

**TESTIMONY OF STEFAN F. TUCKER
ON BEHALF OF THE
SECTION OF TAXATION, AMERICAN BAR
ASSOCIATION,
BEFORE THE SUBCOMMITTEE ON OVERSIGHT
OF THE
U.S. HOUSE OF REPRESENTATIVES
ON THE SUBJECT OF
REVENUE PROVISIONS IN THE PRESIDENT'S
FY2000 BUDGET
MARCH 10, 1999**

I. INTRODUCTION

Mr. Chairman and Members of the Committee:

My name is Stefan F. Tucker. 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. Accordingly, except as otherwise indicated, 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 position of the Association.

As you know, the ABA Tax Section is comprised of approximately 20,000 tax lawyers. As the largest and broadest-based professional organization of tax lawyers in the country, we serve as the national representative of the legal profession with regard to the tax system. We advise individuals, trusts and estates, small businesses, exempt organizations, and major national and multi-national corporations. We serve as attorneys in law firms, as in-house counsel, and as advisors in other, multidisciplinary practices. Many of the Section's members have served on the staffs of the Congressional tax-writing Committees, in the Treasury Department and the Internal Revenue Service, and the Tax Division of the Department of Justice. Virtually every former Assistant Secretary of the Treasury for Tax Policy, Commissioner of Internal Revenue, Chief Counsel of the Internal Revenue Service, and Chief of Staff of the Joint Committee on Taxation is a member of the Section.

The Section appreciates the opportunity to appear before the Committee today to discuss certain proposals contained in President Clinton's budget for Fiscal Year 2000. Our testimony today will not include comments on each and every proposal in the President's budget. We do anticipate, however, that additional individual comments on various proposals will be submitted in the near future. In addition, individual members of the Tax Section would be pleased to provide assistance and comments to members of the Ways and Means Committee and to staff on any proposals you might identify.

Our general focus today will be the overall need for simplification of the tax code and the corresponding need to avoid additional complexity. In addition, we would like to comment on the various tax shelter proposals contained in the

budget, as well as the proposal to tax the investment income of trade associations.

II. SIMPLIFICATION AND COMPLEXITY

The ABA and its Tax Section have long been forceful advocates for simplification of the Internal Revenue Code. In resolutions proposed by the Tax Section and passed by the full ABA in 1976 and 1985, we are on record urging tax law simplicity, a broad tax base and lower tax rates. We have reiterated this position in testimony before the House Ways and Means and Senate Finance Committees on numerous occasions.

Over the past two decades, the Code has become more and more complex, as Congress and various administrations have sought to address complicated issues, target various tax incentives and raise revenue without explicit rate increases. As the complexity of the Code has increased, so has the complexity of the regulations that the IRS and Treasury have issued interpreting the Code. Moreover, the sheer volume of tax law changes has made learning and understanding these new provisions even more difficult for taxpayers, tax practitioners and Service personnel alike.

Although, until recently, many of these changes have not affected the average taxpayer, the volume of changes has created the impression of instability, in that the Code is becoming perhaps too complicated for everyone. This takes a tremendous toll on taxpayer confidence, evidence of which can be found in the broad public support for the IRS restructuring legislation passed last year. This Committee often hears how our tax system relies heavily on the willingness of the average taxpayer voluntarily to comply with his or her tax obligations. Members of the Tax Section can attest to the widespread disaffection among taxpayers with the current Code. Their willingness, and their ability, to keep up with the pace and complexity of changes, is at a point beyond which it should not be pushed.

It now appears that many in Congress are interested in enacting tax reductions this year. Press accounts indicate that various options are being discussed. The Tax Section does not take a position with respect to the wisdom of tax reduction generally or any particular proposals. We do urge, however, that the members of this Committee keep simplification and avoidance of complexity uppermost in their minds as any tax reduction packages are fashioned. Tax relief can be delivered in ways that avoid new, complicated rules and that steer clear of phase-outs that act as hidden marginal rate increases. While such broad-based reductions may not have the cache of new, more targeted provisions, they will avoid the layering of new complexity over old. To paraphrase Hippocrates, if Congress chooses to reduce taxes, we urge you to do no harm.

