New York State Bar Association

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NYSBA

June 22, 1999

The Hon. Bill Archer
Chair
House Ways & Means Committee
1236 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Archer:

In response to the Administration's Budget Proposal for Fiscal Year 2000, filed on February 1, 1999, we have previously submitted a general Report on Corporate Tax Shelters. This Report recommended a strict liability penalty regime for certain appropriately defined corporate tax shelter transactions. In that report, we mentioned that we would be submitting a further report relating to additional tax shelter provisions contained in the Administration's Budget Proposal, specifically (i) the denial of deductions for, and the imposition of excise taxes on, certain fees, (ii) the imposition of excise taxes on certain indemnification and tax benefit guarantee arrangements, and (iii) the imposition of tax on "tax indifferent parties", all related to appropriately defined corporate tax shelter transactions. We enclose, herewith, the Tax Section report dealing with these further tax shelter proposals.

As we indicated in our prior report, we share the Administration's concern that the tax shelter phenomenon poses serious risk to our tax system and we generally support legislation directed specifically at discouraging these types of transactions. In our prior report, we urged Congress to proceed cautiously in formulating a legislative response given the difficulty in defining the scope of these tax shelter transactions, and we recommended a staged approach supporting increased "strict liability" penalties on taxpayers engaging in these transactions and incentives favoring disclosure. For similar reasons, we do not recommend the adoption at this time of additional taxes or strict liability penalties on parties other than the principal.

We continue to believe that a disclosure regime should be adopted. The types of activities that would be subject to these proposed taxes should become items for specific disclosure on corporate taxpayers' tax returns. We believe this would further the possibility of audit scrutiny of defined tax shelter transactions, and thereby potentially discourage taxpayers from entering into these types of transactions.

We would be pleased to discuss this with you and your staff at your convenience.

Very truly yours,

Harold R. Handler, Esq.
Chair

Enclosure

cc: James D. Clark, Esq.

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

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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...)

Analysis:

The Treasury articulated in its General Explanation of the Administration's Revenue Proposals (the "General Explanation") that the reason for this provision is the Administration's increasing concern regarding the prevalence of corporate tax shelters. The explanation stated that these provisions were designed to impede the purchase, promotion and sale of corporate tax shelters.

The current penalty regime does not sufficiently deter tax shelter abuse.[6] An effective anti-abuse regime requires penalties that significantly influence the taxpayer's risk analysis in its determination of whether or not to participate in a tax shelter transaction. By penalizing taxpayers who seek tax advice and concomitantly penalizing the providers of such advice, this proposal could change the manner in which taxpayers assess their investment in legitimate and questionable ventures and may inhibit securing the advice that would be expected to temper improper investment activity.

The proposal does not specify whether the taxpayer and/or the advisor bears either of these tax burdens. It appears the denial of the deduction is intended to have direct impact on the taxpayer and the excise tax to impact the service providers. In any event, the excise tax will almost certainly be borne indirectly by the taxpayer through a combination of increased fees and/or indemnities for excise taxes.

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5. (...continued)
assists the understatement of a corporation's tax liability. I.R.C. §§ 6701(a), (b)(2)

6. General Explanation, at 99.

Regardless of whom the tax burden is legally imposed upon, the proposal potentially penalizes taxpayers for seeking professional advice, including legal advice, accounting, investment banking, consulting and other advisory and service provider fees. For the reasons described below, we believe it is inadvisable to discourage taxpayers from securing appropriate advice.

If tax attorneys are faced with potential excise tax penalties, the attorney-client relationship will be affected adversely. Both the decision as to whether to advise a client to proceed with a transaction and the determination of litigation and settlement strategies may be sources of attorney conflicts. For example, an attorney may view a transaction as being close to the line, but not a corporate tax shelter. For fear of excise taxes, the attorney may not be able to render impartial advice. Similarly, if the attorney who advised on the transaction represents the taxpayer before the IRS, a potential conflict would exist between the client's interest in evaluating IRS settlement offers and the attorney's interest in avoiding excise tax liability.

The focus of imposing penalties on advisors, presumably to disincentivize them as well as the principals, is problematic. The taxpayer, not its advisors, is the responsible party for entering into abusive transactions. The taxpayer is the one who balances the transaction's costs and benefits and ultimately decides whether to participate. If the taxpayer's risk-reward calculation is modified by increased penalties there will be lower demand for tax shelter schemes, and the participation of promoters and advisors will

similarly decline. Subjecting tax advisors to excise tax liability may simply result in a new application of Gresham's law[7], where responsible advisors withdraw from the market.

