REPORT #1019

# NEW YORK STATE BAR ASSOCIATION TAX SECTION

# REPORT ON TAX SHELTER LEGISLATION

AUGUST 27, 2002

**New York State Bar Association Tax Section**

**Report on Tax Shelter Legislation**

This Report sets forth comments of the New York State Bar Association Tax Section on Titles I and II of S. 2498, the "Tax Shelter Transparency Act," as reported by the Committee on Finance to the U.S. Senate as of June 28, 2002 ("S. 2498"), and on Title I of the "American Competitiveness and Corporate Accountability Act of 2002", as introduced in the House of Representatives on July 11, 2002 ("H.R. 5095").[1] The key features of both the Senate and the House proposals (together the "Bills") are heightened penalties for tax shelter transactions. Both Bills impose on taxpayers nondisclosure penalties and increased accuracy penalties in respect of transactions designated by the Secretary of the Treasury ("Treasury") as having the potential for tax avoidance. H.R. 5095 also includes accuracy penalties for transactions that lack economic substance (as defined). The Bills further impose disclosure obligations on persons who are "material advisors" and penalties for noncompliance.

The Tax Section has long supported stiffer penalties for tax shelters. Tax-abusive transactions diminish our country's revenues and undermine the public trust that is essential to our system of self-assessed taxes. These transactions have proliferated alarmingly in recent years, and existing statutory and regulatory regimes have not proven to be effective deterrents. Taxpayers are of course entitled to engage in legitimate tax planning; however, when taxpayers

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1 This report was prepared by an ad hoc committee chaired by Carolyn Joy Lee, the principal draftsman of the report. Helpful comments were received from numerous members of the Tax Section, including Andrew N. Berg, Dickson G. Brown, Eric Chun, Lawrence Cohen, Samuel J. Dimon, William Dixon, David P. Hariton, Robert A. Jacobs, Robert Kantowitz, Janet B. Korins, Robert J. Levinsohn, Erika W. Nijenhuis, Elliot Pisem, Stuart L. Rosow, Michael L. Schler, Lewis R. Steinberg, Lary Wolf and Diana Wollman.

and advisors cross the line of legitimacy to profit from abusive tax avoidance and evasion, they must be given clear reasons to fear the consequences.

Monetary penalties on taxpayers reduce or eliminate the financial attraction of abusive transactions and are, we believe, vitally important. We also agree that deterrence of tax shelter activity requires penalties directed at those who promote and profit from the creation and implementation of tax abusive schemes. Finally, we believe that full and candid disclosure of aggressive positions, and the concomitant assurance of examination, is a very effective means to deter taxpayers from engaging in abusive transactions. We therefore support the Bills' strengthened disclosure requirements and substantially greater penalties and believe they are appropriate tools to combat tax abuse.

Notwithstanding the Tax Section's support of the Bills, we have in the past advocated an alternative approach to confronting the tax shelter issue, one that involves applying significant "strict liability" penalties for understatements attributable to abusive transactions. While we continue to believe that such an approach would have the greatest likelihood of deterring taxpayers from engaging in tax shelters, we also recognize that such a strict liability regime requires that the concept of a "tax abusive transaction" be clearly defined. Moreover, such a definition needs to be precise and clear enough to give taxpayers fair notice of what is proscribed, without being so restrictive as to defeat its efficacy in deterring tax shelter activity. Crafting such a definition is difficult at best. Thus, while the Bills adopt a strict liability standard only for purposes of nondisclosure, we believe that, on balance, they are a reasonable approach to the tax shelter problem. Whether a different or additional approach to substantive penalties will also be needed, only experience will tell.

We also urge that the Internal Revenue Service ("IRS") must have the resources and support needed to serve an effective enforcement role. We have previously expressed our concerns that the current low rates of IRS audits contribute to abusive tax shelter activity. Disclosure of reportable transactions will assist the IRS in targeting audits to potentially abusive transactions, but this will be effective only if the IRS has the ability to follow through on the disclosures it receives. Adequate IRS funding, and the resolve to pursue and penalize taxpayers who engage in abusive transactions, are necessary for the Bills to have their intended impact.

Ultimately, it is not clear that any degree of governmental regulation will stem the current tide of tax abuse by persons who seek to avoid paying their share of the cost of government. The numerous venues in which outright tax evasion currently proliferates represent a basic and very profound challenge to the country. Whether manifested in abusive tax shelter offerings, offshore credit card scams, empty boxes sent to evade sales tax, the tax-free cash economy that operates openly at all levels of society, or any of myriad other forms, there appears to be an unprecedented attitude on the part of many that paying one's taxes is optional, rather than an integral part of the social compact. Stiff penalties are one way to attack tax abuse, but they may not be enough. Successful eradication of rampant tax abuse ultimately will require a sea change in the public perception of taxes. That, in turn, will require that leaders within the government and in the private sector actively foster the understanding that taxes embody the community's mutually agreed upon contract for paying for the costs of societal order. Justice Oliver Wendell Holmes, writing in 1927, said it most eloquently: "Taxes are what we pay for civilized society . . . ." Compania General de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100. Until that basic understanding of taxation has been restored within our communities, tax abuse will likely continue to be a persistent and very costly national

problem. Legislation like that proposed in the Bills may therefore be necessary, but it is clearly not sufficient.

With respect to the specific provisions proposed in the Bills, we have the following comments:

1. The proposed penalties for failing to disclose "Reportable Transactions"[2] (or "RTs") and "Listed Transactions" (or "LTs") may not be large enough to provoke disclosure by very large businesses or very wealthy individuals engaging in tax shelter transactions. The additional accuracy-related penalties and the disclosure required of material advisors may compel effective disclosures, but we suggest that Treasury actively monitor disclosures to ascertain whether very large tax shelter transactions are in fact being disclosed.

2. The lack of statutory parameters defining the Reportable Transactions and Listed Transactions on which the Bills' proposed penalty structure is premised leaves these important elements of the proposals entirely to administrative interpretation. This raises concerns about the potential for overbroad assertions of the penalties.

3. 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.

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[2] In this Report, we use the term "Reportable Transaction" (or "RT") to refer to transactions within the meaning of Proposed §6707A(c)(1) that are not also "Listed Transactions" under Proposed §6707A(c)(2). While the Bills technically define "Listed Transactions" as a subset of "Reportable Transactions", we thought it useful here to use the term Reportable Transactions to refer only to those Reportable Transactions that are not listed.

