NEW YORK STATE BAR ASSOCIATION

One Elk Street, Albany, New York 12207 • 518.463.3200 • www.nysba.org

TAX SECTION

2009-2010 Executive Committee

ERIKA W. NIJENHUIS
Chair
Cleary Gottlieb Steen & Hamilton LLP
One Liberty Plaza
New York, NY 10006
212/225-2980
PETER H. BLESSING
First Vice-Chair
212/848-4106
JODI J. SCHWARTZ
Second Vice-Chair
212/403-1212
ANDREW W. NEEDHAM
Secretary
212/474-1440
COMMITTEE CHAIRS:
Bankruptcy and Operating Losses
Stuart J. Goldring
Russell J. Kestenbaum
Compliance, Practice & Procedure
Bryan C. Skarlatos
Diana L. Wollman
Consolidated Returns
Lawrence M. Garrett
Edward E. Gonzalez
Corporations
David R. Sicular
Karen Gilbreath Sowell
Cross-Border Capital Markets
Douglas R. McFadyen
Andrew Walker
Employee Benefits
Andrew L. Gaines
Andrew L. Oringer
Estates and Trusts
Carlyn S. McCaffrey
Jeffrey N. Schwartz
Financial Instruments
Michael S. Farber
William L. McRae
"Inbound" U.S. Activities of Foreign Taxpayers
Peter J. Connors
David R. Hardy
Individuals
Paul R. Comeau
Sherry S. Kraus
Investment Funds
David H. Schnabel
Marc L. Silberberg
New York City Taxes
Maria T Jones
Irwin M. Slomka
New York State Taxes
Robert E. Brown
Arthur R. Rosen
"Outbound" Foreign Activities of U.S. Taxpayers
Andrew H. Braiterman
Yaron Z. Reich
Partnerships
David W. Mayo
Joel Scharfstein
Pass-Through Entities
James R. Brown
Elliot Pisem
Real Property
Robert Cassanos
Jeffrey Hochberg
Reorganizations
Deborah L. Paul
Linda Z. Swartz
Securitizations and Structured Finance
Jiyeon Lee-Lim
W Kirk Wallace
Tax Exempt Entities
Elizabeth T Kessenides
Richard R. Upton

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE

S. Douglas Borisky, Kathleen L. Ferrell, Marcy G. Geller, Charles I. Kingson, Donald Korb, Robert J. Levinsohn, Lisa A. Levy, John T Lutz, Gary B. Mandel, Charles M. Morgan, Regina Olshan, David M. Schizer, Peter F G. Schuur, Eric Sloan, Andrew P Solomon, Eric Solomon, Gordon E. Warnke

September 22, 2009

Sen. Max Baucus, Chair Senate Finance Committee U.S. Senate Washington, DC 20510	Sen. Charles E. Grassley Ranking Minority Member Senate Finance Committee U.S. Senate Washington, DC 20510
Rep. Charles B. Rangel, Chair House Ways and Means Committee U.S. House of Representatives Washington, DC 20515	Rep. Dave Camp Ranking Minority Member House Ways and Means Committee U.S. House of Representatives Washington, DC 20515

Re: Comments on Proposed Modifications to Section 6662 Penalty in America's Affordable Health Choices Act of 2009

Dear Sirs:

We write to convey the comments of the New York State Bar Association Tax Section on section 453 of the America's Affordable Health Choices Act of 2009 (the "Health Act"), H.R. 3200, introduced in the House of Representatives on July 14, 2009.* The Health Act proposes

---

* The principal drafter of this letter was Elliot Pisem, with substantial contributions from David S. Miller, Bryan Skarlatos and Diana L. Wollman. Helpful comments were received from Andrew Berg, Kimberly S. Blanchard, Peter Canellos, Erika W. Nijenhuis, and Michael Schler.

Opinions expressed herein are those of the Tax Section of the New York State Bar Association, and do not represent those of the New York State Bar Association unless and until they have been adopted by the Association's House of Delegates or its Executive Committee.

The letter may be cited as New York State Bar Association Tax Section, *Comments on Proposed Modifications to Section 6662 Penalty in America's Affordable Health Choices Act of 2009* (Report. No. 1190, Sept. 22, 2009).

FORMER CHAIRS OF SECTION:

Edwin M. Jones, John E. Morrissey, Jr, Martin D. Ginsburg, Peter L. Faber, Hon. Renato Beghe, Alfred D. Youngwood, Gordon D. Henderson, David Sachs, J. Roger Mentz, Willard B. Taylor, Richard J. Hiegel, Dale S. Collinson, Richard G. Cohen, Donald Schapiro, Herbert L. Camp, William L. Burke, Arthur A. Feder, James M. Peaslee, John A. Corry, Peter C. Canellos, Michael L. Schler, Carolyn Joy Lee, Richard L. Reinhold, Richard O. Loengard, Steven C. Todrys, Harold R. Handler, Robert H. Scarborough, Robert A. Jacobs, Samuel J. Dimon, Andrew N. Berg, Lewis R. Steinberg, David P Hariton, Kimberly S. Blanchard, Patrick C. Gallagher, David S. Miller

to modify the accuracy-related penalty on underpayments imposed by Internal Revenue Code ("Code") section 6662 to make it more likely that a taxpayer that loses a case on the merits also will be subject to penalties.