The advisor penalty also raises significant procedural questions because only the taxpayer may be a party to the proceedings with the IRS concerning the treatment of the transaction. Surely, non-parties to that proceeding should not be bound by the outcome. Nonetheless, the tax advisor may be prejudiced by the determination of a court, or a statement by the taxpayer that admits to a tax avoidance purpose.

Further, basic fairness issues are raised by the fact that the aggregate tax costs imposed by this excise tax and the other anti-tax shelter proposals approaches and may even exceed the penalty applicable to civil fraud.[8]

The proposal's application is not clear in several respects. The proposal's language imposes the excise tax on "the rendering of advice related to corporate tax shelters."[9] Clearly, this provision covers activity by advisors and promoters that encourage participation in tax shelter activity. This language seems to include the provision of objective legal analysis and advice that recommends *against* participation in a tax motived

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7. Bad money drives out good money. An observation of economics that when two coins are equal in debt-paying value but unequal in intrinsic value, only the one having lesser intrinsic value remains in circulation.

8. See *Hearings on the Revenue Provisions in the President's Fiscal Year 2000 Budget* (statement of David A. Lifson, chair of the Tax Executive Committee of the American Institute of Certified Public Accountants), *reprinted in*, 1999 TNT 81-27, AICPA Testimony at Finance Hearing on Revenue-Rasing Proposals, at ¶ 81-82.

9. General Explanation, at 99.

transaction, which we understand is not intended. Even if advising against participation in a corporate tax shelter is a complete defense, problems remain. Rarely is transactional advice as simple as "do it" or "don't do it". More significantly, an advisor may be prohibited from disclosing what his advice was on account of attorney-client privilege.

Additionally, it is unclear whether the statute of limitations on the excise tax and the denial of deductions commences on the date the tax shelter transaction is closed or the fee payment date or some other date. Should this proposal be enacted, these ambiguities should be addressed and resolved.

Alternatives:

Although we favor limiting strict liability penalties to the principal, we offer some alternatives should the Treasury not follow that approach.

Any excise tax should be limited to the advisors of the parties engaged in the marketing and promotion of tax shelter activities, and not imposed on the providers of independent analysis, negotiation and other advising of taxpayers. The parties involved in the creation of improper investment activity are more appropriately the focus of remedial legislation than the independent advisors of potential investors.

Other alternatives include an expanded due diligence requirement on tax advisors and the creation of new professional responsibility rules. Often, tax shelter opinions are based on facts and business purposes asserted by clients that are unverified by the tax advisors. Because advice and opinions relating to abusive transactions can be based on factual

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,[12] or any other arrangement with the same economic effect, e.g., insurance guaranteeing the tax benefits of the transaction. The maximum payment is the aggregate amount the taxpayer would receive if all the tax benefits of the transaction were denied. The proposal's example states that if a taxpayer purchases protection against the risk of not receiving tax benefits of a transaction valued at $10,000, the taxpayer would be liable for a $2,500 excise tax, even if only $5,000 of the tax benefits were denied.

Analysis:

We find this provision problematic for several reasons. Our primary concern is that taxing insurance arrangements with third parties imposes an unnecessary drag on legitimate contractual risk shifting. Third party contracts will not eliminate the taxpayer's risk. Rather, liability will shift to the third party, which will require professional advice to determine whether to guarantee the transaction. Numerous appropriate transactions contain tax indemnities, change of law protection or similar transactional guarantees. The tax consequences of an investment are clearly and appropriately part of the yield calculation. Just as credit exposure may be guaranteed in a transaction, so too may the intended tax consequences of the transaction. The entire leveraged leasing industry, for example, is based on the indemnification of the expected after-tax benefits that lessor-investors took into account in pricing their transaction. These transactions and

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12. In the context of a tax shelter, a guarantee of tax benefits is necessitated by a change or clarification in the law, as distinguished from a representation of fact and warranty. *Id.*

arrangements are legitimate and should not be placed under pressure merely because they contain tax indemnities.

Second, the excise tax is imposed at the outset of the arrangement, whether or not the benefit is triggered and before any determination is made that the underlying transaction is one that Congress considers improper. This provision contradicts general tax principles by taxing an expectancy of payment, rather than its receipt or realization.

