September 18, 2000

The Honorable William V. Roth, Jr.
Chairman, Finance Committee
United States Senate
104 Hart Senate Office Building
Washington, D.C. 20510

Dear Chairman Roth:

I am writing on behalf of the New York State Bar Association Tax Section (the "Tax Section").[1]

On May 24, 2000, the Senate Finance Committee (the "Committee") released draft proposed legislation dealing with corporate tax shelters (the "Bill"). The Bill contains a new provision, proposed Section 6662A of the Internal Revenue Code, that would mandate enhanced understatement penalties for large corporations engaging in certain tax shelter transactions. The Bill would also (i) amend the corporate tax shelter registration provisions of current Section 6111(d) to, among other things, delete the limitation to transactions offered "under conditions of confidentiality", (ii) expand and increase the penalties on return preparers, "aiding and abetting" and failure to maintain lists (in Sections 6694(a), 6701(a) and 6708(a), respectively) as applied to tax shelters, (iii) authorize the Internal Revenue Service (the "Service") to impose monetary penalties on taxpayer representatives in certain circumstances and direct the Service to update Circular 230 to better address corporate tax shelter transactions, and (iv) direct the Service to develop and implement uniform assessment and disciplinary procedures for matters involving tax shelters.

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1 This letter was drafted by Lewis Steinberg, co-chair of the Tax Section's Committee on Corporations.

We applaud the Committee for taking this legislative step to address abusive corporate tax shelters. As the Tax Section has consistently stated in prior reports and in Congressional testimony, we believe that corporate tax shelter activity is a significant and potentially growing problem that demands the attention of both Congress and the Administration.[2] We also endorse the general approach of the Bill to this problem, which is to revise current law penalty rules and not to change substantive law. Moreover, the direction to the Service to update Circular 230 and to implement uniform procedures for assessment and disciplinary purposes is consistent with our prior comments. Indeed, in a recent report, the Tax Section outlined a number of suggestions for updating Circular 230.[3]

In certain respects, however, the Bill is overly complex and ill-conceived in how it implements its general approach. The Tax Section has consistently supported enactment of a simple two-tiered "strict liability" structure (that is, one in which penalties could not be avoided by receipt of an opinion from a tax advisor and that would provide for enhanced penalties in the case of nondisclosure). The Bill, however, adopts a substantially different approach.

In particular, the heart of the Bill, proposed Section 6662A, would create a complex tripartite penalty structure, where the magnitude of the penalty would depend (in part) on whether the taxpayer, at the time it enters into the transaction, believes that it "will prevail", "should prevail" or "more likely than not will prevail" on the substantive merits. These terms are not defined in the Bill, apparently because the Bill's drafters assumed that these terms have well-understood meanings and that prevailing opinion practice among tax advisors is consistent. Even among practitioners, however, the standards for "will", "should" and "more likely than not" opinions vary greatly, and the use of such terms as a basis for imposing

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2 *E.g.*, New York State Bar Ass'n Tax Section, Report on Corporate Tax Shelters, April 23, 1999.

3 New York State Bar Ass'n Tax Section, Report on Revisions to Circular No. 230, July 31, 2000.

understatement penalties can only lead to ambiguity and inconsistency in interpretation and application.

More fundamentally, in addition to linking penalties to these three standards, the Bill would in some circumstances permit taxpayers to satisfy these standards by obtaining an opinion from an independent tax advisor. For the reasons stated by the Tax Section in its prior reports and testimony, we believe that a new legislative scheme allowing taxpayers to rely on tax opinions to abate understatement penalties with respect to tax shelters will result in insufficient deterrent effect. Moreover, coupled with the tripartite scheme that attempts to mimic current opinion practice, this aspect of the Bill will inevitably lead to substantial "opinion shopping" on the part of some taxpayers.