4. The disclosure required of "material advisors" generally is acceptable but should be modified in certain respects to address practical considerations.
5. We do not believe it would be appropriate for Congress to override the traditional common law privilege attaching to attorney-client communications, or the attorney work-product doctrine, by requiring material advisors to disclose otherwise privileged information. Indeed, we are concerned that requiring disclosure from attorneys may chill effective communications between the targets of tax shelter promotions and their tax advisors, which could undermine to some degree the effectiveness of the proposed legislation.
6. We support the narrowed definition of "reasonable cause" for Listed Transactions and tax-avoidance motivated Reportable Transactions, and have some technical suggestions.
7. We support H.R. 5095's proposed changes to Subchapter K, and have some technical suggestions.
8. We suggest a technical refinement to the change to a "more-likely-than-not" standard for non-tax shelter penalties.
9. The potential overlap of certain penalties should be addressed.
10. The enforcement of all fees-based penalties should follow standard deficiency procedures.

**1. In some circumstances the proposed penalties may not be large enough to ensure disclosure.**

As proposed, the Bills provide two types of penalties for failing to disclose Reportable Transactions and Listed Transactions: disclosure penalties and enhanced accuracy penalties. There are some differences in the penalty regimes proposed by the two Bills.

Under S. 2498 the failure to disclose a Reportable Transaction triggers a nondisclosure penalty of $50,000 ($100,000 for large entities and high-net-worth individuals). Failure to disclose a Listed Transaction triggers a nondisclosure penalty of $100,000 ($200,000 for large entities and high-net-worth individuals). H.R. 5095 proposes a penalty in respect of nondisclosed Reportable Transactions of $10,000 in the case of a natural person, and $50,000 in all other cases. For nondisclosed Listed Transactions, the penalties in H.R. 5095 are $100,000 for natural persons and $200,000 in all other cases.[3]

Both Bills also impose an accuracy penalty of 20% on any "reportable transaction understatement," and increase the penalty for nondisclosed transactions. A "reportable transaction understatement" is an understatement attributable to a Listed Transaction, or to a Reportable Transaction if a significant purpose of the transaction is tax avoidance or evasion. Under S. 2498, the 20% penalty is increased for nondisclosed transactions to 25% in the case of a tax-avoidance motivated RT, and to 30% in the case of a nondisclosed LT. S. 2498 §102, proposing a new §6662A and amending §6662(D)(2)(a).[4] In H.R. 5095 the penalty for an

[3] The application of the disclosure rules to members of pass-through entities will require clarification, presumably through regulations.

[4] Currently there is a single 20% penalty for substantial understatements.

understatement attributable to either a nondisclosed tax-avoidance motivated RT or a nondisclosed LT would be 30%.[5]

As proposed, the penalties for nondisclosure can be waived only in limited circumstances. The nondisclosure penalties are based solely on a failure to disclose and do not depend upon the ultimate success of the taxpayer in defending the merits of the RT or LT.[6] The accuracy-related penalties do incorporate exceptions for reasonable cause, as discussed below.

As between the approaches of S. 2498 and H.R. 5095, we note that the higher the nondisclosure penalty the more likely disclosure will occur. Even the higher penalty structure proposed in S. 2498 may, however, prove ineffective in large matters. Some of the most troubling tax-avoidance behavior involves transactions designed to achieve, for a given taxpayer, tax reductions in the tens of millions of dollars (or even more). Indeed, for many taxpayers the fees involved in designing and executing an RT or LT far exceed the $200,000 maximum proposed nondisclosure penalty. We therefore note that some taxpayers may conclude that the extra penalty risked by nondisclosure (up to $200,000, plus up to an additional 5% or 10% accuracy penalty for any deficiency) is not sufficient to justify the obviously increased audit risk that follows from disclosure. We therefore suggest that the Treasury Department monitor disclosure of large transactions particularly closely to establish whether these new penalties are having the intended effect.

Consideration also should be given to whether, in addition to the penalties imposed on taxpayers, penalties for failure to disclose RTs and LTs might also be imposed on the

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5 Flattening out the accuracy-related penalties as proposed in H.R. 5095 simplifies the analysis, and should have the salutary effect of making disclosure more likely.

6 Senate Committee on Finance Report #107-? (June 28, 2002) ("Finance Committee Report"), at page 4. The Technical Explanation of H.R. 5095 was released by the Joint Committee on Taxation subsequent to the Tax Section's approval of this report, and therefore is not addressed herein.

individuals who sign tax returns for entities and on tax return preparers. Penalties of, for example, $10,000 on the individuals who sign the returns may bring increased focus on the need to conform to the disclosure required for such transactions under the new 6111 rules.

The disclosure required of material advisors under proposed §6111 and the strengthening of Circular 230 and of the Title 31 penalties as proposed should compel significant disclosures by advisors. This also will serve as a backstop against nondisclosure by taxpayers. Active and well-publicized audits and cross-checks of disclosures by taxpayers and by material advisors will further strengthen the efficacy of these disclosure provisions.

2. **We are concerned that the lack of statutory definitional parameters for "Reportable Transactions" and "Listed Transactions" may lead to overbroad assertions of the penalties.**

As noted above, two key concepts that underlie the Bills are the "Reportable Transaction" and the "Listed Transaction." (Compare Reg. §1.6011-4T.) These are defined as follows:

> The term 'reportable transaction' means any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion.
>
> Except as provided in regulations, the term 'listed transaction' means a reportable transaction which is the same as, or similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011.

Proposed §§6707A(c)(1), (c)(2) (emphasis added).

The consequences of classification of a transaction as either an RT or an LT include:

- Taxpayer nondisclosure penalties of $10,000 to $200,000 (as discussed above).
- 20% understatement penalty for tax-avoidance motivated RTs and for LTs.
- Increase in understatement penalty to 25% or 30% if not disclosed.
- Reporting of income tax penalties in reports filed with the SEC.
- Modification of the reasonable cause exception, including limitations on opinion reliance.
- Material advisors' disclosure obligations, and penalties for nondisclosure ranging from $50,000 to 75% of fees received.
- Material advisors' obligations to maintain and disclose lists, and potential $10,000/day penalties for failing to do so.
- Injunctive relief against material advisors.

We understand that defining "tax shelters" is a difficult task. Recognizing this, the Finance Committee Report refers to the Treasury Department's recently announced "Tax Shelter Initiative," and comments favorably on Treasury's stated goal to prescribe

> a series of <u>clear, mutually reinforcing rules</u> for disclosure, registration and list maintenance . . . . The Treasury Department's enforcement initiative will create <u>a single, clear definition</u> of a transaction that must be disclosed and registered, and for which lists must be maintained.