Third, calculation of the maximum payment may be unclear in many situations. For example, in the case of a rescission agreement, it may be difficult at the transaction's outset to determine the cost of unwinding the transaction. In transactions that include financial assets that involve breakage costs, such as interest rate or currency swap arrangements, LIBOR breakage or similar market based costs, it may be impossible to determine the maximum payment at the outset of a transaction. The determination of the maximum payment will lead to disputes of fact and methodology with the IRS and increase the chance of litigation.

Alternatives:

The Treasury explanation states that provisions insulating a purchaser of a corporate tax shelter from risk encourages participation in a corporate tax shelter. One alternative that would address this concern, yet avoid some of our concerns about the Administration's proposal, is to deem a risk insulating provision as a factor indicating that tax benefits were a material factor in the investment decision and therefore a valid factor in determining whether a given transaction is a corporate tax shelter, and requiring any such

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.

Analysis:

A. Uncertain Application. We have a number of questions about how and when the TIP tax is intended to apply.

In determining whether a tax-indifferent party "is allocated income with respect to the corporate tax shelter," does one look to the actual tax consequences to the tax-indifferent party as finally determined (*i.e.*, does substance control) or does one look to the tax consequences intended by the parties (*i.e.*, does form control)?

Can the general anti-avoidance rule and the TIP tax both apply to the same transaction so as to disallow the tax benefits claimed by the corporate taxpayer and to tax the income allocated to the tax-indifferent party?

Is the TIP tax intended to apply only with respect to corporate tax shelters that are determined do not work (*i.e.*, where the form of the transaction and the claimed tax benefits are not respected) or to all transactions that meet the definition of "corporate tax shelter" even if the form of the transaction and the claimed tax benefits are sustained?

B. Allocation of Income to the Tax-Indifferent Party. For the TIP tax to function as intended, we believe one would have to look to the form of the transaction, rather than to its substance, to determine whether the tax-indifferent party is "allocated income with respect to the corporate tax shelter." If one looked to the substance of the transaction, then the provision would seem to apply only in cases where the underlying transaction was respected, which is an odd result. We note that taxing the tax-indifferent party by reference to the form of the transaction could be inconsistent with a general anti-

avoidance rule, which attempts to ensure that corporate tax shelters are taxed in accordance with their substance, rather than their form.[13] This inconsistency seems necessary because the general anti-avoidance rule is intended to serve as a substantive tax provision whereas the TIP tax is intended to serve as a penalty provision. The inconsistency does, however, illustrate the difficult coordination issues that inevitably arise from the multi-pronged approach taken in the Administration Proposal.

C. Application of the General Anti-Avoidance Rule and the TIP Tax. It is hard for us to imagine a case where the TIP tax would apply and the general anti-avoidance rule would not apply. If both provisions could apply to the same corporate tax shelter, the net effect would be to tax the tax-indifferent party on the income generated in the transaction and to disallow the corresponding tax benefits. Viewed this way, the TIP tax is merely a very complicated penalty that (i) is calculated by reference to the tax-indifferent party's unreported income, rather than the corporate taxpayer's disallowed tax benefits, (ii) roughly equals 100% of the corporate taxpayer's understatement (assuming the income generated roughly equals the deductions generated) and (iii) may be collected (under the joint and several rule) from either the tax-indifferent party or the corporate taxpayer. In cases where the TIP tax is collected from the tax-indifferent party, the provision would have the seemingly-unjustified effect of imposing a higher penalty on the tax-indifferent party than the penalty imposed on the corporate taxpayer (100% of the TIP's

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13. Taxing the tax indifferent party is also at odds with the more general principle applicable under our tax system that a transaction is ordinarily taxed in accordance with its substance, rather than its form.

"understatement" vs. 20% of the corporate taxpayer's understatement). We see no reason for such a result. On the contrary, we believe that if a significant penalty is going to apply, it should be imposed only on the corporate taxpayer seeking the improper benefit and not the tax-indifferent party.

If the Administration intends the general anti-avoidance rule and the TIP tax not both apply to the same transaction, then we think that it is preferable for the general anti-avoidance rule to apply, rather than the TIP tax. First, the general anti-avoidance rule has the obvious advantage of taxing the parties based on the substance of the transaction, rather than on what will have been established to be an artificial form. Second, the general anti-avoidance rule impacts the party that chose to pursue the tax-motivated transaction, the corporate taxpayer. Third, the general anti-avoidance rule avoids the significant issues discussed below that arise under the TIP tax, *e.g.*, the ability of tax-indifferent parties to determine if (and to contest any IRS assertion that) they are participating in a corporate tax shelter.

