June 22, 1999

REPORT ON CERTAIN TAX SHELTER PROVISIONS OF NEW YORK STATE BAR ASSOCIATION TAX SECTION

The purpose of this report is to comment on three of the tax shelter provisions contained in the Administration's Revenue Proposals for the Fiscal Year 2000 Budget[1]. The three provisions (the "Supplemental Tax Shelter Provisions") would, respectively: (i) deny deductions for and impose an excise tax on certain fees received in connection with a corporate tax shelter; (ii) impose an excise tax on certain rescission and tax benefit guarantee agreements entered into in connection with a corporate tax shelter; and (iii) tax income allocable to tax-indifferent parties with respect to a corporate tax shelter (the "TIP tax").

Introduction and Overview

This Tax Section recently submitted a general report on corporate tax shelters (the "General Tax Shelter Report").[2] In that Report we indicated our agreement with the

1. This Report was prepared by the Committee on Corporations. Substantial contributions were made by Andrew N. Berg, Dan A. Kusnetz, Gerald S. Janoff, and David H. Schnabel. Helpful comments were received from Harold R. Handler, Robert A. Jacobs, Carolyn Joy Lee, Robert J. Levinsohn, David S. Miller and Charles M. Morgan, III.

2. *See* NYSBA Tax Section, "Report on Corporate Tax Shelters," *reprinted in 83 Tax Notes 879 (May 10, 1999).*

Administration that corporate tax shelters pose substantial issues for our tax system and we supported the strict liability penalty regime proposed by the Administration.

The General Tax Shelter Report expressed our view that the structure of our current penalty system does not adequately deter corporate tax shelter activity. We believe that the corporate tax shelter phenomenon poses sufficiently serious issues for our tax system that we support the enactment of legislation directed specifically at deterring such transactions. We think it is important for Congress to adopt accuracy related penalties which eliminate the reasonable cause exception.

We also believe that encouraging disclosure is an appropriate measure in deterring corporate tax shelter activity. We previously supported varying the amount of the accuracy related penalties depending on whether the material facts concerning the transaction had been disclosed. In the General Tax Shelter Report we stated that, while some of our members support the enactment of substantive provisions directed at corporate tax shelters, we did not support the adoption of a general anti-abuse provision at this time, urging Congress to proceed cautiously in formulating a legislative response given the difficulty in drawing the line between permissible and impermissible transactions.

For similar reasons, we recommend Congress not enact the Supplemental Tax Shelter Provisions at this time. Rather, we recommend a staged approach where increased penalties and incentives favoring disclosure are enacted now. We believe these measures, coupled with increased enforcement efforts and, over time, the development of new substantive tools, can produce tangible progress with respect to corporate tax shelters. If sufficient progress is not realized substantive provisions may be necessary.

We believe that the principal emphasis in the effort to curtail corporate tax shelters initially should be placed on preventing corporate taxpayers themselves from entering into such transactions by significantly altering the cost-benefit calculation with respect to those transactions. We do not believe it appropriate at this time to extend strict liability penalties beyond the taxpayer entering into the corporate tax shelter transaction.

As a general matter, the Supplemental Tax Shelter Provisions impose penalties and transactional costs on many potential parties to a corporate tax shelter transaction besides the principal. Surely in some cases parties other than the principal are active participants in the corporate tax shelter and disincentivizing them would further deter abusive transactions.[3] Nonetheless, we believe that additional strict liability penalties should, at this time, be limited to the principal engaging in the transaction and that the types of penalties and additional taxes envisioned by the Supplemental Tax Shelter Provisions should be imposed only in instances of nondisclosure of the material facts relating to the transaction. We believe this would strike a fair balance between the government's

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3. The Tax Section has in other contexts supported the imposition of penalties on non-principals where the deterrent effect would be significant. For example, in a Report dated January 26, 1981 the Committee on Criminal and Civil Tax Penalties recommended imposition of a civil fraud penalty on individual corporate officers and employees responsible for filing fraudulent returns. For the reasons stated below, we believe the penalties proposed in the Supplemental Tax Shelter Provisions should be limited to situations where there is nondisclosure.

legitimate interest in curbing tax shelter activity and the potential burden of dealing with an imprecise definition of the proscribed conduct.

It is significant to us that a critical element is that there has been considerable difficulty in formulating a suitable definition of corporate tax shelter. In the General Tax Shelter Report we proposed a definition but indicated that we thought it would operate appropriately only in the context of a penalty applicable where the taxpayer's position was not legally sustainable. Our definition was, of necessity, overbroad. In our view, it clearly applied to some transactions that would ultimately be sustained. We were willing to accept an overbroad definition since it was limited to tax motivated transactions, covered a significant range of transactions that should be deterred and, again, would only result in penalty if the taxpayer was unable to sustain its position. We believe that it is desirable to put taxpayers who engage in tax motivated transactions on notice that, should they lose, there would be increased costs, even if that risk might chill some otherwise legitimate activity that is covered by the definition.

One way to view the Supplemental Tax Shelter Provisions is as additional penalties on corporate tax shelter transactions. In that vein, the question for Congress ought to be what is the proper penalty level to achieve the optimal deterrence effect. Penalizing additional parties, while probably producing some marginal increase in deterrence, creates significant complexity, coordination issues and potential for unfairness.