Finance Committee Report, p.4 (emphasis added). The Finance Committee Report then provides that S. 2498:

> does not define the terms 'listed transaction' or 'reportable transaction,' nor does the provision explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, the provision authorizes the Treasury Department to define a "listed transaction" and a "reportable transaction" under section 6011. As part of the Treasury shelter initiative, the Committee expects the Treasury Department to

> issue new regulations under section 6011 that will provide taxpayers with a set of objective standards to be applied in determining whether a taxpayer must disclose information regarding a particular transaction. The Committee anticipates that the new regulations will define a reportable transaction to include (but not be limited to) transactions with any of the following characteristics: (1) a significant loss, (2) a brief holding period, (3) a transaction that is marketed under conditions of confidentiality, (4) a transaction that is subject to indemnification agreements, or (5) a certain amount of book-tax difference.

Finance Committee Report, pp. 4-5 (emphasis added, citations omitted).

We agree that it is difficult to draft a statutory definition of tax shelters that is both sufficiently clear to apprise taxpayers of their obligations and sufficiently nimble to keep pace with new developments. As currently proposed, however, the Bills provide no statutory parameters whatsoever. The effect of the Bills therefore is to allow Treasury to determine unilaterally when the statutory consequences outlined above apply and when they do not. In light of the serious consequences that can ensue from designating a transaction as an RT or LT, including for persons other than the taxpayer, we are concerned that a penalty regime that depends entirely on the discretion of Treasury creates a risk that penalties will be asserted too broadly.

We also are concerned about the proposed statute's definition of LT as including transactions that are "similar" to specifically listed transactions. Proposed §6707A(c)(2). The 2000 and 2002 regulations under §6011 utilized the standard of "substantially similar." Reg. §1.6011-4T(b)(2). It appears that the Bills' use of the term "similar" will encompass a broader

range of transactions as LTs. We believe the regulatory standard of "substantially similar" is adequate, and is more appropriate.[7]

As a practical matter, the inclusion of "similar" transactions in the technical definition of LTs means that LTs can and will include much more than what is actually found on the Treasury list. Where sophisticated taxpayers or shelter promoters intentionally modify transactions in an attempt to circumvent the list, the penalties in respect of "similar" transactions are not objectionable -- indeed, we have noted they may not be enough. On the other hand, enacting legislation that includes significantly harsher penalties if a transaction is an LT, but then leaves the definition of LT so uncertain, raises real concerns. We are concerned, for example, that under the Bills, IRS field auditors could threaten small taxpayers with $100,000, non-waivable penalties for failing to disclose a transaction (of whatever size) that is "similar" to some Listed Transaction.[8]

The uncertainty as to whether a transaction is an LT will also affect material advisors, who have their own disclosure obligations under the Bills. Cautious advisors concerned about the financial and reputational cost of nondisclosure penalties may reasonably interpret the definition of an LT expansively. If uncertainty in reporting obligations prompts taxpayers to seek out advisors who will agree not to disclose, the efficacy of the Bills will be undermined.

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[7] The discussion that follows refers to "similar" transactions rather than "substantially similar" transactions because the former is the currently proposed statutory language. We note that all of our comments would remain applicable if our suggestion to replace "similar" with "substantially similar" is accepted.

[8] We also note a transaction may constitute an RT even if there is no tax avoidance purpose or result (compare proposed §6662A), and that nondisclosure penalties for RTs and LTs apply even if the taxpayer's position is sustained on the merits.

Finally, we note that statutory vagueness coupled with strict liability for nondisclosure and enhanced accuracy penalties may prompt large numbers of protective over-disclosures, particularly by smaller taxpayers and advisors for whom the proposed $50,000 or $100,000 penalties could be very severe. That volume of disclosures may detract from the objectives of the Bills.

In the context of penalizing taxpayers for utilizing abusive tax shelters, a broad grant of administrative discretion in defining tax shelters may be both necessary and appropriate. However, the over-assertion of penalties on audit would be deleterious to good tax administration. For these reasons we suggest that the draftsmen reconsider whether the complete absence of any definitional parameters for the identification of RTs and LTs is appropriate. We further suggest that consideration be given to establishing specific safeguards, such as those suggested below, to ensure that the penalty structure is appropriately applied.

First, it is very important that the regulations and other notices ultimately promulgated by Treasury set forth clear, unambiguous and simple standards under which taxpayers and material advisors can identify Reportable Transactions and Listed Transactions with a high degree of certainty. There should be included as part of the legislative history a specific directive to Treasury that the definitions of Reportable and Listed Transactions be based on clear, objective standards.

It would also be useful to establish by statute a central Treasury coordinator whose approval is a necessary prerequisite to the assertion of the penalties. This would help to ensure that the proposed penalty structure is properly targeted and uniformly applied across the country. (Compare §6751(b).) Coordinating at the national level the determination, for example, of what is "substantially similar" to a listed transaction seems necessary to the fair application of the

RT/LT penalties, and should also be useful to Treasury's understanding of the tax shelter environment.

As currently proposed, the Bills grant the Treasury limited authority to rescind penalties. Proposed §6707A(d). We believe Treasury should have discretion to waive penalties in appropriate cases, and that the grant of discretion should be much broader than is currently proposed. Discretion to abate penalties complements the flexible and potentially overbroad definitions of RT and LT with a similarly flexible means to avoid unreasonably punitive results. Giving broad, equity-based discretion to the Treasury, to be exercised at an appropriately high level, provides a practical administrative solution to the potentially inequitable imposition of penalties in a particular case. Over the long term, this may serve to protect against more substantive erosions of the basic penalty structure.

The standard for exercising abatement authority should simply be whether rescinding the penalty would be consistent with effective tax administration. We do not expect that sophisticated promoters and taxpayers, who invest considerable time and capital in the promotion or purchase of tax shelters, would place much confidence in the prospect that high-level Treasury officials will choose to waive their nondisclosure penalties on equitable grounds. We therefore do not believe that granting this kind of broad administrative discretion to waive penalties would significantly undercut the proposal.

Consideration also should be given to the appropriate treatment of taxpayers who engage in transactions that only subsequently become RTs or LTs. The current §6011 regulations require taxpayers to attach disclosure schedules to their returns for any taxable year with respect to which their tax liability is affected, or could reasonably be expected to be affected, by participation in the RT or LT (such a taxable year, an "Affected Taxable Year").

Moreover, if a transaction subsequently becomes an LT or RT,[9] the taxpayer is required to disclose such transaction in its next filed return, whether or not such return is for an Affected Taxable Year. Reg. §1.6011-4T(d). The Bills appear to retain this disclosure regime.

We understand Treasury's ongoing interest in identifying taxpayers' participation in potentially abusive transactions, regardless of whether or not tax returns have already been filed for all Affected Taxable Years. However, we believe that, in the case where a transaction only becomes an RT or LT (or is substantially similar to a transaction that becomes an LT) after the taxpayer has filed returns for all Affected Taxable Years, it would be overly burdensome in some circumstances to mandate continued disclosure obligations.