Furthermore, proposed Section 6662A would exempt an arrangement from the understatement penalty if (i) at the time the taxpayer entered into the arrangement, it reasonably believed that it "should" prevail on the merits, (ii) there was a material nontax business purpose for the arrangement, and (iii) the taxpayer properly discloses the arrangement. We do not support this exemption because we continue to believe that the prospect of some penalty if the taxpayer loses on the merits is needed even in such cases to deter abusive corporate tax shelter activity.

The Bill would also reduce the penalty to 20 percent even absent disclosure if the taxpayer reasonably believed that it "will" prevail on the merits and there was a material nontax business purpose for the arrangement. Because the Tax Section believes that it is important to incent taxpayers to disclose tax shelter transactions, we believe that this aspect of the Bill is ill-advised.

The final concern we wish to raise is with the Bill's broad definition of tax shelter ("any arrangement if . . . a signficant purpose of such arrangement is the avoidance or evasion of Federal income tax . . ."), which would be deemed satisfied if any one of several specified "tax shelter indicators" is present. As the Tax Section has stated on prior occasions, our endorsement of enhanced understatement penalties for corporate tax shelters

is premised on a properly tailored definition. We believe that the definition used should focus on the fundamentally troubling aspects of targeted transactions from a tax policy viewpoint, rather than on collateral matters such as some of those used by the Bill as "tax shelter indicators". Thus, the definition should combine (a) reference to the taxpayer's purpose of achieving an unintended tax advantage with (b) an objective test, which might differ depending on the general category of the transaction (*e.g.*, investment or financing). Moreover, although we agree that an objective test should be part of any definition, we have expressed concerns about the kind of test in proposed Section 6662A(c)(2)(B), which compares reasonably expected pretax profit with reasonably expected net tax benefits. These concerns, as described in a recent report by the Tax Section,[4] involve the difficulty of defining and measuring expected pretax profit in many situations;[5] thus, we have suggested consideration of an alternative objective test that looks to whether there is any meaningful potential for significant pretax gain (or loss) from the arrangement. In sum, we believe that an overall approach to defining transactions subject to enhanced penalties, which focuses on the fundamentally troubling aspects of abusive transactions, would better identify the types of arrangements that should be targeted and would better accommodate changes in market practice.

The Bill also contains provisions that would expand penalties applicable to persons other than the taxpayer(s) whose tax liability is affected by a tax shelter and that would authorize the Service to impose monetary penalties on taxpayer representatives under certain circumstances. In a prior report, the Tax Section stated that it was currently opposed to imposing additional monetary penalties on investment bankers, tax advisors, and other non-taxpayer participants.[6] Our position in that report was based both on

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4 New York State Bar Ass'n Tax Section, Report on Proposal to Codify Economic Substance Doctrine, July 25, 2000.

5 These concerns are less serious, however, if the test is not part of a substantive disallowance provision, but rather is used only in imposing penalties on a transaction that has been successfully challenged on the technical merits.

6 New York State Bar Ass'n Tax Section, Report on Certain Tax Shelter Provisions, June 22, 1999.

our concern that such penalties could chill legitimate tax planning and counseling and on our belief that an opportunity should first be afforded to see whether other measures we have endorsed would be effective to deter abusive tax shelter activity. However, because of the importance of this issue and the apparent continuing proliferation of corporate tax shelters, the Tax Section is reviewing its position on the imposition of penalties on non-taxpayer participants; at this time it is not our position to oppose categorically such penalties. Subject to that review, we may have additional comments on the provisions of the Bill involving penalties on tax return preparers, taxpayer representatives and "aiding and abetting" understatements.

In conclusion, then, we believe that the Committee has taken an important step in putting corporate tax shelter legislation on the Congressional agenda, and we endorse the general approach of revising penalty rules. Nevertheless, we believe that a different, simpler and better targeted approach to understatement penalties, like the one the Tax Section

has consistently advocated, will result in both greater deterrence and more limited collateral effects on legitimate business-motivated transactions.

Sincerely,

Robert H. Scarborough

cc: Senate Finance Committee

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