To this end, on behalf of the Tax Section, I recently sent to Secretary Rubin a letter expressing our disappointment that the President's budget proposes to add a multitude of new tax credits to the Federal income tax system. Our point in that letter was that, although each credit taken in isolation could be viewed as meritorious, that kind of micro-balancing inevitably leads to the type of tax

system that is, in total, overly complex and undeserving of public respect. Particularly in light of the various, complicated provisions added by the 1997 tax act, Congress and the Administration must focus on the cumulative impact of all new provisions sought to be added. Only then can they resist the accretion of income tax benefits and penalties that are unrelated to the administrable measurement of annual taxable income and ability to pay.

My letter to Secretary Rubin also urged that particularly close scrutiny be given to any proposals that include income phaseouts. These phaseouts have gained popularity in the last two decades, and are responsible for a significant amount of the complexity imposed on individual taxpayers. As noted previously, phaseouts create the effect of a marginal rate increase as a taxpayer's income moves through the phaseout range, and the effects of multiple phaseouts on the same taxpayer can create capricious results. Phaseouts also play a significant role in the creation of marriage tax "penalties," and add to the difficulty in addressing that set of issues. We urge you to resist their continued use in the enactment of additional tax incentives.

We do not claim to have all the answers. The Tax Section will continue, diligently, to point out opportunities to achieve simplification whenever possible, including several ideas that we will discuss later in this testimony. However, it is also necessary that we point out that simplification requires hard choices and a willingness to embrace proposals that are often dull and without passionate political constituencies. Simplification may not garner political capital or headlines, but it is crucial. Complexity fosters non-compliance; simplification enhances understanding and compliance.

To date, simplification has not achieved the commitment that we believe is required. Too often, other objectives have tended to crowd simplification out as a priority. We urge the Ways and Means Committee to adjust this balance. Without a commitment on the part of the members of this Committee to eliminate old and avoid new complexity, the trend will not be reversed. Members of the Ways and Means Committee must endorse simplification as a bedrock principle, and that principle must be communicated to all involved in the tax-writing process. Time must be taken, and effort must be made, to ensure that this goal remains paramount.

To that end, the Congress adopted as part of the IRS restructuring bill a procedure to analyze the complexity of proposals with widespread applicability to individuals or small business. By means of this complexity analysis, the Joint Committee on Taxation will call attention to provisions that could result in substantial increases in complexity, and will suggest ways in which the goals of those proposals can be achieved in simpler ways. We strongly support this increased focus on complexity and urge the members of this Committee to pay heed to the JCT analyses. Only by raising awareness of problems with proposals before they become law will Congress make substantial inroads into the problem.

We would now like to address certain specific areas in which the Tax Section considers the need for simplification immediate.

A. *Alternative Minimum Tax*

As this Committee is well aware, there is an inherent problem with the individual alternative minimum tax which, if not fixed, will result in approximately nine million additional taxpayers becoming AMT taxpayers within the next decade. Many have referred to this problem as a ticking time bomb. Arguably, most of these taxpayers are not of the type envisioned as being subject to the AMT when it was revised in 1986. Moreover, many of these individuals will not even be aware they are subject to the AMT until completing their returns or, worse, receiving deficiency notices from the IRS.

The problem stems generally from the effects of inflation. Married couples with alternative minimum taxable income under \$45,000 (\$22,500 for individuals) are generally exempt from the AMT. These thresholds were effective for tax years beginning after December 31, 1992, but were not indexed for inflation. As time passes, inflation (even minimal inflation, as compounded) will erode these thresholds in terms of real dollars. As a result, more and more taxpayers will be pulled into the AMT. The problem is exacerbated by the fact that the AMT does not permit individuals to claim state taxes as a deduction against the AMT. As the income levels of these individuals increase (with inflation or otherwise), and their state tax liabilities rise correspondingly, they face the increased chance that they will be pulled into the AMT merely because they claimed state taxes as an itemized deduction for regular tax purposes.

