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New York State Bar Association

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October 30, 2001

The Honorable Max Baucus
Chairman
Senate Finance Committee
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable William M. Thomas
Chair
House Ways & Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

The Honorable Charles E. Grassley
Senior Minority Member
Senate Finance Committee
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Charles B. Rangel
Senior Minority Member
House Ways & Means Committee
House of Representatives
1106 Longworth House Office Building
Washington, D.C. 20515

Gentlemen:

I write on behalf of the New York State Bar Association Tax Section (the "Tax Section"). On August 3, 2001, the Senate Finance Committee (the "Committee") released draft proposed legislation designed to block the growing use of tax shelters (the "Bill"). The Bill would, *inter*

alia, significantly increase understatement penalties imposed on taxpayers engaged in specified tax shelter transactions and expand and increase penalties imposed on promoters and others (including tax advisors) involved in tax shelter organization, marketing and reporting.

We commend the Committee on its continuing efforts to craft legislation to combat abusive tax shelters. As we have stated in our prior reports and in our Congressional testimony, we continue to believe tax shelter activity presents a significant problem that potentially is growing, commanding the attention of both the Congress and the Administration.[1] According to the press materials released with the draft legislation, the Bill is intended to shift from an enforcement strategy based primarily on penalizing taxpayers to one that encourages greater disclosure of potentially abusive transactions to enhance the disclosure regime implemented by the Treasury Department in its February, 2000 regulations, and provide the Congress and Treasury time to evaluate the effectiveness of those regulations. We agree that disclosure requirements are an essential and useful tool in deterring and detecting tax shelter activity. Nevertheless, we continue to believe the taxpayer's cost/benefit calculus must be changed by significantly strengthening the understatement penalty regime to significantly deter tax shelter activity.

As we have previously noted, and subject to our comments relating to the definition of a "tax shelter" below, the Tax Section supports enactment of a simple two-tiered "strict liability" structure -- that is, one in which (i) penalties cannot be avoided by the possession of an opinion

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[1] *See, e.g.*, Letter to the Hon. William V. Roth, Jr. from Robert H. Scarborough, dated Sept, 18, 2000, 2000-TNT-184-32 ("Sept. 2000 Letter"); New York State Bar Ass'n Tax Section, Report on Corporate Tax Shelters, April 23, 1999, 1999-TNT-82-89.

from a tax advisor and (ii) penalties will be reduced (but not eliminated) if there has been appropriate disclosure to the Internal Revenue Service.

We agree with your draft legislation's basic premise that if there is an "applicable tax shelter understatement" (generally an increase in tax, arising from the incorrect treatment of a "tax shelter" item, unless there was (i) "substantial authority" for that treatment, (ii) "adequate disclosure" and (iii) a "reasonable belief" the tax treatment was more likely than not appropriate) a 40 percent penalty will be imposed. We are concerned that if the Bill were enacted in its present form, there would be no understatement penalty at all if the disclosure and other requirements to defeat the 40 percent penalty were satisfied. While we agree disclosure should be encouraged, we continue to believe that a taxpayer that engages in a tax shelter transaction and loses on the merits should suffer a significant monetary penalty, even where there has been full disclosure. Therefore, we propose that in the case of an understatement due to a "tax shelter," even where there is "substantial authority," "adequate disclosure" and "reasonable belief," a 20 percent penalty be exacted.

We also recommend that, in applying the $50,000 tax understatement threshold for the penalty (in proposed Section 6662(i)(1)(B)), all tax shelter items for the taxable period be aggregated to prevent taxpayers from manipulating that test. Finally, we suggest that disqualified tax advisors (under proposed Section 6662(i)(1)(B)(ii)) include employees of, partners of, and persons related to tax shelter promoters.

Defining a "tax shelter" has been a problematic aspect of the attempt to introduce and implement effective legislation. The Bill's tax shelter definition ("any arrangement if . . . a significant purpose of such arrangement is the avoidance or evasion of Federal income tax . . .")

is so broad as to sweep within its framework -- and therefore require disclosure with respect to -- almost any tax mitigation transaction, even one clearly countenanced by the Code. The Tax Section has stated on prior occasions that our endorsement of enhanced understatement penalties for tax shelters is premised on a properly tailored tax shelter definition. Moreover, the quantity of disclosure likely to result from the Bill's definition would be enormous, thereby, we believe, rendering the disclosure practically useless to the Internal Revenue Service.