Professionals who act as material advisors may be more likely to be aware of regulatory actions that result in transactions subsequently becoming RTs and LTs. But such advisors may find it difficult to determine whether any advice rendered to clients in the past was related to a transaction that has become an RT or LT. And if the identification of RTs or LTs includes specific factual standards, such as a book-tax difference of a particular dollar amount, advisors may not have the information necessary to determine whether a transaction effected months or years earlier would in fact now be considered an RT or LT as to a particular taxpayer.

For these reasons, and particularly in the absence of statutory parameters defining RTs and LTs, we believe that the heightened penalty regime for nondisclosed RTs and LTs should have a more limited application in the case of transactions that become RTs or LTs after they are consummated.

We believe that the currently contemplated regime operates appropriately, in the case of taxpayers, where a transaction is categorized as an RT or LT before the due date of the

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[9] This might be the case, for example, if the IRS subsequently lists the transaction or there is a change in facts affecting the expected tax effect of the transaction.

tax return for any Affected Taxable Year, as determined by assuming the taxpayer has obtained all available extensions. Consider, for example, the case where (i) a calendar year corporate taxpayer engages in a transaction in 2003 that affects its tax liability only for that year, (ii) the taxpayer files its return on March 15, 2004 at a time when the transaction is neither an RT or LT, and (iii) the transaction becomes an RT or LT by virtue of a regulatory action taken after March 15, 2004 and before September 15, 2004. A majority of our members do not object to the requirement that in such a case the taxpayer must disclose the transaction on the return for its 2004 tax year (or be subject to the heightened penalty regime), even though 2004 is not an Affected Taxable Year.[10]

Similarly, we believe that the currently contemplated regime operates appropriately, in the case of material advisors, with respect to any transaction that is or becomes an RT or LT on or before the date a disclosure return would have been due if the transaction had been an RT or LT at the time it was consummated. As noted herein, we recommend that due date for disclosure by material advisors be 30 or 60 days following the closing of the relevant transaction.

In the case of a transaction that becomes an RT (but not an LT) by virtue of regulatory action subsequent to the time frame discussed in the two preceding paragraphs, we do not believe that disclosure should be required. Insofar as material advisors are concerned, we believe it would be unduly burdensome for regulatory designation of a new RT category (which may well include transactions that are not motivated by tax avoidance) to trigger an obligation to consider the implications for transactions which are not recently consummated, particularly in light of the fact that the material advisors may not even know the facts that would be relevant in

[10] Some of our members consider this requirement of disclosure in the following year tax return an unwarranted departure from the general principle of annual accounting.

determining which past transactions fall within the category. Similarly, for taxpayers, we believe it would be unduly burdensome for designation of a new category of RT to trigger a review of transactions that no longer have an effect on the taxpayer's tax liability.

In the case of a transaction that becomes an LT subsequent to the time frame discussed above, we believe that disclosure obligations, backed by heightened penalties, should apply, but on a more limited basis. In the case of a taxpayer, we believe disclosure should be required on the next filed tax return only where (i) the designation of the LT occurs within three years of the due date for the return for the last Affected Tax Year with respect to the transaction (assuming all extensions are granted), and (ii) the taxpayer has actual knowledge of the designation of the LT. In the case of a material advisor, we believe that disclosure should be required only with respect to transactions (i) as to which the advisor was the "principal promoter" (a concept whose definition should be left to regulations[11]) and (ii) that were consummated less than three years prior to the designation of the LT.

As a final suggestion to avoid overbreadth in the application of the penalties, we suggest that the annual reports required under the Bills serve not solely as a vehicle for measuring the efficacy of the penalties, but also for testing their fairness. The concern is not simply that penalties will be formally imposed or formally rescinded, but that the threat of penalties could be employed at the audit level in an inappropriately coercive manner. Congress can utilize the annual report as an occasion both to learn from Treasury how the penalties are being applied and to invite public commentary on the administration of the penalties.

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[11] We do not believe material advisors other than the principal promoter should have a disclosure obligation in the case where designation of an LT occurs subsequent to the date that disclosure would have been required if the transaction had been an LT at the time it was consummated.

3. **We do not support the imposition of a separate penalty on deficiencies attributable to transactions that lack economic substance, or the proposed codification of a definition of economic substance as proposed in H.R. 5095.**

H.R. 5095 proposes a penalty of 20% or 40% for transactions that lack economic substance; the higher penalty applies if the transaction is not disclosed. This proposed penalty applies to an understatement attributable to any transaction that lacks economic substance, as such term is defined in proposed §7701(m), or that "fails to meet the requirements of any similar rule of law." Proposed §6662B(c)(2)(B).

The proposed statutory definition of "economic substance" provides that "a transaction has economic substance only if (i) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (ii) the taxpayer has a substantial nontax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose." H.R. 5095, §101(a).

The proposed definition of economic substance apparently is relevant under H.R. 5095 not solely to the new penalty proposed under §6662B, but also to the application of the "economic substance doctrine" generally. Proposed §7701(m) states that in applying the "common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance," the foregoing definition of economic substance is to be applied. We have in the past considered and commented on the merits of codifying the economic substance doctrine. In Tax Section Report #977, issued July 25, 2000, we indicated that different members of the Section held differing views on the merits of enacting a statutory definition of economic substance, and on the merits of the specific proposal then under consideration. On balance, we concluded that "we do not have a consensus for enactment of any substantive disallowance rule at this time." Id. p. 4.

This continues to be our position. The common law doctrine embodies a fluid, fact-specific inquiry into the purpose and effect of numerous different kinds of transactions and events. Distilling that inquiry into a specific statutory test could rob the doctrine of the flexibility that gives it strength, or could prove to be a meaningless exercise. We also are concerned that mandating two or three specific statutory markers for noneconomic substance status could have unintentionally overbroad consequences, casting doubt on legitimate tax planning. Nor will the enactment of a definition of economic substance end the practical difficulties associated with this important inquiry -- it will remain a fact-intensive case-by-case inquiry in which finders of fact will articulate their standards and conclusions in varied and perhaps inconsistent ways. We therefore do not support the proposed enactment of a general definition of economic substance.

We also do not support the proposed separate penalty for transactions lacking economic substance. As a substantive matter, we do not believe that a separate penalty regime addressed solely to questions of economic substance is either necessary or appropriate.

Moreover, as drafted, the intended scope of the penalty is technically unclear. In proposed §6662B the penalty applies to "any amount which would be an understatement under section 6662A(b)(1) if such section only applied to items attributable to noneconomic substance transactions." It appears this means that the 20% or 40% penalty for noneconomic substance transactions applies only if the transaction also is an LT or a tax-motivated RT. If that is the intention, it would be much clearer to combine the two concepts into a single section, and to state more clearly the intended effects -- an LT or a tax-motivated RT that also lacks economic substance incurs a 40% penalty if it was not disclosed, and allows for no reasonable cause exception.