This looming problem was compounded by the enactment of various new credits, as incentives, in the 1997 tax act. The provisions, such as the child tax credit under IRC section 24 and the Hope Scholarship and Lifetime Learning credits under IRC section 25A, do not apply for purposes of the AMT. Congress has recognized this problem by enacting a one-year moratorium (for 1998) that allows application of these incentive credits for both the regular tax and the AMT.

We urge this Committee in the strongest possible terms to solve the problems with the AMT once and for all. There is universal acknowledgement that the effects I have described are unintended and unjustified. It is also acknowledged that the revenue cost associated with a permanent solution will only increase over time and may eventually become prohibitive. It would be a travesty if a permanent solution to the AMT became caught on the merry-go-round of expiring provisions. A permanent solution should not be deferred merely because it competes with other, more popular proposals for tax reduction.

B. *Phaseout of Itemized Deductions and Personal Exemptions*

At the urging of the Tax Section, the American Bar Association at its February Mid-Year meeting adopted a recommendation that the Congress repeal the phaseout for itemized deductions (the so-called Pease provision) and the phaseout for personal exemptions (the PEP provision). We recommend that the revenue that would be lost by repeal be made up with explicit rate increases. This would address any revenue neutrality concern as well as any concern with re-

spect to the distributional effects of repeal.

It may be difficult for members of Congress to appreciate the level of cynicism engendered by these two phaseouts. Countless times, taxpayers who might not otherwise be troubled by the amount of tax they are paying have reacted in anger when confronted with the fact that they have lost — either wholly or partially — their itemized deductions and personal exemptions. They are no more comforted when told that these phaseouts should really be viewed as substituting for an explicit rate increase. Almost without exception, they react by asking why Congress refuses to impose the additional rate rather than trying to pull the wool over their eyes.

We have no answer to that question. We take pride in the fact that a private sector organization such as the ABA is willing to recommend a simplification proposal funded by a marginal rate increase on the same taxpayers benefiting from the simplification. We urge this Committee to give serious consideration to the ABA's recommendation.

C. Streamlining of Penalty and Interest Provisions

The 1998 IRS Restructuring Act instructs both the Joint Committee on Taxation and the Treasury Department to conduct separate studies of the penalty and interest provisions of the Code and to make recommendations for their reform.

The Tax Section believes that reform of the penalty and interest provisions is appropriate at this time and look forward to working with the JCT and Treasury. There are many cases in which the application of penalty and interest provisions take on greater significance to taxpayers than the original tax liability itself. The Tax Section is concerned that these provisions often catch individuals unaware, and that the system lacks adequate flexibility to achieve equitable results. In light of the significant changes being made by the IRS, the completion of this study and eventual enactment of the recommendations will be welcome.

The Tax Section has submitted preliminary comments to the staff of the Joint Committee on Taxation that we hope will be useful in developing alternatives. We expect to submit final comments and recommendations to both the Joint Committee and Treasury in the late spring.

D. International Simplification

We are also pleased that various members of the Ways and Means Committee and of the Senate Finance Committee are discussing significant simplifying changes in the international tax area. In particular, we commend Messrs. Houghton and Levin of this Committee for their leadership on this issue.

Provisions of the tax code relating to international taxation are among the most complex in existence. While we recognize that taxation of individuals and corporations earning income in multiple countries necessarily involves numerous complications, we firmly believe that significant simplifying changes can be made to existing provisions without losing sight of the various principles guiding those provisions. We urge this Committee to devote significant effort to these simplification proposals, and we look forward to working with you on that effort.

III. PROVISIONS RELATING TO CORPORATE TAX SHELTERS

The Administration's budget includes no fewer than sixteen provisions dealing in one way or another with the issue of aggressive corporate tax shelters. The purpose of our statement today is not to comment on the specifics of the Administration's proposals. We understand that the Treasury shortly will issue an amplification of its proposals. We are fully prepared to provide detailed comments on the proposals following issuance of the amplification. In the meantime, we wish to offer our own comments on the corporate tax shelter problem and suggest a course of action.