We recommend, therefore, that the definition be modified to *exclude* from the definition of "tax shelter" any transaction structured with a purpose of achieving tax benefits clearly intended by the Code (as gleaned from the Code language, the legislative history, Treasury regulations and administrative rulings) to apply to the transaction. The Internal Revenue Service would be encouraged to publish rulings or regulations listing transactions achieving tax benefits the Service believes clearly intended by the Code[2] and a list of transactions whose purported tax benefits the Service believes are not intended by the Code.[3] That the Service had identified a transaction as one whose benefits the Service believes are not intended by the Code would not be determinative in a judicial proceeding. Instead, a taxpayer would have the right to establish the transaction was not a tax shelter because the tax benefits were clearly

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[2] Examples of clearly intended tax benefits include tax-free reorganizations, tax-free like-kind exchanges, the pass-through benefits of subchapter S or REIT or RIC status and the dividends-received-deduction.

[3] While we recognize the Internal Revenue Service will not be able to describe all the relevant facts of an "acceptable" transaction, we believe the list could describe generic transactions and the Service would be free to challenge any transaction on the grounds that the transaction at issue was not one for which those benefits were intended.

intended by the Code.[4] The legislative history also should clarify that a transaction structured to qualify for a particular Code-granted tax benefit (*e.g.*, a (B) reorganization or a Section 1031 exchange) that is clearly intended to be available to the transaction but is found to contain a technical error (that renders the intended Code section inapplicable), is not a tax shelter.

The Bill also would exact penalties from persons other than the taxpayer whose tax liability is directly affected by the tax shelter. These provisions would impose significant monetary penalties on persons who promote, organize, market or advise with respect to abusive tax shelters, under prescribed circumstances. In a prior report, we stated that we opposed imposing additional monetary penalties on investment bankers, tax advisors, and other non-taxpayer participants.[5] As a result of the importance of this issue and the apparent continuing proliferation of tax shelters, the Tax Section reviewed its position on the imposition of penalties on non-taxpayer participants and, as of last year, no longer opposes categorically these penalties.[6]

We believe it is not clear if the penalties proposed under new Section 6701(a)(2) are intended to apply only to tax practitioners who provide overly aggressive tax opinions, or are also intended to apply to other persons that play critical roles in procuring the abusive tax advice

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[4] The outcome of any such proceeding would have no effect on whether the transaction was or is a "listed transaction" for purposes of the tax shelter disclosure, registration and listing regulations under Sections 6011, 6111 and 6112 (except, of course, to the extent the outcome influences the Internal Revenue Service to the modify its list of "listed transactions").

[5] New York State Bar Ass'n Tax Section, Report on Certain Tax Shelter Provisions, June 22, 1999, 1999-TNT-126-31.

[6] *See* Sept. 2000 Letter.

and passing it on to the potential participants We believe these enhanced penalties should apply to all the abusive tax shelter participants. To clarify this scope of Section 6701(a)(2), we suggest (in the attached Appendix A) some modifications to proposed Section 6701. These modifications are intended to insure that the enhanced aiding and abetting penalty under proposed Section 6701(a)(2) could apply to a promoter or other organizer, marketer or manager of a tax shelter who assists a taxpayer in obtaining or obtains and provides to a taxpayer overly aggressive tax advice. While Section 6700 already applies to these persons, the penalty under Section 6700 applies only if the writing is "false or fraudulent," and it is not clear when – if ever – overly aggressive tax advice becomes "false." We reject the principal that only "false" advice should subject the promoter, organizer, marketer or manager who procures or provides abusive advice to penalties.

Appendix A lists a number of other comments designed, *inter alia*, to insure that (1) the penalties contained in proposed Sections 6700(a) and 6701(b)(3), which would be equal to 50 percent of the gross income derived by the person in connection with the tax shelter, will be based only on that portion of the professional fees that is directly attributable to the conduct giving rise to the penalty,[7] (2) the penalty in proposed new Section 6701(a)(2) can be imposed only with respect to a legal opinion, advice, representation or indication that is written and (3) the advisor remains liable even where the taxpayer has settled with the Internal Revenue Service. The remainder of the Appendix A suggestions are suggested technical corrections.