More generally, we note that the structure of the accuracy-related penalties, particularly under H.R. 5095, would be rather confusing. Section 6662 would continue to

impose the original 20% accuracy-related penalty for understatements that are substantial in amount. That section would also be amended to provide that the reasonable cause exception is not available, for any taxpayer, in the case of a substantial understatement that is attributable to a tax shelter. For this purpose, a tax shelter is defined as any partnership, plan, etc. if a significant purpose is the avoidance or evasion of tax. (See also the comments in section 6, below.) Section 6662A would impose a 20%-30% penalty for LTs and tax-avoidance motivated RTs, with the higher penalty based on nondisclosure, and would contain a restricted reasonable cause exception. Section 6662B would impose a penalty of 40% on understatements attributable to transactions lacking economic substance; the penalty would be reduced to 20% if the transaction is disclosed, but there would be no reasonable cause exception.

We understand that the penalties would not be cumulative. We also recognize that the three proposed regimes are addressed to different sorts of behaviors. Section 6662 relates to the relative size of the underpayment, and imposes strict liability for a 20% penalty upon large deficiencies attributable to transactions having a "significant" tax-avoidance motive. A transaction that is an LT or a tax-motivated RT incurs a higher rate of penalty if not disclosed, but offers some reasonable cause relief if disclosure is made. And whatever the size, motives or cause, a transaction (or at least an LT or tax-motivated RT) with no economic substance incurs a 20% penalty, 40% if not disclosed. One can articulate a rationale for slicing the penalty regime into so many layers, and the *in terrorem* effect of the penalty regime is enhanced by the multiplicity of arguments a taxpayer will be required to answer. It is, however, not clear overall that the complexity created by the three similar yet different sets of penalties is warranted.

Finally, in the context of individuals, H.R. 5095 provides that a noneconomic substance transaction "shall not include any transaction other than a transaction entered into in connection with a trade or business or an activity engaged in for the production of income." The

point of this presumably is to remove from the §6662B penalty regime any understatement of tax liability attributable to personal items and transactions (charitable deductions, home mortgage interest, etc.). Since the determination that a transaction lacks economic substance may reflect the lack of a business context, however, there is a circularity in the proposed provision. That would be cured by adding language to the effect that the transaction was not one which the individual "<u>purported to have</u> entered into in connection with a trade or business . . . ."

4. **The disclosure required of material advisors generally makes sense but should be modified in <u>certain respects to address practical considerations</u>.**

Proposed §6111 would require "each material advisor with respect to any reportable transaction [to] make a return . . . setting forth (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may provide." Proposed §6111(a). A "material advisor" is defined as any person "(i) who provides any material aid, assistance or advice with respect to organizing promoting, selling, implementing, or carrying out any reportable transaction, and (ii) who directly or indirectly derives gross income from such advice or assistance in excess of . . . (i) $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons, and (ii) $250,000, in any other case." Proposed §6111(b). The Secretary also is authorized to prescribe regulations providing that only one material advisor need file in a case where multiple advisors might otherwise be obligated to file, and to prescribe exemptions from the §6111 filing requirements.

The penalties imposed on a material advisor for failing to file a return as required under proposed §6111 are $50,000 per failure, or in the case of an LT, the greater of $200,000 or 50% of the gross income received with respect to the transaction; if the failure was intentional,

the penalty is increased to 75% of the gross income received. (See also the discussion of penalties in sections 9 and 10, below.)

We believe it is appropriate to require disclosure of RTs or LTs by persons who derive income from providing aid, assistance or advice in the implementation of such transactions. It is also important, however, to balance Treasury's need for current information concerning RTs and LTs against the burdens such filing obligations, and the attendant risks of substantial penalties, impose on legitimate businesses.

Our concerns in this regard center on several general observations. First, the broad definition of "material advisor" as a person providing "any material aid, assistance or advice with respect to organizing, promoting, selling, implementing or carrying out any" RT potentially sweeps into the §6111 filing and penalty regime many businesses whose contacts with the transaction are minimal and whose disclosures are likely to be minimally useful. Requiring returns, for example, of Delaware counsel who form a Delaware LLC and opine that it is duly formed and in good standing, or of a brokerage house that executes a trade, imposes significant burdens on persons whose relationship to and knowledge of the RT is minimal.

A second concern is the imposition of obligations to file reports on RTs and LTs when the definitions are vague, as in the current proposal. It also can be unreasonable to impose disclosure obligations on material advisors when the definition of an RT or LT is dependent upon facts to which the advisor does not have access, for example, the amount of fees the taxpayer will pay the promoter or the dollar amount of a book-tax difference. Compare Reg. §1.6011-4T(b)(3). Imposing any duty of inquiry or a "knew or should have known" standard on businesses that are performing customary client services with no promotional role in an RT or LT would represent a significant burden on businesses, yet may not yield useful information.

The proposed "threshold" limitations of a $50,000 or $250,000 minimum fee provide an important practical protection for material advisors, and generally make a great deal of sense. Similar thresholds would also make sense under proposed §6112. In general, a $250,000 fee is substantial enough to serve as a reasonable proxy for assuming that the advisor knows enough about the transaction to understand whether §6111 disclosure is required, and knows enough to make its disclosure useful to Treasury. The lower amount for advice, etc. provided to natural persons also makes sense, as the fees for such transactions may be generally lower. We do, however, have comments on the proposed thresholds.

First, we assume that aggregation rules similar to those currently applied under the tax shelter registration rules (Reg. §301.6111-2T) would apply in measuring the $50,000 and $250,000 thresholds.

Further, it is possible that an advisor can earn more than $50,000, or even more than $250,000, as a fee or a commission for assistance given in implementing or carrying out a transaction, without knowing (i) that the transaction is part of an RT or LT, (ii) precisely what the expected tax benefits are, or (iii) particularly given the use of pass-through entities and single-member LLCs, upon whom the tax benefits of the transaction are intended to devolve. We therefore believe that, in addition to the minimum fee requirement, it will be important that the Treasury Department exercise its regulatory authority to exempt from the §6111 disclosure requirements persons whose involvement is sufficiently tangential so as to make the imposition of §6111 filing obligations unnecessary or unreasonable. Such exemption should include, for example, any person who has not been involved in the development or promotion of the RT or LT, does not have actual knowledge that the aid, assistance or advice it is providing relates to an RT or LT, and whose compensation for the aid, etc. being provided is comparable to standard third-party charges for similar services. We believe this will leave a considerable universe of

material advisors who are obligated to disclose their participation in RTs and LTs, and whose disclosure will provide useful information, while relieving third-party providers of goods and services of the burden and penalty risk of having to investigate normal business transactions in search of RTs and LTs.

