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May 22, 2002

Pamela F. Olson
Acting Assistant Secretary (Tax Policy)
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Room 1334 MT
1500 Pennsylvania Ave., N.W.
Washington, DC 20020

Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, DC 20224

Dear Ms. Olson and Mr. Rossotti:

I am writing on behalf of the Tax Section of the New York State Bar Association in respect of "Treasury's Plan to Combat Abusive Tax Avoidance Transactions" announced by the Treasury Department on March 20, 2002 (the "Treasury Proposals").[1] While the Tax Section intends to submit detailed technical comments once implementing legislation and regulations have been proposed, we thought it important at this time to manifest our support for the overall approach taken in the Treasury Proposals.[2]

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[1] The principal author of this letter is Lewis Steinberg. Helpful comments were received from numerous members of the Executive Committee of the Tax Section of the New York State Bar Association.

[2] For example, we intend to submit comments in the near future on the tax shelter bill, Tax Shelter Transparency Act, S. 2498, 107th Cong. (2002), recently introduced by Senators Baucus and Grassley.

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The Tax Section believes that the Treasury Proposals, once implemented, will constitute a significant step in stopping abusive tax avoidance schemes. In particular, we believe that the proposed enhanced disclosure, reporting and list maintenance (collectively, "disclosure") requirements and the increased mechanisms for ensuring compliance and cooperation by tax shelter promoters and advisors will likely encourage a heightened adherence to the tax law. We strongly endorse the expansion of the disclosure rules to cover individuals and other non-corporate taxpayers. Furthermore, we note that these proposals are broadly consistent with the Tax Section's recommendation, repeated on a number of prior occasions, that increased disclosure penalties, including penalties imposed on a "strict liability" basis, be implemented.[3]

The Tax Section applauds the Government's intention to unify the definition of "reportable transaction" for all disclosure purposes and to clarify the definition of a "listed transaction". We recognize that no amount of definitional tinkering will stop motivated promoters and advisors from adducing hypertechnical interpretations of relevant regulatory and statutory provisions. Nevertheless, we believe that the Treasury Proposals should increase compliance in these areas by reducing confusion and complexity and by eliminating certain exceptions that were particularly susceptible to overly expansive constructions.

In this regard, we understand the Treasury Proposals to represent an attempt to balance two, often conflicting goals--(i) to increase disclosure of potentially abusive transactions, while (ii) not unduly burdening taxpayers engaged in legitimate tax planning activities.[4] To this end and in contradistinction to the existing disclosure regulations, the Treasury Proposals attempt to cast a wide net based upon simple objective standards (such as whether a transaction generates a loss or credit of a given magnitude), rather than subjective and/or interpretatively complex standards based upon taxpayer intent or the extent of legal justification for the subject transaction. By design, the proposed rules will likely require disclosure of a large number of transactions that are not abusive.

The Tax Section has no philosophical objections to the approach taken in the Treasury Proposals, notwithstanding their potential for over-inclusiveness; indeed, given the apparent paucity of disclosures under the existing regime, we anticipate that broader disclosure requirements will have a salutary impact on compliance with substantive tax rules. In significant part, our support for this approach is based upon our understanding that the new disclosure rules, like the existing ones, will apply differently to promoters/advisors and to taxpayers, with the former being required to

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[3] See, e.g., New York State Bar Ass'n Tax Section, Report on Certain Tax Shelter Provisions (June 22, 1999), *reprinted in* 1999 Tax Notes Today 126-31 (July 1, 1999); New York State Bar Ass'n Tax Section, Report on Corporate Tax Shelters (April 23, 1999), *reprinted in* 83 Tax Notes 879 (May 10, 1999).