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[7] This is the way the penalty is structured in proposed 31 U.S.C. Section 330(b), which authorizes a monetary penalty that shall not exceed the gross income derived by the person "from the conduct giving rise to the penalty" and in

Finally, we are concerned about the possibility of a nontaxpayer participant being subject to multiple penalties under these proposed Code sections, resulting in an overall penalty in excess of the gross income derived by the person from the tax shelter. Under current law, a practitioner or promoter could not be subject to both a Section 6694 return preparer penalty and a Section 6701 aiding and abetting penalty[8] or a Section 6700 promoting abusive tax shelter penalty and a Section 6701 penalty.[9] These rules would be retained under the Bill. However, under the Bill, a practitioner or promoter could be subject to two "50 percent of gross income from the shelter" penalties under Sections 6700 and 6708 (or under Sections 6701 and 6708) plus a 100 percent of gross income from the shelter penalty under 31 U.S.C. Section 330(b) (*i.e.*, Circular 230) — in other words, a total penalty equal to 200 percent of the gross income derived from the tax shelter activity. We question whether this result was intended and, more importantly, whether it is appropriate as a policy matter. We recognize that failing to maintain a list under Section 6112 (giving rise to a Section 6708 penalty) is significantly different conduct than promoting, aiding or abetting tax shelter involvement (as proscribed by Sections 6700 and 6701) and that cumulative penalties would decrease the likelihood that a practitioner would decide that once he or she had violated one of these provisions, he or she might as well violate the others. We are concerned, however, that the same activity that is a violation of Circular 230 (such as providing a tax opinion that does not comply with Circular 230 Section 10.33 or proposed Circular 230 Section 10.33 or 10.35) could also be viewed as violation of Section 6700 or 6701 and we

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proposed Section 6708(a)(1), which limits the penalty to 50 percent of the gross income derived "from such activity."

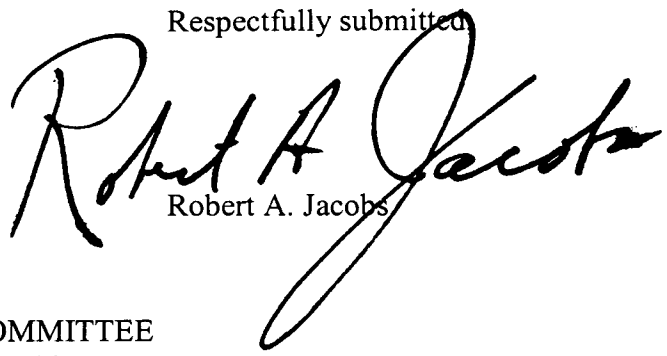
[8] *See* Section 6701(f)(2).

[9] *See* Section 6701(f)(3).

do not think a practitioner should face a penalty of 150 percent of the gross income from providing the opinion in such a case.

In summary, we believe the Committee has taken an important step once again in putting tax shelter legislation on the Congressional agenda, and we endorse the general approach of revising penalty rules. We believe that the approach to understatement penalties we have outlined here will result in improved deterrence, more useful disclosure and fewer collateral effects on legitimate business-motivated transactions.

Respectfully submitted,



Robert A. Jacobs

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APPENDIX A

1. New Section 6662(a)(1): change "this section" to "this paragraph (a)(1)"; and in existing Section 6662(b) change "This section" to "Paragraph (a)(1) of this section"

2. New 6662(i)(3)(B)(iii)(III): change "relevant" to "material"

3. New 6662(i)(3)(B)(iv): add at the end before the period: "and the regulations issued thereunder"

4. New 6707A(b)(2): after "tax avoidance transaction for purposes of section 6011" add "on or before the date the return was filed"

5. New 6707A(d): add at end before period "or any other provision of this title"

6. Section 6701(a)(1)(C): after "who knows" add "or who reasonably should know"

7. New Section 6701(a)(2)(A)(ii): revise first line to read: "such assistance, procurement, or advice involves supplying, obtaining or providing written advice or a written opinion or representation or other writing that indicates (directly or indirectly)"

8. New Section 6701(a)(2)(A)(ii): change "giving rise" to "which would give rise"

9. New Section 6701(b)(2)(A)(ii): change "would more likely than not prevail or not give rise to a penalty" to "would more likely than not prevail or more likely than not give rise to a penalty"

10. New Section 6701(b)(2)(B): add a new sentence before the last sentence: "An opinion, advice, representation or indication is unreasonable for this purpose if (I) there is not substantial authority for such position and (II) the person does not reasonably believe that the position is more likely than not proper (in each case, as such terms are defined for purposes of section 6662(i))."

11. New Section 6701(b)(2)((B): in last sentence after "then subparagraph (A)(ii)" add "and the first sentence of this subparagraph (B)"

12. New Section 6701(b)(3): change "in connection with the tax shelter" to "from the conduct giving rise to the penalty"

13. Section 6701(c)(2): after "the fact the penalty" add "under this section"

14. New Section 6708(a)(1): after "to which there was a failure" add "and derived from the activity that gave rise to the requirement under section 6112"