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March 18, 2004

The Honorable Charles E. Grassley
Chair
Senate Finance Committee
United States Senate
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Washington, DC 20510

The Honorable Max Baucus
Ranking Minority Member
Senate Finance Committee
United States Senate
511 Hart
Washington, DC 20510

Re: S. 1637 - JOBS Act - Tax Shelter Penalty Provisions

Dear Chairman Grassley and Ranking Member Baucus:

I understand that the Senate Finance Committee has begun consideration of the Committee's FSC/ETI replacement legislation (S. 1637, the JOBS Act). The JOBS Act (referred to herein as the "Bill") also contains a number of provisions designed to curtail tax shelters. This letter addresses certain aspects of the Bill relating to tax shelter penalties.

The Tax Section has made several submissions to either Treasury or Congress with respect to tax shelters in recent years and has consistently and repeatedly expressed its concern about the tax shelter phenomenon.[1] In particular, Report No. 1019 (8/27/02),

[1] The Tax Section's most recent submission to the Committee on October 16, 2003 (Report No. 1041: Tax Shelter Hearings) contained copies of the following NYSBA Reports on the tax shelter topic: (i) No. 1039 (9/24/03): Letter to Hon. William Thomas on H.R. 2896, the American Jobs Creation

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Report on the Tax Shelter Transparency Act (S. 2498) and Report No. 1039 (9/24/03): Letter to Hon.William Thomas on H.R. 2896, the American Jobs Creation Act of 2003, addressed a number of legislative proposals essentially identical to those in the Bill.

Although the Tax Section has communicated almost all of the following points in previous submissions, we thought it would be helpful to highlight for the Committee a select number of important points relating to tax shelter penalties:

1. Non-disclosure Penalties on Taxpayers (Section 402) and Material Advisors (Section 408) - The Bill would impose (i) strict liability penalties for non-disclosed Listed Transactions and (ii) waivable penalties for non-disclosed Reportable Transactions.[2]

a. Overview - For the reasons described in 1c below, we view the conditions associated with the "waivable" penalties to be so stringent that we believe such penalties will operate, in practice, as strict liability penalties. In addition, although the Tax Section has consistently endorsed strict liability penalties in certain circumstances for taxpayers engaging in tax shelter activities where those taxpayers ultimately lose on the merits (see discussion in 2 below relating to accuracy-related understatement penalties), we do not support strict liability penalties for mere non-disclosure violations.[3]

Some degree of definitional overbreadth is essential to the implementation of a disclosure regime. If the disclosure rules are drawn too tightly, taxpayers will too easily be able to avoid their

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Act of 2003; (ii) No. 1033 (6/6/03): Report on Abusive Tax Shelters; (iii) No. 1025 (1/7/03): Report on Proposed Tax Shelter Regulations; (iv) No. 1019 (8/27/02): Report on the Tax Shelter Transparency Act (S. 2498) and the American Competitiveness and Corporate Accountability Act (H.R. 5095); (v) No. 979 (9/18/00): Letter to Hon. William V. Roth, Jr. concerning proposed legislation dealing with Corporate Tax Shelters; (vi) No. 977 (7/25/00): Report on Proposal to Codify Economic Substance Doctrine; No 950 (4/23/99): Report on Corporate Tax Shelters.

2 The Bill does not provide an explicit definition of a Listed or Reportable Transaction; rather, Treasury is delegated the authority to supply the definitions - the existing Regulations define these terms (See Treas. Reg. § 1.6011-4).

3 Report Nos. 1039 and 1041, supra.

application. Treasury's prior experience has reasonably convinced it that it is necessary to cast a wider disclosure net in an effort to gather the necessary information related to tax shelter-related transactions. For this reason, and as previously communicated, while we think penalties should accompany violations of disclosure rules, and while we support a higher level of penalties for non-disclosed positions, we believe such penalties should be tempered by exceptions to be administered by the IRS in appropriate situations - the IRS should be granted the authority to waive non-disclosure penalties in appropriate situations where taxpayers have acted in good faith and where the waivers will not impair compliance with the tax laws.

Since announcing its Plan to combat Abusive Tax Avoidance Transactions in 2002, Treasury has regularly solicited recommendations for refining the Reportable Transaction definitions; and that process is ongoing. Treasury has acknowledged that the current definitions, by design, are overbroad and that even with continued refinement they likely will apply to many transactions that are not "tax shelters" in the traditional sense. In addition, for many regular business transactions, it remains difficult to discern whether or not a technical disclosure requirement exists under the regulations.[4] Treasury has determined that it will have a better chance of identifying abusive transactions via disclosure if the relevant disclosure rules apply in a somewhat less discriminating manner, thereby making it less likely that abusive transactions will escape detection. A less-discriminating screening device, however, will inevitably also capture non-tax motivated transactions. The combination of both casting a wider disclosure net and imposing non-waivable penalties would likely lead to one or both of two undesirable conditions: (i) massive over-disclosure, as well-advised taxpayers will be encouraged to disclose all transactions that have any connection, however remote, to a Reportable Transaction so as to avoid an otherwise "non-waivable" non-disclosure penalty or (ii) unwarranted application of the non-disclosure penalties to taxpayers who will not have underpaid their taxes and who may have innocently failed to disclose Reportable Transactions due to the overbreadth of the Reportable Transaction definitions.