Very generally, under current law, a 20 percent "accuracy-related penalty" may be imposed under Code section 6662 if, among other matters, a taxpayer has substantially understated its tax on its income tax return. This penalty does not apply (i) if the taxpayer's treatment of the item on its tax return is supported by "substantial authority" (the "substantial authority defense"), or (ii) if there is a reasonable basis for the taxpayer's position and the taxpayer has appropriately disclosed the item on its tax return (the "disclosure plus reasonable basis defense"). In addition, under Code section 6664, generally no penalty will be imposed if there was reasonable cause for an underpayment and the taxpayer acted in good faith with respect to that item (the "reasonable cause and good faith defense"). More onerous rules apply to "tax shelters" and "reportable transaction understatements." These rules are described in more detail below.

Section 453 of the Health Act would modify current law in several ways:

1. *Non-Economic Substance Penalties.* In the case of any underpayment that is attributable to a "disallowance of claimed benefits by reason of a transaction lacking economic substance (within the meaning of new section 7701(o)) or failing to meet the requirements of any similar rule of law," a penalty equal to 20% of the underpayment would be imposed on a "strict liability" basis.[1] In other words, none of the defenses provided by current law, such as the "reasonable cause and good faith" defense, the "substantial authority" defense, or the "disclosure plus reasonable basis" defense, would apply. The penalty would be doubled to 40% if the transaction were not adequately disclosed on the taxpayer's tax return.

2. *Tax Shelter Penalties.* In the case of any substantial understatement of income tax attributable to a "tax shelter," the "reasonable cause and good faith" defense available under current law to imposition of the Code section 6662 penalty would cease to be

[1] Section 452 of the Health Act proposes to add a new subsection (o), codifying the "economic substance doctrine," to Code section 7701. Section 453(a), (b) of the Health Act would enact the penalties described in the text. We call transactions proposed to be subject to this rule "noneconomic substance and similar transactions "

The Tax Section has previously submitted comments on prior proposals to codify the economic substance doctrine. *See* New York State Bar Association Tax Section, *Summary Report on the Provisions of Recent Senate Bills that Would Codify the Economic Substance Doctrine* (Report No. 1032, May 21, 2003), available at the Tax Section's website; New York State Bar Association Tax Section, *Report on Tax Shelter Legislation* (Report No. 1019, Aug. 27, 2002); New York State Bar Association Tax Section, *Report on the Treasury's Proposal to Codify the Economic Substance Doctrine* (Report No. 977, July 24, 2000). We believed then, and believe now, that codification of the doctrine is not an effective means of combating abusive tax shelters. In our 2003 report, we supported in principle other provisions of the 2003 bills that imposed the more onerous penalty rules now found in Code section 6662A, relating to reportable transaction understatements, and the Code section 6662 rules applicable to tax shelters, as more effective targeted measures to prevent abusive transactions.

available, thereby imposing the penalty on a "strict liability" basis in the case of "tax shelters" as well.[2]

3. *Large Corporation Penalties*. In the case of any substantial understatement of income tax by any person required to file periodic or other reports under section 13 of the Securities Exchange Act of 1934 or by any corporation with gross receipts in excess of $100,000,000 for the taxable year involved, the existing defenses of "reasonable cause and good faith," "substantial authority," and "disclosure plus reasonable basis" would cease to apply. However, a defense to imposition of the Code section 6662 penalty would be available to the extent that a portion of the understatement is "attributable to any item with respect to which the taxpayer has a reasonable belief that the tax treatment of such item by the taxpayer is more likely than not the proper tax treatment of such item."[3]

These changes would apply to transactions entered into after the date of enactment of the Health Act.

We have for many years supported "strict liability" penalties as a means of combating abusive transactions, and of increased penalties in the case of nondisclosure.[4] Abusive transactions undermine the fairness and public trust that are essential to our system of self-assessed taxes. We have also consistently recommended, however, that strict liability penalties be imposed only when the conduct to be subject to penalty is described in terms sufficiently precise and clear to give taxpayers fair notice of what is proscribed. We believe that the penalty also should be limited to truly abusive cases. Restricting the imposition of "strict liability" penalties to clearly defined and egregious cases serves the values of deterrence, fairness (and the perception of fairness), and avoidance of disputes between taxpayers and the Internal Revenue Service.[5]

---

2 Section 453(b) of the Health Act. As described in more detail below, the term "tax shelter" is very broadly, but vaguely, defined.

3 Section 453(d) of the Health Act.

4 *See, e.g.*, New York State Bar Association Tax Section, *Report on Corporate Tax Shelters* (Report No. 950, April 23, 1999); New York State Bar Association Tax Section, *Report on the Treasury's Proposal to Codify the Economic Substance Doctrine* (Report No. 977, July 24, 2000); New York State Bar Association Tax Section, *Letter to Senate Finance Committee Chairman William V. Roth* (Report No. 979, Sept. 18, 2000); New York State Bar Association Tax Section, *Report on Tax Shelter Legislation* (Report No. 1019, Aug. 27, 2002); New York State Bar Association Tax Section, *Letter on S. 1637 – JOBS Act – Tax Shelter Penalty Provisions* and *Letter on H.R. 2896 – Tax Shelter Penalty Provisions* (Reports No. 1055 and 1056 (March 18, 2004)). These reports can be found on the website of the New York State Bar Association (www.nysba.org, Sections/Committees, Tax Section, Tax Section Reports), along with other Tax Section reports on penalty proposals.