D. Ability of Tax-indifferent Parties to Determine if the Transaction is a Corporate Tax Shelter. We are also concerned that, if the TIP tax were enacted, tax-indifferent parties generally would need to examine each transaction they engage in with a corporate taxpayer to determine whether the transaction could be viewed as a "corporate tax shelter." This examination would require the tax-indifferent party to ascertain, among other things:

(i) whether a corporate participant in the transaction is attempting to obtain a reduction, exclusion, avoidance, or deferral of tax, or an increase in a refund (other than one clearly contemplated by the applicable provision);

(ii) whether the reasonably expected pre-tax profit to the corporate participant from the transaction is insignificant relative to the reasonably expected net tax benefits of the transaction; and

(iii) whether the transaction involves the improper elimination or significant reduction of tax on economic income.

Our concern is not so much that the TIP tax would actually be imposed on a tax-indifferent party in a case where it was not on notice that it might be participating in a corporate tax shelter. Rather, our principal concern is the chilling effect the TIP tax will have on legitimate transactions as tax-indifferent parties (particularly foreign tax-indifferent parties) are forced to prove to themselves, prior to engaging in a transaction, that the transaction could not be viewed as a corporate tax shelter of one of the other participants. Tax-indifferent parties will take this provision very seriously, even in regular commercial transactions, given the potentially significant adverse financial consequences to them. We can readily imagine the following comment from a foreign participant in a legitimate multi-party transaction:

> We understand our share of the income is not subject to U.S. tax under the general rules applicable under the Internal Revenue Code. However, if that 'super provision' applies, then we would be taxed in the U.S. on our share of the income, we would be required to file a U.S. tax return and we would be subject to the audit jurisdiction of the United States Internal Revenue Service. We must be indemnified against that risk.

Our concern is heightened by the fact that the determination of whether a transaction is a corporate tax shelter depends largely on facts exclusively relating to and known to the corporate taxpayer (and *its* investment) and not to the tax-indifferent party. In deciding whether to engage in a particular transaction, how does a tax-indifferent party obtain the information necessary to determine the corporate participant's "reasonably expected pre-tax profit" or whether that pre-tax profit is "insignificant" relative to the "reasonably expected net tax benefits?" Participants might be reluctant to share that information with third parties. Yet this is precisely what the provision seems to require.

Moreover, a tax-indifferent party that reasonably concludes a transaction is not a corporate tax shelter, based upon a corporate taxpayer's factual representations, remains liable for the TIP tax if the IRS successfully challenges the representations and establishes the transaction was a corporate tax shelter.

In addition, we think it problematic that if the IRS asserts a transaction was a corporate tax shelter, the tax-indifferent party would be at the mercy of the corporate taxpayer in garnering factual evidence to dispute the IRS assertion. In the face of such an IRS assertion, the corporate taxpayer might be reluctant to provide information about its "reasonably expected pre-tax profit." Although this reluctance may be tempered somewhat if the corporate taxpayer is jointly and severally liable for the tax, it does not change the fact that the tax-indifferent party also will be liable for tax despite its inability to obtain the information required for its defense..

Moreover, given the difficulty this Committee and the Administration has had in settling on a satisfactory definition of a "corporate tax shelter", it seems ill advised to require foreign investors (who may not be familiar with U.S. tax principles) to make the determination. The concern arises, in part, from the fact that the definition of "corporate tax shelter" could easily be read to apply to a broad range of transactions, including transactions the Administration did not intend to address. Given the definition's uncertain application, we simply do not believe it a good idea to require foreign investors to make this judgment in light of the potentially significant economic consequences.

E. Additional Foreign Issues. We are also concerned that the proposal could subject foreign persons to United States tax on income that has no nexus to the United States. This would be a dramatic change in United States taxation of foreign persons. Although we share the Administration's concern about the growing prevalence of corporate tax shelters, we do not believe that it currently warrants such a fundamental change in the taxation of foreign persons. Rather, such a change should be enacted (if at all) only if the strict liability penalty regime and increased disclosure proves to be inadequate disincentive.

Moreover, we believe foreign jurisdictions are likely to regard the corporate tax shelter phenomenon as essentially an internal United States problem that does not justify United States taxation of foreign persons on income that is neither United States source nor effectively connected with a United States trade or business. As a result, foreign jurisdictions may retaliate by enacting provisions aimed at United States investors.