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4 Report No.1039 (9/24/03): Letter to Hon. William Thomas on H.R. 2896, the American Jobs Creation Act of 2003, made use of several examples in the Appendix to illustrate the overbreadth of the then current Reportable Transaction regulations.

The Tax Section continues to support the structure and approach of the Reportable Transaction regulations. We also believe it is essential that, by reason of the inherent overbreadth of those regulations, the IRS be explicitly authorized to exercise its discretion to waive non-disclosure penalties in circumstances where it determines taxpayers have acted in good faith and where the waivers of such penalties will not impair compliance with the tax laws.

b. Listed Transaction Definition - Some Vagueness and Overbreadth - The Treasury Regulations define a Listed Transaction as a Reportable Transaction which is the same as, or substantially similar to, a transaction specifically identified by the Treasury as a tax avoidance transaction for purposes of Section 6011. The Treasury has identified and designated over thirty transactions as Listed Transactions. Because we believe taxpayers and promoters have received notification with sufficient specificity as to most such Listed Transactions, we have supported imposition of non-disclosure penalties under a more stringent standard.[5] The vagueness and ambiguity associated with one aspect of this otherwise reasonably precise standard, however, provides further support for Treasury being given the authority to exercise its discretion to prevent unintended applications of the non-disclosure penalties. This vagueness and ambiguity is evidenced in the Treasury Regulations, which define the term "substantially similar" to "include any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy."[6] Thus, a Listed Transaction consists of, in addition to one or more of the over thirty particular transactions enumerated in Treasury Rulings and Notices, any transaction that is expected to obtain similar types of tax consequences and that is either factually similar or based on similar tax strategies to those specifically enumerated transactions. In practice, there are occasions when it can be quite difficult to apply such an imprecise definition.

c. Non-disclosed Reportable Transactions - The restrictive "waiver" provisions proposed for non-disclosed Reportable Transactions other than Listed Transactions are too rigid. It is unrealistic to believe that any kind of practical waiver mechanism can

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5 See Report No. 1039, supra.

6 Treas. Reg. § 1.6011-4(c)(4).

be implemented by the IRS if, to be successful, it depends on personalized non-delegable sign-off by either the Commissioner of the IRS or the head of the Office of Tax Shelter Analysis. Consider that over 140 million income tax returns are projected to be filed with the IRS for calendar year 2004 and that over 100,000 individuals are projected to be employed by the IRS during 2004. The Bill proposal, by mandating personalized non-delegable waiver sign-off by the IRS Commissioner or the head of the Office of Tax Shelter Analysis, in practical effect would amount to the imposition of a strict liability penalty regime for failure to disclose Reportable Transactions. As indicated both in 1a above and 2 below, the Tax Section believes that broader discretion should be provided to the IRS to administer the appropriate waivers from the non-disclosure penalties. Although the Office of Tax Shelter Analysis may be an appropriate level within the IRS for the development of appropriate procedures to be used in administering penalty waivers, and although it might not be advisable for the IRS to delegate authority to waive these new penalties directly to revenue agents without first establishing a set of guidelines to be consistently applied, in general the Tax Section believes the IRS should be granted the authority to determine on its own the appropriate levels of management to be involved in administering any such waivers. In this regard, however, it may be advisable to require the IRS to report to Congress on a periodic basis to explain the waiver procedures it has established and its recent practical experience in administering them.[7]

2. <u>Accuracy-Related Understatement Penalties</u>

a. <u>Non-waivable Understatement Penalties for Undisclosed Transactions</u> - The Bill would impose a strict liability understatement penalty in connection with certain non-disclosed Reportable Transactions. Understatement penalties attributable to disclosed Reportable Transactions would have the benefit of a more stringent reasonable cause exception.[8] We recommend that consideration be

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7 Section 402 of the Bill would add new Section 6707A(d): Authority to Rescind Penalty. It contains five specific requirements that must be satisfied as a condition to having a non-disclosure penalty rescinded. Consistent with our comments above, we recommend that these requirements be replaced with a broad grant of discretionary authority to the IRS. The proposed requirements are too restrictive and inflexible and will inhibit the proper administration of the waivers.