5 Experience has demonstrated that, at least in some cases, imposing stiff penalties without allowing taxpayers any opportunity to demonstrate why an exception or waiver of the penalty should apply may have unanticipated consequences and may not be viewed as promoting tax compliance, even with respect to transactions that the Internal Revenue Service considers patently unlawful *See* Letter from Senator Max Baucus, Representative John Lewis, Senator Charles Grassley and Representative Charles W. Boustany on June 12, 2009 to the Honorable Douglas W Shulman (requesting a suspension of enforcement of strict liability penalties imposed on

We believe that the proposed provisions do not meet these standards. The statutory language proposed to describe noneconomic substance and similar transactions is inappropriate for a "strict liability" penalty because it would include a broad class of cases, many of which might not reflect egregious conduct.[6] Similarly, the definition of "tax shelter," which has been present in its current form in Code section 6662 since 1997, is insufficiently precise and focused to serve as the touchstone for imposition of a "strict liability" penalty. These concerns and several technical comments on the proposed statutory provisions are described in detail below. We also make several recommendations for steps to be taken in lieu of adopting these strict liability provisions, including (i) a comprehensive study of penalties, (ii) a clarification of the standards applicable to tax shelter transactions, (iii) some comments on possible adjustments to the rate at which penalties are imposed, taking into account whether the taxpayer has disclosed the transaction on its tax return, and (iv) adequate funding for the Internal Revenue Service's enforcement activities.

Statutory Background

Code section 6662(a) imposes a penalty equal to 20% of the portion of any underpayment attributable to "any substantial understatement of income tax."[7] However, Code section 6662 does not apply to any portion of an underpayment on which a penalty is imposed under Code section 6663, relating to fraud, or to the portion of any underpayment which is attributable to a "reportable transaction understatement" on which a penalty is imposed under Code section 6662A.

Substantial Understatement Attributable to Items Arising from Neither Tax Shelter Nor Reportable Transaction

Code section 6662(c)(1) provides that there is a substantial understatement of income tax for any taxable year if the amount of the understatement exceeds certain numerical thresholds.[8] In the case of an understatement attributable neither to a "tax shelter" nor to a "reportable transaction," the Code provides three possible defenses to application of the penalty:

---

certain "listed transactions" entered into by small business taxpayers); Letters dated July 6, 2009 from the Honorable Douglas W. Shulman (announcing suspension of collection enforcement activities with respect to certain transactions with tax benefits below a specified level).

[6] Our 2003 report on economic substance codification gives 18 examples of transactions that might be considered noneconomic substance transactions but that most, if not all, tax practitioners would think perfectly legitimate, and many of which have been approved by the IRS in rulings and other guidance.

[7] Code section 6662 also imposes a 20% penalty on the portion of any underpayment attributable to: (1) negligence or intentional disregard of rules or regulations; (2) any substantial valuation misstatement under chapter 1 of the Code; (3) any substantial overstatement of pension liabilities; and (4) any substantial estate or gift tax valuation understatement.

[8] "Understatement" is defined in Code section 6662(d)(2)(A) as the excess of (i) the amount of the tax required to be shown on the return for the taxable year over (ii) the amount of the tax imposed which is shown on the return, reduced by any rebate.

1. That "there is or was substantial authority for [the taxpayer's] treatment" of the item;[9]
2. That "the relevant facts affecting the item's treatment are adequately disclosed in the return or in a statement attached to the return, and there is a reasonable basis for the tax treatment of such item by the taxpayer"[10] or
3. That there was a reasonable cause for the understatement and the taxpayer acted in good faith with respect to the understatement.[11]

These rules are intended to protect and support our voluntary compliance system, by recognizing that taxpayers may in good faith take positions that the courts ultimately do not uphold, while also encouraging taxpayers to disclose their more aggressive positions to the government in a manner conducive to allowing the Internal Revenue Service effectively to identify, review and audit those positions in a timely fashion. These core penalty rules take into account the objective merits of a taxpayer's position, the extent to which the taxpayer has made an effort to comply with the law, and the extent to which the taxpayer has reported the position in a way that facilitates enforcement of the law. We generally believe that this balance is appropriate.

Substantial Understatement Attributable to Items Arising from Tax Shelter, but Not from Reportable Transaction

The "substantial authority" and "disclosure plus reasonable basis" defenses do not apply to item that is attributable to a "tax shelter," defined as "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax."[12] Only the "reasonable cause and good faith" defense of Code section 6664(c) applies to such items. The Treasury Regulations subject that defense to the limitation that, in the case of a "tax shelter" item, a finding of reasonable cause and good faith cannot be based on "legal justification" (including the taxpayer's belief as to the merits of the taxpayer's underlying

---

9 "Substantial authority" is generally thought to mean that the taxpayer's position has about a 40 percent likelihood of success if challenged. Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)*, vol. I, page 152 (JCS-3-99, July 22, 1999).

10 "Reasonable basis" is generally thought to mean that the taxpayer's position has about a 20 percent likelihood of success if challenged. *Id.*

The "substantial authority" and "disclosure plus reasonable basis" defenses are now provided by Code section 6662(d)(2)(B) in the case of "substantial understatements of income tax" that are not attributable to "tax shelter" items.

11 This defense is now provided by Code section 6664(c) in the case of all underpayments subject to penalty under Code section 6662. This defense may apply to a portion of an understatement, and also applies to the types of underpayments listed in note 7, *supra.* A "reasonable cause and good faith" defense to the penalty imposed by Code section 6662A on "reportable transaction understatements" is similarly provided by Code section 6664(d).