The sheer number of proposals included in the Budget obviously reflects the Treasury Department's concern about the corporate tax shelter phenomenon. While we believe the Committee should carefully consider the number of proposals included in the Budget, their possible overlap, and their potential impact on normal business transactions, the Tax Section strongly shares the Treasury's concerns with very aggressive positions being taken by taxpayers and their advisors in connection with certain transactions and the fact that these transactions frequently are being mass marketed. We also share the concern expressed by Chairman Archer regarding practices that abuse the tax code by making unintended end runs around it, and we compliment the Chairman for articulating his concern publicly and, thus, bringing additional attention to this problem.

A. *The Problem*

We have witnessed with growing alarm the aggressive use by large corporate taxpayers* of tax "products" that have little or no purpose other than reduction of Federal income taxes. We are particularly concerned about this phenomenon because it appears that the lynchpin of these transactions is the opinion of the professional tax advisor. The opinion provides a level of assurance to the purchaser of the tax plan that it will have a good chance of achieving its intended purpose. Even if the taxpayer ultimately loses, the existence of a favorable opinion is generally thought to insulate the taxpayer from penalties for attempting to understate its tax liability. While some might dispute this as a legal conclusion, recent cases tend to support the absence of risk for penalties where favorable tax opinions have been given.

Because of our concern that opinions of tax professionals are playing such a key role in the increased use of corporate tax shelters, the Tax Section has established a task force to consider amendments to the American Bar Association's rules for standards of practice of our members. We undertook a similar project in the early 1980's when so-called "retail" tax shelters proliferated. That effort

*While we refer to "corporate" tax shelters, consistent with Treasury's solutions to the tax shelter problem, the problem is not necessarily limited to corporate taxpayers. Consideration should be given to making some or all of the solutions agreed to by the Committee applicable to all large business taxpayers, lest we soon witness a surge of "tax products" directed at limited liability companies and large partnerships.

resulted in the promulgation of ABA Formal Ethics Opinion 346 and in the adoption of a similar standard in Treasury's Circular 230, which contains the ethical standards that tax professionals must comply with under threat of losing the right to practice before Treasury and IRS. We expect that our task force will recommend changes in these disciplinary rules to address the current tax shelter phenomenon.

Likewise, we are concerned about the blatant, yet secretive, marketing of these corporate tax shelters. As discussed below, unless penalties that cannot be seen as mere minor costs of doing business by the promoters are imposed upon the promoters, and strongly and diligently enforced, no end is or will be in sight.

The tax shelter products that concern us generally have the following features. First, there is a discrepancy between the book treatment of the transaction and its treatment for Federal income tax purposes (stated simply, the creation of a significant tax loss with no similar loss for financial accounting purposes). Second, there is little economic risk to the corporation from entering into the transaction other than transaction costs. Third, one party to the transaction is frequently what the Treasury refers to as "tax indifferent" (that is, a foreign taxpayer not subject to U.S. tax, a U.S. organization exempt from Federal income tax, or a taxable U.S. corporation that has large net operating loss carryovers). Finally, and most telling, it is generally assumed by the promoter, by counsel and apparently by the taxpayer itself that, if the "product" comes to the attention of Treasury or Congressional staffs, it will be blocked, but almost invariably prospectively, by administrative action or by legislation.

The aggressive tax shelters that concern us do not overuse tax benefits consciously granted by Congress (such as accelerated depreciation or credits) nor are they tax-favored methods of accomplishing a business acquisition or financing. They are transactions that the parties themselves would generally concede have little support in sound tax or economic policy, but are, the parties assert, transactions not clearly prohibited by existing law. Not surprisingly, explicit or implicit confidentiality is also a common requisite of today's tax shelter products.

The modern tax shelter transaction usually feeds off a glitch or mistake in the tax law, often one that is accessed by finding, or even creating, a purported business purpose for entering into the transaction. Tax shelter products that capitalize on mistakes in the Code are not as troublesome to us as those that depend upon the existence of questionable facts to support the success of the product. Mistakes in the Code will eventually be discovered and corrected by the IRS, Treasury, or the tax-writing Committees of Congress. When mistakes are discovered and corrected by legislation, it is the prerogative of Congress to determine whether the situation warrants retroactive application of the correction.