The Supplemental Tax Shelter Provisions would include fundamental changes to our tax system, such as the taxation of foreign persons on income that has no nexus with the

United States and the imposition of excise taxes on lawyers, accountants and investment bankers. We are very concerned about imposing these kinds of significant strict liability penalties given the difficulties we have had in coming up with a suitable definition of corporate tax shelter. We believe much could be accomplished if the Supplemental Tax Shelter Provisions were fully abated in cases where there was adequate disclosure or, where appropriate [4], the Supplemental Tax Shelter Provisions become disclosure items thereby creating a greater likelihood for audit scrutiny.

Specific Comments on the Supplemental Tax Shelter Provisions

I. Deny Deductions for Certain Tax Advice and Impose an Excise Tax on Certain Fees Received

Description of Provision:

Generally, a corporate taxpayer may deduct fees paid for tax planning, including advice related to corporate tax shelters, as an ordinary and necessary business expense. The Administration has proposed to deny this deduction for fees paid or incurred in connection with the purchase and implementation of corporate tax shelters and the rendering of tax advice relating to such transactions. This proposal also imposes a 25 percent excise tax on fees received in relation to such transactions. Fees for representing a taxpayer before a court or the IRS are excepted from this provision.[5]

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4. Disclosure by lawyers may be inappropriate in many circumstances because of the attorney-client privilege. For that reason we think an excise tax on fees received is inadvisable.

5. Under current law, a tax advisor is subject to a $10,000 penalty only when he aides or
(continued...)

assumptions that may be untrue, an increased due diligence requirement could reduce the number of corporate tax shelters.

Professional regulation and ethical standards in the legal and accounting professions should provide appropriate standards for advice given to a potential tax shelter participant.[10] This self-policing is a more appropriate mechanism for regulation of advisors rather than imposing an excise tax/penalty regime on advisors for rendering independent advice. Because revised professional standards would affect only attorneys and accountants, they would not affect the behavior of some promoters and advisors of tax shelters, such as investment banks and consultants. Therefore, mere professional regulation in the absence of other reforms might not provide a complete solution.

II. Impose Excise Tax on Certain Rescission Provisions and Provisions Guaranteeing Tax Benefits:

Description of Provision:

The Administration proposes to impose on purchasers of a corporate tax shelter with a tax benefit protection arrangement, a 25 percent excise tax based on the maximum possible payment under the arrangement at the time the arrangement is entered into. A tax benefit protection arrangement includes a rescission clause,[11] guarantee of tax benefits

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10. For a proposal for establishing professional standards for advisors to purchasers of corporate tax shelters, *see* James P. Holden, Dealing with the Aggressive Corporate Tax Shelter Problem, 52 *Tax Lawyer* 369, 373-77 (1999).

11. A typical rescission clause requires the promoter or counterparty to unwind the transaction and make the taxpayer whole financially, should a change or clarification in the law interfere with the transaction's success. General Explanation, at 100.

arrangement to be specifically disclosed on the corporate taxpayer's return. Another alternative might be applying an at-risk type of rule, denying deductions in connection with a corporate tax shelter where there were risk insulating arrangements.

Should it ultimately be determined that rescission provisions and tax benefit guarantees should be subject to an excise tax, the penalty base should be limited to the benefit paid, rather than the hypothetical expectancy of payment.

III. Tax Income Allocable to Tax Indifferent Parties

Description of Provision:

The proposal would provide that any "income allocable" to a "tax indifferent party" with respect to a "corporate tax shelter" is taxable to such tax-indifferent party. The definition of corporate tax shelter appears to be the same as the definition used in the Administration's proposal relating to the substantial understatement penalty. In general, each participant in the corporate tax shelter would be jointly and severally liable with the tax-indifferent party for the taxes imposed.

Tax-indifferent parties would include foreign persons (*i.e.*, non-resident alien individuals and foreign corporations); Native America tribal organizations; tax-exempt organizations; and domestic corporations with expiring loss or credit carryforwards. A loss or credit carryforward would generally be treated as expiring if it is more than three years old.

In the case of foreign persons, the tax would be determined without regard to any exclusion or exemption provided in a treaty or otherwise. Any such income or gain that is not U.S.-source FDAP income would be treated as effectively connected with a U.S. trade or business without regard to whether the income is U.S. or foreign source. If the foreign person properly claims the benefit of an income tax treaty, the U.S. tax otherwise owed by the foreign person could be collected only from the other participants in the corporate tax shelter transaction who are not exempt from U.S. tax. Present-law standards (*e.g.*, Code Section 6114) would apply in determining whether a foreign person "properly claims" the benefit of a treaty for these purposes. In no event would the foreign person be liable for taxes with respect to the transaction in excess of the U.S. taxes (if any) not reduced or eliminated pursuant to the applicable income tax treaty for which relief is claimed.

In the case of Native American Tribal organizations, the tax could be collected only from participants in the corporate tax shelter transaction who are not exempt from U.S. tax. In the case of tax-exempt organizations, the income would be characterized as income subject to UBIT. In the case of domestic corporations with expiring loss or credit carryovers, the income would be subject to tax without regard to the otherwise available losses or credits.

For all the reasons described below, we do not support this TIP tax. We believe that it would be effective to require any transaction with a tax indifferent party to be specifically disclosed on the corporate taxpayer's return, thereby increasing the likelihood of audit scrutiny.