12 Code section 6662(d)(2)(C).

position) unless there is substantial authority for the taxpayer's treatment of the item in issue and the taxpayer reasonably believed that the taxpayer's tax treatment of the item was more likely than not the proper treatment.[13]

Reportable Transaction Understatement

Special rules apply to the portion of any underpayment which is attributable to a "reportable transaction understatement," defined generally to be an understatement attributable to any "listed transaction" or to any "reportable transaction" (other than a listed transaction) if a significant purpose of such transaction is the avoidance or evasion of Federal income tax.[14] If a taxpayer has a reportable transaction understatement for any taxable year, there shall be added to the tax an amount equal to 20% of such understatement.[15]

The penalty for "reportable transaction understatements" is not imposed with respect to a portion of an understatement if the taxpayer meets each of a series of conditions (some of them quite onerous): (1) it is shown that there was a reasonable cause for such portion; (2) it is shown that the taxpayer acted in good faith with respect to such portion; (3) the relevant facts affecting the tax treatment of the item are adequately disclosed in accordance with Treasury Regulations prescribed under Code section 6011; (4) there is or was substantial authority for the taxpayer's treatment of the item; and (5) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.[16] Thus, what one might call an "enhanced reasonable cause and good faith" defense is available even in the case of a "reportable transaction understatement," but only if a number of facts beyond those needed to establish a "basic reasonable cause and good faith" defense in the case of a non-reportable transaction can be demonstrated, and only if the taxpayer properly discloses the transaction.

---

[13] Treasury Regulation section 1.6664-4(f). Although the Regulation refers only to corporate taxpayers, it is assumed that the same rule will apply to non-corporate taxpayers now that the treatment of corporate and non-corporate taxpayers is identical under the "tax shelter" rules of Code section 6662(d)(2)(C), as was not the case at the time that the Regulation was promulgated.

[14] "Listed transaction" and "reportable transaction" are defined in Code section 6662A(d) by reference to Code section 6707A(c), which in turn makes reference to Code section 6011. Treasury Regulation section 301.6707A-1T(b)(2) provides that "listed transaction" is defined in Treasury Regulation section 1.6011-4(b)(2), and section 301.6707A-1T(b)(1) provides that "reportable transaction" is defined in section 1.6011-4(b)(1). Generally, a "listed transaction" is a transaction that the Internal Revenue Service has determined to be a tax avoidance transaction, or a substantially similar transaction. A "reportable transaction" is a transaction that has a specified "hallmarks" of a tax avoidance transaction, such as certain types of confidentiality requirements; contractual protection based on the tax that the taxpayer must actually pay, after audit; losses in excess of specified thresholds; or a transaction designated by the Internal Revenue Service as a "transaction of interest." As the loss case demonstrates, a reportable transaction can be, and frequently is, a legitimate transaction not driven, or substantially driven, by tax motivations.

[15] Code section 6662A. Under Code section 6662A(c), the penalty is increased to 30% of the amount of the understatement if the relevant facts affecting the tax treatment of the item are not adequately disclosed in accordance with Treasury Regulations prescribed under Code section 6011.

[16] Code section 6664(d)(3) contains a number of special rules relating to the "reasonable belief" requirement.

"Strict Liability" Penalties Should Not Be Imposed in the Manner Proposed

Penalties serve a vital deterrent function in preserving our system of self-assessment. At the same time, the availability of various defenses to the penalties for understatement of income tax is essential to the fair working of our tax system. The Internal Revenue Code and Treasury Regulations are extraordinarily complex -- unsurprisingly so, in view of the complexity and variability of transactions to which they must apply -- and it is inevitable that they will not provide clear and certain rules for every possible situation.[17] It is a well-established principle that taxpayers are not required to increase their tax liability beyond what is legally owing,[18] nor must the taxpayer resolve all legal uncertainties in favor of the Government in preparation of a tax return.[19] Moreover, the threat that a "strict liability" penalty may be asserted can enable the Internal Revenue Service to pressure a taxpayer into an inappropriate settlement at a time that the taxpayer has potentially meritorious defenses to an asserted underpayment.

Accordingly, the Tax Section has, as noted above, previously expressed its support for the imposition of "strict liability" penalties as an important tool in providing taxpayers sufficient incentives to comply with their tax liabilities. We believe, however, that strict liability penalties should be imposed only in situations where two criteria are met regarding the conduct to be penalized: first, that the conduct be egregious, and, second, that the conduct be clearly defined. We do not believe that either of these criteria is met in the two situations for which "strict liability" penalties are proposed in the Health Act, nor do we perceive any other reason that underpayments attributable to noneconomic substance or similar transactions or to Code section 6662(d)(2)(C) "tax shelters" should be subject to "strict liability" penalties (or should otherwise be singled out from other understatements for the purpose of applying penalties stricter than those under current law). Accordingly, we do not support these proposals.

---

[17] Even at a time when the Code was much briefer (and, in the view of many, much simpler) than it is now, Judge Learned Hand famously described that tax law as a "fantastic labyrinth" whose words "merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception ... that offer no handle to seize hold of ... [that] leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract...." L. Hand, Thomas Walter Swan, 57 YALE L.J. 167, 169 (1947).

[18] Again to quote Judge Hand, "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934).

[19] *See* Bernard Wolfman, James P. Holden, and Kenneth L. Harris, *Standards of Tax Practice* § 202.2 (Tax Analysts 1999) (discussing whether proper standard for determining taxpayer's self-assessment responsibilities is disclosure of positions that are not "nonfrivolous position" or disclosure of "position[s] ... that, although litigable, [are] not likely to prevail," but dismissing possibility that taxpayer be required to "self-assess according to the government's version of the proper tax liability").

Noneconomic Substance and Similar Transactions

The Health Act proposes to create a "strict liability" penalty -- one to which there is no defense of "substantial authority," "disclosure plus reasonable basis," "basic reasonable cause and good faith," or even "enhanced reasonable cause and good faith" -- in the case of any underpayment attributable to any "disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rules of law." For a number of reasons, this rule does not comport with our view of the limited circumstances in which a "strict liability" penalty would be appropriate.

