comply with our proposed Circular 230 amendments.

Such penalties should be set at levels commensurate with the fees or benefits such parties stood to realize if the transaction were successful. In addition, separate procedural rules should be provided to
assure such parties of due process, similar to the rules applicable in the case of penalties on tax return preparers.

5. **Define "large tax shelter" for purposes of proposed disclosure requirement.**

6. The definition of "tax shelter" presently contained in section 6662(d)(2)(C)(iii) should be retained. The term "large tax shelter" would be defined as any tax shelter involving more than $10 million of tax benefits in which the potential business or economic benefit is immaterial or insignificant in relation to the tax benefit that might result to the taxpayer from entering into the transaction. In addition, if any element of a tax shelter that could be implemented separately would itself be a "large tax shelter" if it were implemented as a stand-alone event, the entire transaction would constitute a "large tax shelter."

7. **Clarify that, where the economic substance doctrine applies, the non-tax considerations must be substantial in relation to the potential tax benefits.**

8. Most courts, as well as careful tax advisors, apply the economic substance doctrine by weighing the potential tax and non-tax results of a contemplated transaction. We think this is entirely consistent with long-standing congressional intent. Codification of this rule would provide a clear statement of the standard generally applied by courts under the economic substance doctrine, and would prevent reliance on unclear or conflicting judicial articulations of that standard in rendering opinions on tax-driven transactions. Any such codification would not, however, displace current law where the business purpose test is currently applied without a weighing of the tax and business objectives, such as the business purpose rules applied in the context of section 355 and in most tax-free corporate acquisitions.

9. **Articulate a clear Congressional policy that existing enforcement tools should be utilized to stop the proliferation of large tax shelters.**

10. Congress should make clear its view that examination of large tax shelter transactions by the Internal Revenue Service should be considered a tax administration priority. This should include the application of both civil and criminal penalties when appropriate.

**Amplification of Certain Legislative Recommendations**

**Return Disclosure Requirement**

0. **Rationale.**

1. We seek to achieve two objectives in proposing enactment of a "large tax shelter" return disclosure requirement. The first objective is to reduce the incentive to engage in transactions that would not withstand scrutiny on the ground that the likelihood of detection is small. Many tax shelter products and transactions are comprised of purportedly separate transactions or steps, often intended to obscure the overall transaction and frequently involving steps both within and outside the United States. As such, these transactions are extremely complex and often impossible to detect through information contained in a tax return, even by an experienced revenue agent. We believe Congress should mandate specific tax return disclosure obligations that will lessen the significant role that the likelihood of escaping detection currently plays in the corporate tax shelter equation. On the assumption that a return disclosure system is designed to be compliance friendly, as we believe it can, the argument that legitimate transactions may be affected should be considered with a healthy dose of skepticism. Whether legitimate in the eyes of the taxpayer or not, we would ask what is inappropriate about fair disclosure in a tax return context, even if the transaction is legitimate?

The second objective of the proposed return disclosure requirement is to encourage taxpayers and their advisors to pay careful attention to the actual facts underlying the proposed transaction prior to its consummation. We remain concerned, as we have previously testified, that often the
facts assumed in analyzing the tax shelter are not the facts that actually occur. We believe the return disclosure requirement will underscore the importance of the actual facts of the transaction and encourage the taxpayer and its advisors to more carefully scrutinize the transaction in advance.

2. Certification by the chief financial or other senior officer.

3. We believe the proposed chief financial officer certification is an extremely important component of the return disclosure requirement for two reasons. First, the chief financial officer, because of his or her position in the company, can be certain that the business people within the organization who likely were involved in implementing the transaction, and, thus, who likely are most familiar with the actual facts, will be involved in preparation of the certification. It will be in the direct interest of the chief financial officer to assure such involvement, and there will be much less risk that the taxpayer’s return preparation personnel are isolated from the actual facts.

Second, because these transactions by definition are large (we suggest a $10 million reporting threshold) and because they are very aggressive, we think it is appropriate to encourage the taxpayer’s senior management to personally consider the proposed transaction. If the chief financial officer knows that he or she will be required to execute the certification, we expect the officer will be much more interested in being personally advised of the transaction and of its risks before it is consummated.

Because of the potentially serious civil and criminal penalties that could result to a corporate officer who commits perjury by executing an inaccurate certificate, the legislation should provide appropriate separate administrative and judicial procedures that will accord the officer full due process. To this end, procedures should be established for reviewing officer certification issues that are independent of the audit process.

Mr. Chairman, the Tax Section attaches particular importance to the proposed large tax shelter return disclosure requirement because we believe it has the potential to accomplish two important objectives: (1) reduce the incentive to hide the ball from the IRS and (2) encourage a more careful factual and legal analysis of the transaction on the front end, before the transaction is consummated. If the disclosure requirement has this effect in even a fraction of the corporate tax shelter schemes currently on the market, it will make a significant contribution to tax administration and the American people’s confidence in the tax system.

Affirmation of Economic Substance Standard

We are aware that certain advisors take the position that any amount, even a de minimis amount, of risk, profit or other economic return is sufficient to satisfy the judicial economic substance doctrine. While we believe this view does not reflect present law, it is important to foreclose such assertions. It is for this reason that we make the relatively modest suggestion that Congress legislatively affirm that when a court determines 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.

Our recommendation does not require the Congress to adopt a definition of economic substance or specify the particular circumstances in which the doctrine is relevant. We think both of these matters are best left to the courts where judicial discretion can be applied on a case-by-case basis. However, we think it is appropriate and important for the Congress to affirm what we believe to be current law, namely, that the non-tax considerations in the transaction must be substantial in relation to the potential tax benefits. It would also be helpful if Congress would make it clear that in evaluating the non-tax aspects of a transaction, such as potential economic profit, all of the costs associated with the transaction, including fees paid to promoters and advisors, should be taken into account.
Conclusion

One of the arguments that we expect the Committee will continue to hear from opponents of corporate tax shelter legislation is that the Internal Revenue Service already has the tools to deal with corporate tax shelters on its own, without legislation. For example, the Committee may be told that recent court decisions in the Commissioner’s favor prove this point. We urge the Committee not to fall for this assertion. In spite of these recent decisions, we have observed no slowdown in the sales of tax shelter products; indeed, as we have indicated, we see a broadening of the market to smaller businesses and wealthy individuals. In addition, it is impossible to expect the Internal Revenue Service, even under the best of circumstances, to audit, let alone litigate, all of these transactions. Ours is a self-assessment system. It works best when taxpayers are motivated to take their return reporting obligations seriously. We think the only reasonable way to meaningfully impact the current corporate tax shelter phenomenon is to seek to modify the behavior of taxpayers, their tax advisors and those involved in the marketing of tax shelters through an improved self-policing system. Changes to Circular 230 will help. Increased audit activity by the Internal Revenue Service is very important. But, Congress also has a responsibility. We urge the Committee to take the lead by adopting legislation along the lines we recommend. As you proceed in your deliberations, please know that members of the Tax Section are prepared to lend a helping hand.

Mr. Chairman, thank you for the opportunity to appear before the Committee today. I will be pleased to respond to any questions.