The disclosure required of material advisors should be effective only after regulations have been promulgated under §6111 as amended. Disclosure should be limited to the types of RTs and LTs, the specified material advisors, and the required information disclosures that are set forth in regulations promulgated under new §6111. Notice of proposed disclosure obligations, and the opportunity to receive and incorporate comments on the practical effects of proposed material advisor returns, will be very important to achieving a useful disclosure regime that is not unreasonably burdensome.

We recommend that material advisors not be obligated to file returns under §6111 until 30 or 60 days after the consummation of the RT or LT. This will be sufficiently contemporaneous with the closing of RTs and LTs to provide the Secretary with up-to-date information on tax shelter activity, while at the same time ensuring that the §6111 returns report actual transactions and the facts and advice pertinent to such transactions as they actually occur.

Authorizing Treasury to permit a single filing under §6111 makes sense. We suggest that the procedures established by Treasury include a notification that the designated filer can provide to other advisors potentially covered by §6111. The notification would acknowledge that the designated filer will comply with the §6111 disclosure requirements and generally would absolve the recipient of any penalties for not disclosing.[12]

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[12] Cf. Treas. Reg. §301.6111-IT, Q&A 38-39.

### 5. **Congress should not override the common law attorney-client privilege or the work-product doctrine.**

The common law has long accorded clients a privilege which bars their attorneys from disclosing confidential client communications. The attorney-client privilege prevents disclosure of information conveyed in confidence to a lawyer by a client in the course of seeking legal advice. The rationale for this privilege is that it enables the client to provide important information to a lawyer, so that the lawyer will be able to represent the client effectively. The attorney-client privileges recognize that a full understanding of all of the relevant facts is necessary for the attorney to provide comprehensive and meaningful legal advice.

Case law also has established a privilege for material created or collected by an attorney in the course of preparation for possible litigation; such material is protected from disclosure in discovery. Hickman v. Taylor, 329 U.S. 495 (1947). The purpose of protection of work product is to encourage careful and thorough preparation by the lawyer. Work-product protection is limited to material prepared specifically for litigation and extends beyond client communications. While the attorney-client privilege is absolute, work-product protection may be qualified by the type of matter sought by the adversary and the extent of the adversary's need for it.

The explosive growth of tax shelters presents a serious threat to federal, state and local revenues, and to the fundamental integrity of our self-assessment system of taxation. We understand that the attorney-client privilege has often been cited (perhaps incorrectly) in efforts to deflect governmental inquiries into, and audits of, abusive tax shelter transactions.[13] We do not, however, believe that the tax shelter problem has reached the point where it is necessary to

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[13] We are not commenting in this report on the scope of the attorney-client privilege or the work-product doctrine with respect to federal income tax matters.

abrogate the federal law privileges afforded to attorney-client communications or attorney work product in order to identify and audit tax shelters.

To the contrary, we believe that the core values protected by the attorney-client privilege and the work-product doctrine are vital to the integrity of the tax system. Full and frank communications from our clients are absolutely essential if we are to provide them with sound advice on their rights and obligations under the tax laws. Open and truthful communications, unfettered by concerns of potential privilege-breaking disclosures,[14] are among the best protections against tax-abusive transactions. Clients need and deserve to be told whether, taking all facts into account, a transaction does or does not achieve the tax benefits sought. Enabling clients to communicate all facts, so that their attorneys can develop reasoned judgments as to the merits of a transaction, ultimately protects the integrity of the tax system. The assurance of confidentiality for full and frank communications by the client to its tax attorneys is therefore a very important tool in shutting down abusive tax shelters. By contrast, impairing the free flow of information by making client disclosures non-privileged will inevitably result in responsible tax attorneys receiving less than a full accounting of the facts, and consequently being less able to provide sound, informed advice as to their clients' tax obligations.[15]

We therefore believe that the systemic benefits of preserving the attorney-client privilege and the doctrine of work-product confidentiality far outweigh the benefits of requiring disclosure of otherwise privileged matters under §6111 or §6112. We strongly oppose the

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[14] Because the confidentiality accorded attorney-client communications does not survive the disclosure of such communications to a third party, removing the privilege by requiring §6111 disclosure of privileged information would (absent nationwide changes in privilege rules) effectively eliminate the privilege as to all persons.

[15] For similar reasons, the work-product doctrine enables thorough and vigorous preparation for tax controversies. That process, in turn, often fleshes out the true merits of important legal and factual positions, a process which is necessary to the efficient management of tax controversies and frequently aids in the settlement of cases.

enactment of any disclosure obligation that would require attorneys to disclose otherwise privileged information. It is not clear that the Bills in fact propose to override the attorney-client privilege,[16] nor is it clear they would.[17] To eliminate any confusion and ensure that privileged information is not required to be disclosed, we believe it is important that any statutory requirement (under §6111, §6112 or elsewhere) to disclose information, advice, etc. should specifically exclude information that is covered by the then existing federal rules in respect of attorney-client privilege or the work-product doctrine.

With such an exclusion, it may transpire that an attorney will not disclose information based on the belief that it is privileged, while later it is discovered that the client had in fact waived the privilege by revealing the privileged communications to a third party. In such a situation the attorney should not be subject to a nondisclosure penalty if, at the time the disclosure was otherwise due, the attorney believed in good faith that the material was still privileged.

Where communications to and from attorneys, or materials prepared by attorneys, are not privileged, we generally support the disclosure and list-keeping requirements proposed in the Bills. We would, however, offer a further observation for consideration by Congress and the Treasury Department.

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16 The Bills omit a requirement in a prior draft of S. 2498 that material advisors disclose the advice given, apparently cutting back on the obligation to disclose privileged materials. However, the Bills continue to require disclosure of "information describing any potential tax benefits expected" and "such other information as the Secretary may prescribe." Proposed Section 6111(a)(2),(3). Both of those prescriptions could include privileged information.

17 Compare U.S. v. Goldberger & Dubin, P.C., 935 F.2d 501, 506 (2d Cir. 1991) (discussing $10,000 cash transaction reporting requirement of Section 6050-I and finding, "[t]o the extent that the congressional intent, as expressed in Section 6050-I, conflicts with the attorney-client privilege, the latter must give way to the former") with U.S. v. Sindel, 53 F.3d 874, 876 (8th Cir. 1995) (disclosure was not required where it would "[reveal] the substance of a confidential communication" protected by the federal common law of attorney-client privilege.)

Wholly apart from questions of attorney-client privilege, responsible tax professionals who are concerned about their clients' welfare serve an important role in dissuading abusive behavior. By vetting proposed transactions and providing dispassionate substantive analyses of the merits and risks of specific proposals, tax advisors often successfully counsel taxpayers to avoid questionable transactions. We believe that the continuing ability of tax professionals to communicate frankly with their clients regarding proposed "tax shelters" is important to protecting taxpayers, and the fisc, from abusive transactions.