8 Section 403 of the Bill.

given to providing the Treasury/IRS with discretion to waive the otherwise strict liability understatement penalties in appropriate situations, as described below.

The Tax Section has consistently been supportive of adopting strict liability penalties in certain circumstances where the taxpayer's position is ultimately found to be incorrect; and for adopting stiffer penalties for nondisclosure. We have highlighted, however, that strict liability penalties are least suitable for application in situations where the proscribed behavior is defined broadly. The imposition of non-waivable penalties in circumstances where taxpayers do not have a reasonably clear idea of the proscribed behavior is unlikely to achieve the desired objectives. If taxpayers believe that they will be subject to higher-level understatement penalties on a strict liability basis for non-disclosure, particularly in circumstances where there is a reasonable degree of uncertainty surrounding the definitions of the proscribed behavior, the result is likely to be the receipt by the IRS of excessive amounts of disclosure, motivated by an abundance of caution on the part of taxpayers.

Section 403 of the Bill would apply the strict liability understatement penalty to (i) non-disclosed Listed Transactions and (ii) any non-disclosed Reportable Transaction "if a significant purpose of such transaction is the avoidance or evasion of Federal income tax." As indicated in the discussion in 1b above, the term Listed Transaction is presently defined in Treasury Regulations in an imprecise manner and therefore reflects a degreee of vagueness and ambiguity. Further, with respect to Treasury's efforts to prescribe rules that will identify only those Reportable Transactions (other than Listed Transactions) having a significant purpose of tax avoidance or evasion, prior experience suggests it will be difficult for Treasury to do so without also risking some degree of vagueness and ambiguity.

On that basis, and by reason of the fact that Section 403 of the Bill could apply in some circumstances in an overbroad manner, the Tax Section recommends that consideration be given to providing the Treasury/IRS with appropriate discretion to waive the otherwise strict liability penalties in those situations where taxpayers are determined to have acted in good faith and in circumstances where the waiver will not impair compliance with the tax laws.[9] As to non-disclosed

[9] This same comment would apply to Section 417 of the Bill, proposing to disallow a deduction for interest on underpayments attributable to non-

Listed Transactions, however, although some members of the Tax Section's Executive Committee continue to believe that it may be appropriate to impose strict liability understatement penalties in such situations generally, even those members recognize that discretion to waive such penalties could be appropriate where the defined borders of the term Listed Transaction are too uncertain.

b. Inappropriate Base for Calculating Understatement Penalty – Unlike with respect to the existing substantial understatement penalty in Section 6662 of the Code, where the term understatement is defined to equal the excess of the proper amount of tax required to be shown on the taxpayer's tax return over the amount of tax actually shown on such return,[10] Section 403 of the Bill would define "reportable transaction understatement" as an amount equal to the product of (i) the increase in taxable income caused by a Reportable Transaction and (ii) the highest rate of tax then in effect. The proposed definition of "reportable transaction understatement", by reason of being defined with reference to the increase in taxable income, rather than by reference to the increase in actual tax liability, could result in the imposition of an "understatement" penalty even in a situation where the taxpayer would not otherwise be liable for any U.S. federal income tax. The Tax Section recommends that the Bill define the term "reportable transaction understatement" in the same manner as the term "substantial understatement", both for consistency and to ensure that strict liability penalties of this type are imposed only in circumstances where the taxpayer would otherwise actually owe tax.

c. Higher-Level Non-waivable Penalties if Included in Revenue Agent's Report ("RAR") - Section 403 of the Bill provides that if a higher-level (i.e., 30%) strict liability penalty is included in a RAR, which can only occur if the IRS Chief Counsel (or a IRS National Office delegate) approves such inclusion, the penalty cannot be compromised as part of any settlement with the IRS, absent personal approval of the IRS Commissioner. We recommend that this proposal be withdrawn.

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disclosed reportable transactions. Due to the overbroad definition of Reportable Transaction, we recommend that consideration also be given to providing Treasury with authority to prevent this result in appropriate circumstances.

10 See Section 6662(d)(2)(A).

For the same reasons outlined above, the term Reportable Transaction is intended by Treasury to be defined in a manner that, inevitably, will result in its application to transactions where there is no tax motivation or where the connection to impermissible tax planning is attenuated at best. We respectfully suggest that mandating imposition of what, in practice, will amount to non-waivable penalties in all situations where the penalties are included in RARs reflects an inappropriate level of Congressional micro-management of the IRS audit process. We believe the IRS is best-suited to decide for itself how to administer the audit and settlement process and to adopt the procedures it thinks are best-suited to handling settlement of disputes with taxpayers. As an example, the Office of Tax Shelter Analysis has been established for the specific purpose of tax analysis and administration of tax shelter matters and is uniquely well-suited to develop appropriate procedures for administering the tax penalty rules applicable to Reportable Transactions - without having outcomes dictated solely by whether a RAR, possibly prepared at a time when not all the underlying facts are known, happens to assert a particular penalty.

d. Disqualifed Tax Advisor - As indicated in prior submissions, we support the notion that taxpayers should not be able to establish their reasonable beliefs by relying on tax opinions rendered by advisors whose independence is in question. However, we have expressed the view before and remain concerned that the specific standards listed in the Bill are over-inclusive in some circumstances.