Far more troublesome is the practice of reducing taxes by misusing sound provisions of the Code. Exploitation of rules that generally work correctly by applying them in contexts for which they were never intended, supported by questionable factual conclusions, is the hallmark of the most aggressive tax

shelters today. Discovery on audit is the tax system's principal defense, but, in a self-assessment system, the audit tool cannot be expected to uncover every sophisticated tax avoidance device. The law should provide clear incentives for taxpayers to comply with the rules and, in all events, properly to disclose the substance of complex transactions.

Thus, our concern is centered on the transaction that depends upon a dubious factual setting for success. Foremost among these is the conclusion or assertion that there is a real, non-tax business purpose or motive for entering into the transaction. There are others. In some cases, it will be essential for the opinion-giver to conclude that the transaction in question is not a step in a series of transactions, which, if collapsed into a single transaction, would not achieve the tax benefits sought. A third type of factual underpinning often essential to the delivery of a favorable tax opinion is the permanence, or intended long-term economic viability, of a business arrangement among the parties (for example, a joint venture, partnership or newly formed corporation). A venture may be represented to be a long-term business undertaking among the parties, when in fact it is a complex, single-purpose, tax-motivated arrangement which was formed shortly before and will be dissolved shortly after the tax benefit is realized.

In most of these cases, the tax law is quite clear. Without the presence of a sufficient business purpose, unless the transaction is not a step in a series of related events, or unless the new business venture represents a valid business arrangement with a sufficient degree of longevity, the tax benefit claimed is simply not available under existing law. That bears repeating. Most if not all of the tax shelter transactions that concern us depend upon avoidance of well-established principles of law such as the business purpose doctrine, the step-transaction rule, the substance-over-form doctrine, or the clear reflection of income standard. Thus, the role of the opinion giver often disintegrates into the job of designing or blessing a factual setting to support applicability of the Code provisions that will arguably produce the desired benefit. The result is the application of a provision of the Internal Revenue Code that otherwise has a logical and sound policy purpose to reach a result that is nonsensical, in some cases almost ludicrous.

A sad additional fact is that all parties to these transactions know there is substantial likelihood that the device employed, including the imaginative assertion of the proper factual setting, will not be uncovered by IRS agents even if the corporation is audited, as most large taxpayers are. The tax law is too complex and the returns of major taxpayers are too voluminous. Many tax shelter products involve numerous parties, complex financial arrangements and invoke very sophisticated provisions of the tax law. It often takes time and painstaking analysis by well-informed auditors to ascertain that what is reported as a legitimate business transaction has little, if any, purpose other than the avoidance of Federal income taxes. Accordingly, there is a very reasonable prospect that a product will win the "audit lottery." This aspect of the problem is compounded by the fact that present law gives no reward for full disclosure in the case of corporate tax shelter transactions.

Let me emphasize that the transactions that concern us — and the tax opinions that support them — are altogether different than attempts to reduce taxes on a business transaction that has a true business or economic objective independent of reduction of Federal income taxes. But drawing distinctions between tax-dominated transactions and true business transactions that may involve major tax planning is sometimes tricky, particularly in the legislative context. For that reason, we recommend that the Congressional response to the tax shelter problem be measured and appropriate. It should not overreach; it should not risk inhibiting legitimate business transactions. As we all know, taxpayers have the right to arrange their financial affairs to pay the minimum amount of tax required under the law. Our desire is that in doing so they not avoid the intent of the law by benignly neglecting judicial and administrative principles in which the tax law is quite properly grounded.

B. *Possible Solutions*

We recommend that your emphasis be on compelling the full disclosure of the nature and true economic impact of specified classes of transactions. No taxpayer, or taxpayer's advisor, has the right to ignore or obfuscate the essential facts necessary to support the legal position relied upon to produce the desired tax benefit. Thus, we recommend that provisions be added to the Code that would give the parties a clear incentive to focus on the essential facts relied upon to bring the transaction within the applicable Code provisions. If that factual underpinning, and its legal significance, is properly understood by the taxpayer and its advisors, and is properly disclosed on the tax return, then the system will work much better. The facts to which I refer include objective facts that bear on the subjective inquiry the law requires. The inquiry would not need to state a conclusion as to the taxpayer's state of mind, but the objective facts that indicate the taxpayer's actual intent or purpose should be fully understood by the parties and clearly disclosed on the tax return.