First, no reason has been articulated for treating the claiming of tax benefits that are ultimately denied on the grounds of "lack of economic substance" more onerously than taxpayers who claim tax benefits that are ultimately denied on other grounds. Unless it is intended that "lack of economic substance" be used as a rubric to cover every sort of tax-motivated transaction or structure (in which case, there would be little difference between a noneconomic substance or similar transaction and a "tax shelter"), we see no reason to believe that the claiming of nonallowable tax benefits arising from noneconomic substance or similar transactions, as a class, is likely to be significantly more egregious conduct than the claiming of nonallowable tax benefits from other kinds of transactions.

Second, the proposed codification of the economic substance doctrine itself contains a crucial, if intended, ambiguity, in that section 7701(o)(5)(D) would provide, "The determination of whether the economic substance doctrine is relevant to a transaction (or series of transactions) shall be made in the same manner as if this subsection had never been enacted." In other words, section 7701(o), if enacted, will tell us ***how*** certain computations relevant to application of the economic substance doctrine are to be performed, thereby perhaps putting to rest a number of interpretive issues that have arisen over the years, but it will not resolve the more controversial and difficult questions -- ***when*** to apply the doctrine and ***which*** transactions (or portions of transactions) need to be tested separately under the doctrine.[20] Accordingly, there is likely to be room for a large amount of good faith dispute as to the existence (or lack of existence) of any underpayment at all in many cases in which the Internal Revenue Service asserts that the economic substance doctrine, even in its codified form, should apply. In such a case, the ultimate determination by a court that an underpayment attributable to application of the economic substance doctrine does exist should not be sufficient, in and of itself, to cause a penalty to be imposed.

Finally, this "strict liability" penalty would be imposed not only on underpayments attributable to disallowance of claimed tax benefits by reason of a transaction's lacking economic substance, but also on underpayments attributable to disallowance of claimed tax benefits by reason of a transaction's "failing to meet the requirements of any similar rule of law." No definition is provided for the term "similar rule of law" (a term that occurs nowhere else in the Code or in the Treasury Regulations thereunder), and the description of the revenue

[20] A complete analysis of proposed section 7701(o) is beyond the scope of this letter, but see the reports cited in note 1, *supra*, for comments on prior versions of that proposal.

provisions of the Health Act by the Joint Committee on Taxation[21] contains little guidance as to its meaning.[22] Members of the Tax Section's Executive Committee have suggested a number of possible (and inconsistent) meanings. Some believe that the term might be read to refer to any "anti-abuse rule" set out in the Code or Treasury Regulations, while other believe it might even be expanded to encompass some range of judicial doctrines, such as "substance over form" or "step transaction."[23] In light of this ambiguity, the provision as currently drafted does not give fair warning of what sort of conduct may be subject to this onerous penalty, nor would it likely serve a more effective deterrent function with respect to noneconomic substance and similar transactions than would the existing penalty structure, if it were applied to such transactions.

Tax Shelter Transactions

The Health Act would also impose a strict liability penalty on substantial understatements of income tax attributable to "tax shelter" items. We are opposed to this provision, as no reason has been articulated for eliminating the "reasonable cause and good faith" defense available under current law[24] and as the class of cases that would be subject to the

---

[21] JCX-30-09 (July 14, 2009).

[22] The description in the Joint Committee on Taxation report contains a single footnote (no. 130) with an example of a transaction that would fall within this "catch-all" category (a "transaction that is disregarded as a result of the application of the same factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine"). There is no indication, however, that the example sets the outer limit for application of the "similar rule of law" concept, and we are concerned that the Internal Revenue Service might attempt to apply that concept in a much more open-ended manner.

[23] Further ambiguity is caused by the fact that a reference to judicial doctrines might be narrowly construed to include only those relating to the "substance" of the transaction or might include even such principles as "continuity of interest" in a reorganization.

[24] We do believe that it is appropriate, whenever a "reasonable cause and good faith" defense is raised, for the Internal Revenue Service and the courts to inquire closely regarding whether the requirements for application of that defense have been met. For example, in some cases, a taxpayer may have engaged in "opinion shopping" and, notwithstanding the taxpayer's having ultimately found the one advisor that was willing to render a favorable opinion, the taxpayer's subjective belief that the taxpayer's treatment of the item in question is correct -- even if the taxpayer truly subjectively holds such a belief -- may not be reasonable. Similarly, the sophistication of the taxpayer or its employees in respect to particular tax matters may, in certain cases, cause reliance on an opinion to be unreasonable in the circumstances. Guidance to examiners regarding the relevant facts to be considered in determining whether or not to assert a penalty is contained at Internal Revenue Manual 20.1.5 6.1(7). The courts have been quite vigilant in recent years in restricting taxpayers' ability to rely on tax opinions where either the taxpayer's actions (or failure to act) or the tax advisor's lack of expertise or information or a conflict of interest made it inappropriate to permit the taxpayer to use reliance on the tax opinion to avoid penalties. *See, e.g., Long Term Capital Holdings, LP* v. *United States*, 150 Fed. Appx. 40 (2d Cir. 2005) (penalties upheld where taxpayer provided attorney with unreasonable assumptions and reasonable investigation by law firm would have revealed taxpayer assumptions to be false); *Neonatology Associates, P A* , 115 T.C. 43, 99 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002) (unreasonable to rely on an insurance agent's opinion regarding a product's tax implications because the agent did not have sufficient expertise and the agent had a conflict of interest, and the conclusion was too good to be true). (At the same time, the Service should recognize that reliance on an opinion is not unreasonable just because the Service may disagree with the opinion's conclusion!)

proposed "strict liability" penalty does not satisfy the criteria of egregiousness and lack of ambiguity described above.