We are concerned that requiring tax professionals to file returns with the IRS regarding "reportable transactions" could have a chilling effect on taxpayers' willingness to consult responsible advisors about proposed transactions. The proposed reporting required from advisors could cause the taxpayers to seek more aggressive advisors who will agree not to report, or could in other direct and indirect ways distance taxpayers from responsible and disinterested tax advice and analysis. This would undercut the purpose of the proposed legislation.

We understand that the wholesale exemption of professional tax advisors (i.e., those subject to Circular 230) from the Bills' disclosure requirements is not realistic. At the same time, in cases in which a transaction also includes a promoter[18] or some other "material advisor" who will in fact be required to disclose, the value of the additional disclosure that results from requiring the taxpayer's tax lawyer or accountant to file disclosure returns with the IRS should be weighed against the burdens this disclosure can put on the advisor-client relationship. The importance of the government's need for information should be balanced against the systemic detriment that can ensue from introducing potential conflicts -- in the form of responsibilities to

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[18] The Bills' proposal to permit the Treasury Department to provide for only one discloser suggests that Treasury can identify circumstances in which incremental additional disclosure may not be necessary.

report to the IRS, and the risk of substantial penalties -- into a tax advisors' relationship with his or her client.

We therefore believe that, in addition to revising the proposed statutory amendments to clarify that they do not override privilege, Treasury also should be authorized and directed to consider the extent to which persons who occupy a traditional tax advisor role with respect to the taxpayer (as compared to a role as a promoter of a particular deal) should be exempted from the obligation to file tax returns reporting on their clients.

### 6. We support the accuracy-related penalties for LTs and tax-avoidance motivated RTs and the narrowed definition of reasonable cause, but have certain technical suggestions.

We support the extension of the current accuracy-related penalty for substantial understatements to understatements (regardless of size) attributable to LTs, and to RTs "if a significant purpose of such transaction is the avoidance or evasion of Federal income tax." Proposed §6662A. We also support the higher level of accuracy-related penalties proposed for nondisclosed transactions. Proposed §6662A(c).

Under the Bills, the only exception to the new §6664A accuracy penalty for LTs and tax-avoidance motivated RTs will be the "reasonable cause" exception of new §6662(d). Proposed §6662(d) provides that no accuracy-related penalty will apply "if it is shown that there was a reasonable cause for [the RT underpayment] and that the taxpayer acted in good faith with respect to such portion" of the underpayment. The Bills further propose that this "reasonable cause exception" be available only if (A) the relevant facts are adequately disclosed under §6011; (B) there is or was substantial authority; <u>and</u> (C) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. Proposed §6664(d)(2)(A)-(C). "Reasonable belief" is statutorily defined to require a belief "based on the facts and the law that

exist at the time the return . . . is filed," and "relates solely to the taxpayer's chances of success on the merits." Proposed §6664(d)(3).

Under the text of proposed §6664(d), five criteria, encompassing disclosure, objective authority and subjective belief, must be met to avoid a 20% to 30% penalty on LT and tax-avoidance RT underpayments. In the realm of these tax-shelter type transactions, we support this narrowing of the reasonable cause exception to the accuracy-related penalties; indeed, as described in the Introduction to this Report, we have in the past recommended strict liability for understatement penalties in respect of tax shelters.

The Bills also circumscribe taxpayers' abilities to rely upon tax opinions to mitigate penalties. Currently, the regulations under §6664 provide that reliance upon professional advice can constitute reasonable cause and good faith "if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith." Reg. §1.6664-4(b)(1); see also Reg. §1.6664-4(c). The Bills would, by legislation, specify two categories of tax opinions that "may not be relied upon to establish the reasonable belief of the taxpayer." Proposed §6664(d)(3)(B)(I). With the comments noted below, we support this approach of identifying certain types of opinions as insufficient bases for establishing a reasonable belief.

The first category is opinions rendered by "disqualified tax advisors." These include advisors (i) who participate in the organization, management, promotion or sale of the transaction; (ii) who are compensated by another material advisor; (iii) who have a fee arrangement contingent upon all or part of the tax benefits being sustained; or (iv) who have, as determined under regulations, a "continuing financial interest with respect to the transaction."

We support the notion that taxpayers should not be able to establish their reasonable belief by relying on tax opinions rendered by advisors whose independence is in

question. However, we are concerned that the specific standards listed in the proposed statute are possibly over-inclusive in some circumstances.

For example, the definition of "material advisor" set forth in the Bills precludes a taxpayer from relying on an advisor who "participates in the organization [or] management . . . of the transaction." Proposed §6664(d)(3)(B)(ii)(I). Where a tax opinion is (often repeatedly) provided to a taxpayer by the promoter's chosen tax counsel, this rule seems appropriate. In some circumstances, however, the proposed rule could have unreasonably severe consequences. For example, where the taxpayer's longtime advisor assists in preparing the documentation for a transaction that is "Reportable" because the taxpayer has sustained a loss deductible under section 165, and that advisor also provides to its longstanding client an opinion that the loss is allowable, it is difficult to justify a rule that precludes the client from relying on the advice of its regular tax advisor. As another example, where one material advisor retains another material advisor based on the latter's greater expertise in a specific substantive area, it is not necessarily the case that the independence of the specialist is at issue.

It is difficult to articulate by statute all of the circumstances in which tax advisors should or should not be considered per se disqualified. We therefore suggest that, assuming the legislation will permit reliance on the tax opinions of some advisors but not others, the statute should articulate the fundamental quality or qualities that generally will disqualify tax advisors, and leave the specific rule-making to Treasury. We believe that an appropriate general statutory standard would be to disqualify any tax advisor who has a material financial interest in the transaction or in the success of the proposed tax treatment of the transaction. We also note that it is necessary that the standards for disqualifying an advisor must reflect arrangements that the taxpayer should in the usual course be aware of in obtaining the opinion.

The second category of excluded opinions is the "disqualified opinion." This category includes any opinion that (i) is based on "unreasonable factual or legal assumptions (including assumptions as to future events)"; (ii) "unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person"; (iii) "does not identify and consider all relevant facts"; or (iv) "fails to meet any other requirement as the Secretary may prescribe." Proposed §6664(d)(3)(B)(iii).

Again, the statute should provide some context for a regulations-based definition of "disqualified opinion." The three standards proposed in the Statute all identify substantive shortcomings in the facts on which the opinion is based, or in its stated legal assumptions, which shortcomings make the opinion unreliable. These conditions appropriately differ from analyses of the substantive legal discussions set forth in the opinion, which most taxpayer are ill-suited to undertake. Proposed §6664(d)(3)(B)(iii)(IV) should therefore incorporate as a standard for the regulations it authorizes some linkage to the business or transactional context on which the opinion is premised, and not permit the disqualification of an opinion based on substantive legal matters.