[4] We also understand the Treasury Proposals to be designed to achieve these goals in as simple a manner as possible.

register transactions at a time proximate to the transaction, while the latter will only be required to disclose transactions when they file their tax returns.[5]

However, we note that adoption of the expanded disclosure requirements for loss transactions, in particular, may result in the IRS being "blanketed with paper". While not strictly a legal issue (and one that may be susceptible of resolution through, for example, use of sampling procedures), adoption of overly broad loss disclosure requirements may tax the Government's limited resources. We have given serious consideration to suggestions for narrowing the disclosure triggers, such as excluding inventory property or property that has been held unhedged for a specified period of time from the "loss transaction" trigger, delineating carve-outs from the "book-tax difference" trigger, or, finally, adding a general requirement that a disclosable transaction (other than a listed transaction) be marketed. However, on balance, we believe that adoption of such exceptions would create an unwarranted risk that abusive transactions will avoid detection by the IRS.[6]

Moreover, while the Tax Section does not believe that the expanded disclosure requirements will generally be unduly burdensome to taxpayers or have a chilling effect on legitimate commercial transactions, we do recognize the possibility that a taxpayer may in good faith erroneously fail to disclose a non-tax motivated transaction that legitimately gives rise to a loss, credit or book-tax difference.[7] We recognize that, given the proposed dollar thresholds for disclosure and the fact that any such transactions will not trigger underpayment penalties (since, on the facts we describe, no underpayment will have occurred), the occurrence and impact of such cases may be quite limited.[8] We also recognize that adoption of a blanket exemption for such transactions may blunt taxpayer incentives and reintroduce the types of complexity and subjectivity that the Treasury Proposals are intended to eliminate. Nevertheless, we believe that imposition of the proposed penalties for failure to comply with the disclosure requirements may appear to be

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[5] Crafting the disclosure rules for promoters and advisors will require attention to a number of issues not fully discussed in this letter. For example, a particular advisor may not reasonably know that a particular transaction satisfies the definition of a disclosable transaction. Thus, a tax lawyer preparing a marketing opinion for a transaction that is disclosable solely by virtue of generating a significant book-tax difference may not be aware of this fact. Furthermore, under certain circumstances, disclosure rules applicable to lawyers may implicate issues of attorney-client privilege. We expect to cover these and related points in a subsequent report.

[6] We have also considered more complex variants of these types of exceptions, such as an inventory exception to the "loss transaction" trigger that does not include inventory having a transferred or exchanged basis. Given the complexity of these types of modified exceptions, however, we have concluded that this is not a particularly fruitful way of dealing with potential over-inclusiveness problems.

[7] This is more likely to occur in the case of an individual or small business taxpayer who lacks sophisticated tax advice.

[8] As discussed below, we suggest that consideration be given to lowering the dollar thresholds for disclosure triggers. If this is done, of course, cases of inadvertent noncompliance may occur more frequently than would otherwise be the case.

unduly harsh in isolated cases. On balance, therefore, we believe that the IRS should be explicitly authorized in the relevant legislative amendments implementing the expanded disclosure regime to exercise discretion to waive the nondisclosure penalty in circumstances where it determines that the taxpayer acted in good faith and where waiver of the penalty will not impair compliance with the tax laws.[9]

The triggers for disclosure also run the risk of being under-inclusive. For example, current and future tax shelter transactions may rely on Code Sections 162 or 163, rather than Section 165, to generate deductions. However, while we are concerned about the possibility that this type of under-inclusiveness will adversely impair the effectiveness of the disclosure rules, we have been unable to come up with simple and effective ways for fixing this problem without giving rise to either great complexity or significant over-inclusiveness. We also are concerned that the relatively high dollar thresholds for triggering disclosure obligations of individuals and corporations engaging in transactions giving rise to losses or book-tax differences may effectively exempt from disclosure a substantial number of abusive (non-listed) transactions engaged in by high net worth individuals and small businesses. We therefore suggest that consideration be given to reducing the dollar thresholds.[10]

The Treasury Department has proposed to amend the regulations under Code Sections 6662 and 6664 to provide, among other things, that a taxpayer cannot rely on a legal opinion as a defense to accuracy-related penalties in the case of reportable transactions that are not disclosed. The Tax Section has consistently supported a strict liability approach to disclosure failures in the case of tax shelters. However, the regulations allowing taxpayers to rely on a tax opinion for purposes of establishing a reasonable cause defense to an accuracy-related penalty are relatively long-standing. Some taxpayers and their advisors may therefore, rightly or wrongly, question the Government's power to alter these regulations under the "legislative reenactment" or other doctrines. Without taking a position on whether or not such amendments would be within the authority of the Treasury Department and IRS, the Tax Section believes that, for purposes of ensuring compliance

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[9] We are not suggesting creation of an exception for nondisclosure modeled on the existing "reasonable cause" exceptions of Code Sections 6662(d)(2)(B) and (C) and Code Section 6664(c)(1), which allow a taxpayer to avoid an accuracy-related penalty by proffering a "more likely than not" opinion from a tax advisor. As discussed below, the Treasury Proposals would eliminate this exception for disclosure failures in the context of the accuracy-related penalties, a position which we strongly endorse. Unlike the accuracy-related penalties, however, the proposed $10,000/$50,000 penalty for a taxpayer's failure to disclose a reportable transaction (other than a listed transaction) would generally apply regardless of whether the underlying transaction violated any substantive provision of the tax law (and thus gave rise to an underpayment of tax).