Since 1997, the term "tax shelter" in Code section 6662 has been defined to mean a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax. Although this definition has been in the Code for twelve years, we are not aware of any decided cases in which the question of whether or not a penalty would be imposed on a taxpayer turned squarely on whether or not a particular transaction fell within this definition of a "tax shelter."[25] (Under current law, what is at stake in this determination of "tax shelter" status is whether or not the "substantial authority" or "disclosure plus reasonable basis" defenses, or only the "reasonable cause and good faith" defense, will be available; the Health Act would "raise the ante" by denying any defenses at all to substantial understatement penalties asserted in the context of "tax shelters.") We believe that, if a "strict liability" penalty is to be imposed on a class of transactions, the parameters of that class should be much better defined.

We also note that Treasury has left its interpretation of the concept of "significant purpose of tax avoidance" quite ambiguous. Section 10.35(b)(10) of "Circular 230" states that the "***principal purpose*** of a partnership or other entity, investment plan or arrangement, or other

---

[25] The few decided cases in which a penalty was imposed because a "tax shelter" was found under the "significant purpose of tax avoidance" test have involved "Son-of-BOSS" and similar transactions that would likely have failed a more stringent "principal purpose of tax avoidance" test as well, *see, e.g*, *Enbridge Energy Co. v. United States*, 553 F. Supp. 2d 716, 101 AFTR 2d 2008-1733 (S.D. Tex. 2008); *Stobie Creek Investments, LLC v. United States*, 82 Fed. Cl. 636, 102 AFTR 2d 2008-5442 (2008), or have involved situations in which the taxpayer could not have satisfied the requirements for the "substantial authority" or the "disclosure plus reasonable cause" defense, had they been applicable. Moreover, we have found no decided cases in which the courts rejected the Government's argument where the taxpayer satisfied the requirements for the "substantial authority" defense or "disclosure plus reasonable basis" defense but the Government contended that a penalty should nevertheless be imposed because a "tax shelter" did exist. Accordingly, whatever limitations may exist on the "significant purpose tax shelter" concept have not yet been clearly articulated. (In *Canterbury Holdings, LLC v. Commissioner*, T.C. Memo 2009-175 (July 27, 2009), a case in which the taxpayer asserted a "reasonable cause and good faith" defense under Code section 6664(c)(1), based on reliance on the advice of a qualified professional, the Tax Court with little analysis and no citation of authority rejected the Commissioner's contention that the transaction before the Court constituted a "tax shelter"; acceptance of the Commissioner's contention would presumably have required that the taxpayer, in addition to showing "reasonable cause and good faith" under all the facts and circumstances, comply with the additional requirements of "substantial authority" and "reasonable belief that more likely than not" set out in Treasury Regulation section 1.6664-4(f).)

Several other cases have arisen under Code section 7525(b), which incorporates the Code section 6662 "tax shelter" definition by reference. Under Code section 7525(b), certain communications between a taxpayer and a federally authorized tax practitioner that would otherwise be protected from disclosure by privilege under section 7525(a) lose that protection if they are made in connection with the promotion of the participation of the taxpayer in a "tax shelter." In that context, the courts have described the "tax shelter" definition as "broad." *See Valero Energy Corp. v United States*, 103 AFTR 2d 2009-2683, 2009-2687 (7th Cir. June 17, 2009) (citing *United States v BDO Seidman, LLP*, 492 F.3d 806, 823, 100 AFTR 2d 2007-5052, 2007-5063 (7th Cir. 2007)). We do not believe that it is (or should be) the intent of Congress to apply a "strict liability" penalty to a "broad" class of cases.

plan or arrangement is not to avoid or evade Federal income tax if that partnership, entity, plan or arrangement has as its purpose the claiming of tax benefits in a manner consistent with the statute and Congressional intent." The next sentence goes on to say: "A partnership, entity, plan or arrangement may have a ***significant purpose*** of avoidance or evasion even though it does not have the principal purpose of avoidance or evasion under this paragraph (b)(10)." (Emphasis added.) This language does not foreclose the possibility that a transaction that is being reported consistently with the Code and with Congressional intent could still have a "significant purpose of tax avoidance."[26] We think such an interpretation would be misguided, and was not intended by the drafters, since claiming tax benefits consistent with the statute and Congressional intent should not be considered tax avoidance or evasion. However, neither Treasury nor the courts have clarified this question.

Comparison to Reportable Transaction Understatements

As described above, a "reasonable cause and good faith" exception under Code section 6664(d) does exist under current law to the imposition of the Code section 6662A penalty for reportable transaction understatements, so long as three additional requirements (disclosure, substantial authority, and "reasonable belief that more likely than not") are met. Enactment of the proposed "strict liability" penalties would result in an anomaly, under which the penalty rules for noneconomic substance or similar transactions, or tax shelters, would differ depending on whether the transactions were also reportable transactions.

Understatements attributable to reportable transactions -- including listed transactions, the great bugaboo of our modern tax law -- that also happened to be noneconomic substance and similar transactions or "tax shelters" would not be subject to the Code section 6662 penalty. Accordingly, the new denial of the Code section 6664(c) "reasonable cause and good faith" defense (which is applicable only to the section 6662 penalty) would thus be irrelevant to them. Rather, such understatements would remain subject to the Code section 6662A penalty, and the escape hatch of the Code section 6664(d) "enhanced reasonable cause and good faith" defense would still be open, if the taxpayer could meet the five requirements of that section. On the other hand, understatements attributable to noneconomic substance and similar transactions and "tax shelters" that did not rise (or fall) to the level of reportable transactions would be subject to the section 6662 penalty, with no possibility for any defense at all. We assume this is a drafting oversight. In our view, however, if the Code section 6664(d) "enhanced reasonable cause and good faith" defense is considered to be sufficiently circumscribed as to be appropriate in the case of understatements attributable to listed (and other