For example, one circumstance arises in a situation involving a law firm that is working on a public corporate finance transaction for a client and has corporate lawyers drafting the documents and tax lawyers involved in issuing a tax opinion to the client in connection with the transaction. Section 403(c) of the Bill, adding new section 6664(d), would prohibit the law firm from issuing a tax opinion that the taxpayer could rely on, by reason of the fact that the corporate lawyers of the same firm drafted the corporate documentation. We doubt that was intended. As another example, it is not uncommon for underwriters to assume the costs of issuer's legal counsel in connection with corporate financing transactions. It is unclear whether this type of financial connection would be implicated by the disqualified tax advisor proposal. Issues of the type presented in these examples are difficult to address by statute.

We recommend that the statute articulate the fundamental principle that tax opinions issued by advisors whose independence is in question cannot be relied upon to support the reasonable cause defense. The specific rule-making authority to implement these rules should be delegated to Treasury. If Congress has sufficient confidence in Treasury to delegate to it the authority to define the critical term Reportable Transaction, the foundation upon which all the other tax shelter penalty rules depend, we certainly think it should have the confidence in Treasury to delegate to it the necessary authority to specifically identify "disqualified tax advisors" for purposes of the strengthened reasonable cause exception.

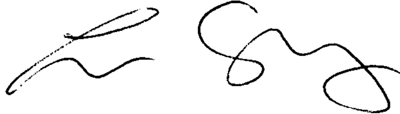
3. Treasury Discretion to Prescribe Rules To Address Situations Where Reportable Transactions are Designated After The Fact – Sections 402, 403 and 408 provide for the imposition of penalties in the case of failures to disclose Reportable Transactions on tax returns, failures to pay tax attributable to Reportable Transactions and failures to file information returns with respect to Reportable Transactions, respectively. In their current form, the above Sections are somewhat ambiguous as to how the rules would apply in situations where the IRS designates a transaction as a Reportable Transaction only after the applicable returns have been filed. The Bill language can be read to suggest that the applicable non-disclosure-related penalties could definitely apply to taxpayers with respect to transactions previously entered into, even though the designations as Reportable Transactions may not occur until after the returns are filed. The Tax Section recommends that the Bill provide Treasury with sufficient discretion to adopt appropriate rules in those circumstances where it has designated transactions as Reportable Transactions only after taxpayers have filed their returns, so as to avoid unfairness in the application of the new penalties.

4. Effective Date Issues - Some of the tax shelter penalty provisions of the Bill (e.g., Sections 402 and 408) are proposed to be effective for tax returns the due dates of which are after the date of enactment. Thus, depending upon when in 2004 the Bill is enacted, the new penalties could apply to many taxpayers with respect to their 2003 tax returns and will relate to prior transactions entered into at a time when the new rules were not in effect. In its current form, the Bill does not appear to give any discretion to Treasury to ameliorate unfairness in the application of the new penalty provisions caused by effective date transitional issues.

Considering the fact that the definition of Reportable Transaction is, by design, overbroad and still in the process of refinement based on ongoing communications between the Treasury and the practitioner and taxpayer communities, we recommend that consideration be given to delegating to Treasury the authority to implement certain of the penalty provisions on a transitional basis, if it believes such an approach would best serve the purpose of sound administration of the tax laws.

5. Economic Substance - Sections 401 and 404 of the Bill would codify the definition of economic substance and impose a separate penalty on deficiencies attributable to transactions that lack economic substance. For reasons previously described, we do not support either the imposition of a separate penalty on deficiencies attributable to transactions that lack economic substance, or the proposal to codify a definition of economic substance.[11]

Respectfully submitted,



Lewis R. Steinberg
Chair

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Department of the Treasury
Mark W. Everson, Commissioner, Internal Revenue Service
Eric Solomon, Deputy Assistant Secretary, Regulatory Affairs
Department of the Treasury
Helen M. Hubbard, Tax Legislative Counsel,
Department of the Treasury
Emily A. Parker, Acting Chief Counsel

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[11] Report No. 1032 (5/21/03): Report on Economic Substance Doctrine; Report No. 1019 (8/27/02): Report on the Tax Shelter Transparency Act (S. 2498 and the American Competitiveness and Corporate Accountability Act (H.R. 5095).