[10] The potential scope of the disclosure requirements is also reduced by the fact that, while related transactions are aggregated, unrelated transactions are not. While this might be fixed by broadening the aggregation rule, we suspect that this may increase the administrative burden on taxpayers and the risk of over-inclusiveness. It would also require different disclosure triggers for promoters and advisors, on the one hand, and taxpayers on the other. On balance, therefore, we believe that lowering the dollar thresholds is a superior approach to dealing with potential under-inclusiveness.

with the new strict liability disclosure standards, it would be advisable for the Government to seek specific legislative authorization for the required changes to the regulations.

While we believe the Treasury Proposals to be a significant step in combating abusive tax avoidance schemes, we continue to believe that other steps are also necessary. In particular, the Tax Section has consistently advocated a strict liability approach to accuracy-related penalties in the context of tax shelters, and not merely in the case of nondisclosure.[11] We understand that the Government's reluctance to advocate such an approach may be based, in part, on the difficulties in formulating a definition of "tax shelter" or "tax motivated transaction" that will allow for strict liability imposition of such penalties without having a chilling effect on legitimate tax planning and commercial transactions.[12]

While we recognize the difficulties of crafting such a definition,[13] we also continue to believe that enhanced disclosure is not enough. Absent adoption of a general strict liability approach to accuracy-related penalties in the case of tax shelters, we fear that taxpayers will continue to take aggressive and unwarranted positions on their tax returns and continue to play the "audit lottery".[14] However, we believe that this risk can be mitigated by aggressive follow-through on the proposal to establish procedures for early examinations of potential tax avoidance transactions, coupled with rapid designation of abusive transactions as "listed transactions".

Finally, as the Government itself recognizes, the most important element in stopping abusive tax-motivated transactions may be successful litigation. Anecdotal evidence suggests that taxpayers' willingness to engage in aggressive transactions ebbs and flows depending on the Government's record of wins and losses in the courts. In this regard, we welcome the recent comments by IRS Chief Counsel B. John Williams, as amplified by the statements of other Treasury Department and IRS officials incident to release of the Treasury Proposals, that litigation has been and will continue to be an important element in combating abusive tax-motivated schemes. The Tax Section believes that litigation focusing on representative tax shelter transactions and argued on narrowly tailored statutory or common law

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[11] See sources cited supra note 3.

[12] As noted above, the modified disclosure rules proposed in the Treasury Proposals would likely sweep into their ambit a large number of non-tax motivated transactions. However, given the objectivity of the standards for disclosure and the relative ease with which disclosure can be effected, we do not believe this approach to be generally problematic.

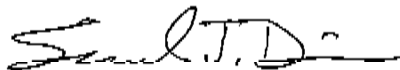
[13] See New York State Bar Ass'n Tax Section, Report on Corporate Tax Shelters, supra note 3, 83 Tax Notes at 894-97.

[14] By adopting a broad definition of "reportable transaction", the Government may unwittingly encourage such behavior. Anecdotal evidence suggests that certain tax advisors have suggested that by "burying the IRS with paper", broad disclosure rules will actually hinder the IRS's ability to target truly abusive transactions. Whether this is in fact the case, of course, may be less relevant to taxpayer behavior (at least in the near term) than what taxpayers and their advisors believe to be the case.

grounds is likely to have a greater impact on taxpayer behavior than broad pronouncements or "scattershot" litigation strategies. As always, the Tax Section would enthusiastically support increased Congressional funding for IRS tax shelter litigation efforts.

In conclusion, the Tax Section supports the recent and continuing efforts of the Treasury Department and IRS to clamp down on abusive tax shelter activity. More needs to be done, but the Treasury Proposals constitute an important effort in the right direction.

Respectfully submitted,



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