---

[26] It is unclear from the regulations whether the second quoted sentence is intended simply to make clear that a "significant" tax evasion purpose can exist even if it does not rise to the level of a "principal" purpose -- that is, whether it focuses simply on the quantum of tax evasion purpose -- or whether it is intended to imply that there can be a tax avoidance or evasion purpose even where the purpose of an arrangement is the claiming of tax benefits in a manner consistent with the statute and Congressional intent. The preamble to the regulations does not explicitly address this issue, but could be read to imply that the latter is possible. The latter view, which suggests an extremely broad range for the concept of "significant purpose" is also found in "Tax Analysts Obtains IRS OPR Outline for Circular 230 Practitioner Phone Forum," *Doc 2005-13608, 2005 TNT 120-20* (June 22, 2005), discussed in N. Giesselman, *A Significant Problem Defining a "Significant Purpose" and the Significant Difficulties That Result*, Tax Notes, June 5, 2006, page 1123.

reportable) transactions, the rules applicable to other noneconomic substance and similar transactions and "tax shelters" should be no more onerous.

Rules for "Large or Publicly Traded Persons" Are Inappropriate

The Health Act contains special rules that would deprive a "specified person" with a substantial understatement of income tax of the ability to invoke any of the existing defenses ("substantial authority," "disclosure plus reasonable basis," and "reasonable cause and good faith") to the Code section 6662 penalty. However, no penalty would be imposed with respect to the portion of any understatement "which is attributable to any item with respect to which the taxpayer had a reasonable belief that the tax treatment of such item by the taxpayer is more likely than not the proper tax treatment of such item."

A "specified person" is any person required to file periodic or other reports under section 13 of the Securities Exchange Act of 1934 and any corporation with gross receipts in excess of $100,000,000 for the taxable year involved. All persons treated as a single employer under Code section 52(a), relating to "controlled groups of corporations," are treated as one person for purposes of the $100,000,000 gross receipts test.

We assume that the argument in favor of this proposal is that "large" taxpayers are likely to be both aware of the need for sophisticated tax advice in connection with the preparation of their tax returns and able to pay for such advice, and that it is thus appropriate to hold them to a higher standard of reporting. However, "large" taxpayers are also more likely (than "smaller" taxpayers) to engage for non-tax reasons in complex transactions the consequences of which are not clearly established by existing law. Moreover, courts in recent years have closely scrutinized taxpayers' defenses against penalties and have taken into account the sophistication of the taxpayer in question, holding more sophisticated taxpayers to what is in effect a higher standard.[27] We do not believe that it is appropriate to penalize taxpayers, whether sophisticated or not, for taking good faith positions, supported by reasonable authority,[28] in non-abusive cases. Accordingly, we do not support this proposal.

We also note that taxpayers filing reports under section 13 of the Securities Exchange Act generally must include therein financial statements in which reserves for tax liabilities are computed in accordance with FIN 48, under which a reserve for the entire amount of a tax return position must be maintained until the position is "more likely than not" correct,[29] thereby providing a check against over-aggressive tax reporting. As a result, a taxpayer that cannot convince its auditors that a position it intends to take on its tax return satisfies that standard must immediately reduce its financial statement income by the full amount of tax that

---

[27] *See, e.g., Larson v. Commissioner*, T.C. Memo. 2008-187 ("not a sophisticated taxpayer" and not penalized); *Smith v Commissioner*, T.C. Memo. 2007-368 ("sophisticated and successful" taxpayer penalized).

[28] Or good faith, disclosed positions, supported by a "reasonable basis."

[29] See FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes: an interpretation of FASB Statement No. 109, No. 281-B (June 2006), ¶¶ 6, 10.

would be owed if the taxpayer litigated the issue and lost. It is our experience that taxpayers filing reports under section 13 are highly conscious of the need to set aside tax reserves for questionable positions, and that the accounting rules serve as an additional – and in some cases, the most compelling – reason for such taxpayers to avoid tax positions that do not have substantial justification under the law. We do not believe it to be a productive use of the time and resources of taxpayers, the Internal Revenue Service, or the courts to engage in disputes over whether the "more likely than not" determinations made by the taxpayer in connection with preparation of its financial statements were, in fact, reasonable.

If a "large taxpayer" rule is to be adopted, we acknowledge the need to apply some sort of "controlled group" test in that context. Taxpayers can often take advantage of the ability to conduct business through a multiplicity of entities in order to come below various numerical thresholds set out in the Code, and, in those cases, use of a "controlled group" concept is important to prevent avoidance of important substantive principles. Moreover, taxpayers, at the time that they are affirmatively planning and implementing transactions, can -- at least in many cases -- be fairly charged with the duty of inquiring into the affairs of business entities under common control. Accordingly, in those sorts of cases, the burdens of expense to the taxpayer in investigating the financial and tax attributes of other business entities at the time a transaction is implemented and reported, expense to the Government in examining the affairs of other business entities in order to insure that the taxpayer has properly computed its own taxable income, and intrusiveness (and, in some cases, loss of legitimate tax benefits that would have been enjoyed on a "separate company" basis) to the shareholders and management of entities that may have no connection to the transaction at issue can perhaps be justified.