We also believe that the definition of unreliable "disqualified opinions" should be premised on the condition that the taxpayer "knew or should have known" that an assumption or reliance stated in the opinion was "unreasonable," or that the facts considered were not all of the relevant facts. In some circumstances taxpayers legitimately may not understand a transaction or an issue deeply enough to appreciate what is missing from a tax opinion, or to know upon which assumptions or representations it would be unreasonable for the tax advisor to rely. Where the person giving the opinion otherwise has no apparent conflict of interest and instead serves only the taxpayer, and where the taxpayer does not know and has no reason to know that an

assumption, representation or statement of facts is flawed, it does not seem necessary to override the taxpayer's actual reasonable belief that is premised on the opinion.

### 7. **We support H.R. 5095's proposed changes to Subchapter K, but have certain technical suggestions.**

H.R. 5095 includes several amendments to Subchapter K to disallow "partnership loss transfers." First, §704(c) would be amended to require that the built-in loss attributable to contributed property "(i) . . . shall be taken into account only in determining the amount of items allocated to the contributing partner, and (ii) except as provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value immediately after the contribution." In addition, sections 743 and 734 would be amended to effectively make a §754 election mandatory in any case in which there is a "substantial" built-in loss immediately after the transfer of a partnership interest. For this purpose, a built-in loss is substantial if it exceeds the greater of $250,000 or 10% of the basis of the transferee's interest (for purposes of §743) or of the partnership's aggregate bases in its remaining assets (for purposes of §734).

We agree that the elective nature of §754 has been used in structuring tax shelters, and that mandating the basis adjustments proposed will curtail certain forms of current transactions. We support these changes. The legislative history should confirm, however, that the mandatory application of §754 to a particular transaction will not result in the partnership's being required to apply §754 thereafter, as would be the case if it had freely elected application of §754.

We also support the proposed change to §704(c), but suggest that the regulatory authority of the Treasury to provide exceptions should be available under both clauses (i) and (ii) so that Treasury can address any necessary exceptions to the proposed new rule as they become

apparent. For example, contributions of depreciated properties to partnerships subject to nonrecourse debt occur outside the classic tax shelter context with regularity. The application of the new proposals to these transactions, including the interaction of the definitions of "built-in loss" with section 7701(g),[19] may not yet be fully appreciated. The desire to stem tax shelters legitimately can and should address current tax-driven transactions that manipulate Subchapter K to achieve unwarranted benefits, but it is important to be cautious about piecemeal changes to Subchapter K that could have unintended ancillary effects. Providing regulatory authority to Treasury to create exceptions will enable Treasury and taxpayers to avert such unintended results.

8. **We suggest a technical refinement to the proposed changes in the penalties for transactions that are not RTs or LTs.**

Current law provides that a penalty is not imposed if there "is or was" substantial authority for the taxpayer's position. The Bills would change the penalty relief provision to require that a taxpayer have a reasonable belief that the treatment shown on the return was "more likely than not" the correct treatment.

Rather than premising the penalty on what a taxpayer can document as its subjective belief at the time the return was filed, we believe that if a taxpayer can demonstrate on audit that a position taken on the return is a position which reasonable persons could believe was more likely than not correct, then the taxpayer should be considered to have satisfied the proposed statutory standard. This would obviate the need to assemble proof and documentation as to the taxpayer's subjective belief regarding every issue reflected on the return, while still providing the substantive level of belief/authority that is sought in the proposed amendment.

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19 That section provides that for purposes of determining the amount of gain or loss, fair market value shall be deemed to be not less than the amount of the mortgages.

9. **The potential overlap of certain <u>penalties should be addressed</u>.**

For a failure to file an information return under §6111, or for filing "false or incomplete information," proposed §6707 imposes on material advisors a penalty of up to 75% of "the gross income derived by such person with respect to aid, assistance, or advice which is provided with respect to the reportable transaction before the date the [§6111] return is filed."

For failure to maintain lists and disclose as required under §6112, proposed §6708(a) imposes a potential penalty of $10,000 per day, with a reasonable cause exception.

Proposed amendments to §6694 impose a penalty of up to $5,000 on income tax preparers (who also would be subjected to a "reasonable belief" standard).

The §6700 penalty for promoting an abusive tax shelter is increased by S. 2498, in the case of any statement which the promoter "knows or has reason to know is false or fraudulent as to any material matter," to "50% of the gross income derived (or to be derived) from such activity by the person on which the penalty is imposed." S. 2498 §215. Under §6700(c), that penalty would be "in addition to any other penalty provided by law."

Finally, §214 of S. 2498 and §117 of H.R. 5095 amend U.S. Code Title 31, §330(b) (regulating practice before the Treasury Department) to provide that "[t]he Secretary may impose a monetary penalty on any representative . . . or on any firm or other entity if it knew, or reasonably should have known, of [its representative's penalty-producing] conduct . . . not [to] exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty."

We have no objection to imposing substantial monetary penalties on advisors, promoters and representatives with respect to their involvement in abusive transactions. We also believe that penalties designed to eliminate a substantial amount of the fees earned from such

activities are legitimate and are more likely to ensure that such persons attend to their legal responsibilities. However, the penalties measured by gross income should be coordinated such that the penalties imposed under §§6707, 6700 and Title 31, §330(b) do not in the aggregate exceed 100% of the gross income received.

### 10. **The enforcement of all fees-based penalties <u>should follow standard deficiency procedures</u>.**

Taxpayer penalties proposed or amended under the Bills (§6707A nondisclosure and §6662A accuracy penalties) would, it appears, be subject to the usual deficiency procedures. See §§6201 et seq. The "promoter and preparer" penalties in the Bills for nondisclosure (§6707) and for failure to maintain lists (§6708) also appear to be subject to the usual deficiency procedures. See §§6665, 6671.

By contrast, the §6694 preparer penalty is reviewable in District Court if the preparer pays at least 15% of the asserted penalty and timely sues for a refund. See §6694(c). The same rule applies to promoter penalties under §6700, and to frivolous filing penalties under §6702. See §6703.

Suspension and disbarment proceedings under Title 31, §330 currently are conducted by administrative law judges. Presumably, under the Bills as proposed, administrative law judges likewise would adjudicate any proposed monetary penalty.

In shifting to a penalty regime that contemplates forfeiture of 50%, 75% or 100% of gross income, and by authorizing such penalties across all three existing adjudicative regimes, the Bills create a potential for duplicative, overlapping and even inconsistent penalty proceedings. This does not seem justified. We therefore recommend that the same deficiency procedures apply to all assertions of fees-based penalties, and we believe the Tax Court is the appropriate forum for hearing such cases.