In order to focus the inquiry on the facts relied upon to support these tax sensitive transactions, there should be a realistic possibility that penalties will be levied where the non-tax economic benefits from a transaction are slight when compared to the potential tax benefits. We agree with the Treasury Department that, in these types of transactions, promoters who market the tax shelter and professionals who render opinions supporting them should face penalties as well as the taxpayer. The Treasury Department has, in addition, suggested that tax-indifferent parties should face a potential tax if the transaction is ultimately found wanting. Under proper circumstances, that seems desirable. All essential parties to a tax-driven transaction should have an incentive to make certain that the transaction is within the law.

You may hear the argument that changes such as those we are advocating will cause uncertainty and unreliability in the tax law. As noted earlier, the Tax Section strongly supports as much simplicity and clarity as possible throughout the Code. However, total certainty is impossible where complex transactions are involved. This is particularly true when the parties seek to avoid judicial prin-

ciples developed to deny tax benefits to overly tax-motivated transactions. Taxpayers and their advisors know that relative certainty can easily be achieved in legitimate business transactions by steering a safer course and staying in the middle of the road. The more clearly the transaction stays within established judicial and administrative principles, the more certainty is assured. When they venture to the outer edge, certainty cannot be assured, nor should it be; the parties who consciously risk going over the edge should clearly understand there are severe consequences for doing so.

In an important way, the protection of common law and general anti-abuse principles contributes to certainty and reliability in the tax law. Tax shelter transactions commonly depend in large part on very literal interpretations of the words of the Code or regulations. They utilize the clarity in the way the tax law is written to undermine its purpose. In so doing, these transactions discourage the writing of clear and certain tax law in favor of more vaguely stated principles that cannot be so easily skirted. One of the important results of anti-abuse principles developed by the courts is the protection of clearly-stated provisions of law on which taxpayers can rely with certainty for every day business transactions.

As you can see, we think the best and most effective route for this Committee to follow in dealing with the corporate tax shelter problem is increased, meaningful disclosure, with proper due diligence of, and accountability for, the factual conclusions relied upon by the taxpayer. This will, perforce, have to involve an expanded penalty structure as well. If this is done properly, there may be no need for some of the more complex and broader changes Treasury has proposed. Consistent with our comments on simplicity earlier in this statement, we would encourage the Committee to be mindful of the significant complexity that could be imposed on thousands of taxpayers who are not employing tax shelters if the solutions selected to address this problem are overly broad.

Finally, this Committee and the Congress need to be certain that the Internal Revenue Service's resources are adequate to deal with the tax shelter issues. In part, promoters of tax shelters are successful in marketing their products because they and large taxpayers have concluded that the IRS is less to be feared today. They are aware of the problems within the agency, the Congressional criticism it has received, and its dwindling resources. Our recommendations are directed primarily at increased reporting and disclosure for "large tax shelters." We think such changes, together with expanded penalties, will increase voluntary compliance. However, the Internal Revenue Service must have the resources to analyze the information reported and to pursue noncompliance vigorously, or the increased reporting will be a paper tiger.

C. Specific Proposals

We would suggest the following changes in the Internal Revenue Code to accomplish the goals outlined:

1. *Additional Reporting for "Tax Shelters"*

A question should be added to the corporate income tax return requiring the taxpayer to state whether any item on the return is attributable to an entity, plan, arrangement or transaction that constitutes a "large tax shelter" (as defined below). If the answer is yes, detailed information should be required to be furnished with the return, including:

- (a) A detailed description of the facts, assumptions of facts, and factual conclusions relied upon in any opinion or advice provided by an outside tax advisor with respect to the treatment of the transaction on the return;
- (b) A description of the due diligence performed by outside advisors to ascertain the accuracy of such facts, assumptions and factual conclusions;
- (c) A statement signed by the corporate officer with principal knowledge of the facts that such facts, assumptions or factual conclusions 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 in the outside advisor's advice or opinion, the statement would need to describe such variances;
- (d) Copies of any written material provided in connection with the offer of the tax shelter to the taxpayer by a third party;
- (e) 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; and
- (f) A full description of any express or implied warranty from any person with respect to the anticipated tax results from the tax shelter.