However, use of the section 52 "controlled group" concept gives rise to certain technical concerns. For example, if the Internal Revenue Service were to assert a substantial understatement of income tax penalty against a corporation which itself had less than $100,000,000 in gross receipts and the corporation wished to assert a "substantial authority" or "disclosure plus reasonable basis" defense to the penalty (or a "reasonable cause and good faith" defense that was not based on "reasonable belief that more likely than not"), the taxpayer would have to produce evidence negating the possibility that the gross receipts of any other corporations considered to be members of its Code section 52 "controlled group" could drive the taxpayer over the $100,000,000 threshold. Such evidence could be difficult for the taxpayer to obtain in any case in which the members of the "controlled group" were not in fact under common management and, in the absence of a full-blown examination of those other corporations, difficult for the Service to evaluate; moreover, if the dispute between the taxpayer and the Service found its way to court, litigation over this sort of issue could easily distract the parties and the court from focusing on more substantive matters.

On the other hand, the Health Act does not deal explicitly with situations, likely to arise on a frequent basis, involving the computation of gross receipts of corporations that are partners in partnerships or other pass-thru entities. Accordingly, we suggest that the application of the Code section 52 "controlled group of corporations" rules be narrowed so that it does not apply to cases where members of the "controlled group" are not under common management, but that the Secretary of the Treasury be granted explicit authority to prescribe Regulations

governing the computation of gross receipts in the case of corporations that hold investments in pass-thru entities and in the case of corporations filing consolidated returns.

Alternatives

We recognize that penalties are an important tool to encourage voluntary compliance in our system of self-assessment, particularly in the case of transactions that may be strongly tax-motivated. We also believe that both administration of the tax system and fairness are served by providing taxpayers with incentives to disclose their questionable tax positions, particularly in cases where there is no "right" answer. As the two factors that are generally considered to affect the deterrent value of a penalty are its severity and the certainty of its imposition, we suggest the following, in lieu of the "strict liability" proposals of the Health Act:

1. A comprehensive study of the impact of the penalties imposed by current law on taxpayers, promoters, and return preparers be conducted, with the goal of rationalizing the system and eliminating anomalies that have arisen over the years through piecemeal legislation.[30]

2. Pending completion of such a study, in order to provide focus to the Internal Revenue Service and the courts in their application of the "reasonable cause and good faith" defense in the case of "tax shelter" transactions, the Code should state explicitly that, in the case of such transactions, the standards now contained in Treasury Regulation section 1.6664-4(f) apply.

3. If, pending completion of such a study, it were considered necessary to make temporary adjustments to the existing rules, the rate of the Code section 6662 penalty might be increased -- perhaps to 30% (the rate now applied to nondisclosed reportable transaction understatements) -- in the case of **undisclosed** "tax shelters," so long as the "reasonable cause and good faith" defense was retained in such cases.[31] (The same would be true in the case of noneconomic substance and similar transactions, if it were determined to enact the proposed codification of the "economic substance" doctrine and to have special penalty rules for such transactions.) While we are not economists and are thus unwilling to attempt to predict precisely what percentage of compliance would be achieved by such

[30] The ABA Statement of Policy Favoring Reform of Federal Civil Tax Penalties, 2009 TNT 75-25 (April 21, 2009) would provide a useful framework for beginning this process. We note that the AICPA also has recently recommended civil tax penalty reform. American Institute of Certified Public Accountants, *Report on Civil Tax Penalties. The Need for Reform* (Aug. 28, 2009).

[31] As noted above, we feel strongly that it is important to retain an incentive in the penalty structure that will encourage taxpayers to disclose transactions having ambiguous tax consequences. Accordingly, we would be opposed to an increase in penalty rates, even if restricted to "tax shelter" and similar transactions, that punished underpayments attributable to disclosed transactions as onerously as underpayments attributable to undisclosed transactions. If penalties were increased for transactions of the kind described in the text, although we would continue to be concerned about the broadness and ambiguity of the definitions of the classes of transactions that would be subject to this increased penalty level, our concern would be greatly mitigated by the availability of a defense in appropriate cases.

an increase, our anecdotal experience in counseling our clients leads us to believe that such an increase would have a significant deterrent effect, without punishing taxpayers whose behavior was not objectionable.

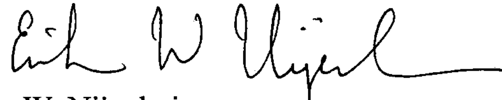
4. Outside the context of "tax shelters," the "substantial authority" and "disclosure plus reasonable basis" defenses should be retained at this time. Similarly, either the "reasonable cause and good faith" defense – or, at a minimum, the "enhanced" reasonable cause and good faith defense – should be available for all transactions.[32]

5. Funding for the Internal Revenue Service should be maintained at levels that taxpayers perceive that there is a significant likelihood that their returns will be selected for audit.

* * *

We appreciate your consideration of our comments. Please let us know if you would like to discuss these matters or if we can assist you in any other way.

Respectfully submitted,



Erika W. Nijenhuis
Chair

cc: Thomas Barthold
Chief of Staff
Joint Committee on Taxation

John L. Buckley
Chief Tax Counsel (Majority)
House Ways and Means Committee

Cathy Koch
Chief Tax Counsel (Majority)
Senate Finance Committee

Michael Mundaca
Acting Assistant Secretary
for Tax Policy
Department of the Treasury

Joshua Odintz
Tax Legislative Counsel
Department of the Treasury

---

[32] We note that under current law, the rules applicable to tax shelters provide no incentive for a taxpayer to disclose its position, because the only defense is the enhanced reasonable cause and good faith defense. While the purpose of this letter is not to propose changes to current law, we suggest that the penalty study recommended above consider whether these rules should be modified to provide taxpayers with a reason to disclose their tax shelter positions.

Mark Prater
Chief Tax Counsel (Minority)
Senate Finance Committee

Jon Traub
Chief Tax Counsel (Minority)
House Ways and Means Committee