2. *Broaden the Substantial Understatement Penalty to Cover Outside Advisors, Promoters, and "Tax Indifferent Parties"*

If the substantial understatement penalty of existing law is imposed on the taxpayer, a similar penalty should be imposed on any outside advisors 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 "tax indifferent parties," unless any such party can establish that it had no reason to believe the transaction was a tax shelter with respect to the taxpayer.

3. *Definition of "Large Tax Shelter" for Purposes of the Substantial Understatement Penalty*

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.”

4. *Specific New Penalties Should be Provided in the Case of Tax Shelters that Fail to Disclose the Required Information (Whether or Not the Tax Shelter is Ultimately Sustained or Rejected by the Courts)*

In a self-assessment system, accurate reporting and disclosure are essential. Where that does not occur, penalties are necessary. This is particularly true in the case of large and complex tax-motivated transactions. There should be a clear disincentive to playing the audit lottery in these types of transactions. This could be coupled with a reduction in the rate of any otherwise applicable penalties for those corporations that comply with the disclosure requirements set forth in 1, above. This would provide an incentive (and not just a disincentive) to make such disclosures.

5. *Articulate a Clear Congressional Policy that Existing Enforcement Tools Should be Utilized to Stop the Proliferation of Large Tax Shelters*

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.

IV. TAXATION OF INVESTMENT INCOME OF TRADE ASSOCIATIONS

One of the proposals included in the President’s budget raises serious concerns for the American Bar Association. We have been asked by the ABA to convey to this Committee its grave concerns about this proposal.

The proposal would tax all net investment income of trade associations, business leagues, chambers of commerce and professional sports leagues (under IRC section 501(c)(6)) in excess of \$10,000 per year. The tax would be imposed at generally applicable corporate rates. The tax would not be imposed to the extent such net income was set aside to be used for any charitable purpose described in IRC section 170(c)(4).

The principal basis for the Administration’s proposal is the erroneous assumption that the endowments that have been accumulated by some trade associations represent excessive dues payments by the members of these organizations. Thus, the Administration argues, the investment income earned on these excessive dues payments should be subject to tax just as they would have been if the dues had been set at the proper level, and the “excess” invested individually by the members of the association.

The ABA has serious reservations about this analysis. Even if it is correct to assume that these endowments represent excessive dues payments received in earlier years, the investment income earned on the excess (whether earned by the trade association or by its members) has the practical effect of reducing dues that become payable in future years. Therefore, the only significant consequence of permitting these excess dues to be invested by a tax exempt entity without

taxation is to defer the government's receipt of the tax on such income from the year of the initial dues payment to the year in which the excess dues are applied to carry out the trade association's exempt activities.

We understand the theoretical economic analysis that underlies this proposal. We would submit, however, that this theoretical analysis ignores the real world, practical implications of the proposal. As a large trade association, the ABA must point out that this proposal will discourage the accumulation of endowments, severely hamper multi-year planning, and limit the ability of these organizations to fund socially desirable programs.

For example, these organizations (like any other) fund large outlays over time, rather than in the year of the outlay. Dues of trade associations and other section 501(c)(6) organizations are set at levels necessary to fund such outlays by allowing them to accumulate funds for capital expenditures, etc. A tax on investment income would make planning for such large expenditures very difficult, and highly impractical. The organizations would be forced either to collect their dues on a level basis and incur the tax (thus necessitating higher, fully deductible dues to make up the difference) or to lower their dues, not accumulate any savings, and then make special assessments in the year of the large expenditure in order to fund the project (with such special assessments also being tax deductible). There is simply no good reason to put these organizations to that choice.

There is also no valid policy reason for singling out trade associations for this treatment, but excluding other mutual-benefit organizations such as labor unions, agricultural and horticultural organizations, and civic associations. All these types of organizations, although exempt from income tax under different provisions of the tax code, are essentially treated the same for tax purposes. Given this identity of treatment, it is not appropriate to single out organizations exempt from tax under section 501(c)(6) for this new investment tax.

V. CONCLUSION

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

