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PENALTY AND INTEREST PROVISIONS IN THE INTERNAL REVENUE CODE

HEARINGS

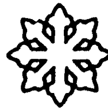
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

MARCH 8 AND 9, 2000



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CONTENTS

MARCH 8, 2000

Opening Statements

	Page
Roth, Hon. William V., Jr., a U.S. Senator from Delaware, chairman, Committee on Finance	1
Moynihan, Hon. Daniel Patrick, a U.S. Senator from New York	3

Administration Witnesses

Talisman, Jonathan, Acting Assistant Secretary for Tax Policy, Department of the Treasury, Washington, DC	4

Congressional Witnesses

Paull, Lindy, chief of staff, Joint Committee on Taxation, Washington, DC	10

Public Witnesses

Faber, Peter L., partner, McDermott, Will & Emery, New York, NY	25
Kies, Kenneth J., managing partner, Washington National Tax Services, PricewaterhouseCoopers, LLP, Washington, DC	27

MARCH 9, 2000

Opening Statements

Roth, Hon. William V., Jr., a U.S. Senator from Delaware, chairman, Committee on Finance	35
Moynihan, Hon. Daniel Patrick, a U.S. Senator from New York	35

Public Witnesses

Akin, Judith, enrolled agent, National Association of Enrolled Agents, Oklahoma City, OK	36
Lifson, David A., chair, Tax Executive Committee, American Institute of Certified Public Accountants, New York, NY	38
Sax, Paul J., chair, Section of Taxation, American Bar Association, San Francisco, CA	40
Scarborough, Robert H., chair, Tax Section, New York State Bar Association, New York, NY	42
Shewbridge, Charles W., III, president, Tax Executives Institute, Inc. and Chief Tax Executive, BellSouth Corporation, Atlanta, GA	44
Olson, Nina E., executive director, Community Tax Law Project, Richmond, VA	53
Ernst, Mark A., president and chief operating officer, H&R Block, Inc., Kansas City, MO	55

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Akin, Judith:	
Testimony	36
Prepared statement	61
Coverdell, Hon. Paul:	
Prepared statement	66

	Page
Ernst, Mark A.:	
Testimony	55
Prepared statement	66
Faber, Peter L.:	
Testimony	25
Prepared statement	86
Kies, Kenneth J.:	
Testimony	27
Prepared statements	90
Lifson, David A.:	
Testimony	38
Prepared statement	111
Moynihan, Hon. Daniel Patrick:	
Opening statements	3, 35
Letter from Lawrence Summers	133
Letter from Erwin Griswald	136
Olson, Nina E.:	
Testimony	53
Prepared statement	137
Paull, Lindy:	
Testimony	10
Prepared statement	143
Roth, Hon. William V., Jr.:	
Opening statements	1, 35
Sax, Paul J.:	
Testimony	40
Prepared statement	199
Scarborough, Robert H.:	
Testimony	42
Prepared statement	209
Shewbridge, Charles W., III:	
Testimony	44
Prepared statement	212
Talisman, Jonathan:	
Testimony	4
Prepared statement	232
Responses to questions from Senator Mack	246

COMMUNICATIONS

Ceridian Corp.	249
Coalition for the Fair Taxation of Business Transactions	252
Coalition of Service Industries	255
Hyatt, Gil	259
Nilles, Kathleen M., Esq.	267
Tax Fairness Coalition	271
Washington Counsel, P.C.	280

PENALTY AND INTEREST PROVISIONS IN THE INTERNAL REVENUE CODE

WEDNESDAY, MARCH 8, 2000

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:08 a.m., in room SD–215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators Grassley, Hatch, Moynihan, Baucus, Breaux, and Robb.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will please be in order.

Throughout the extensive IRS investigation and oversight hearings this committee began more than 2 years ago, it became clear that one of the issues in need of serious attention is that of interest and penalties.

There is no question that the appropriate use of interest and penalties as incentive for tax compliance is important to good management and in the best interests of taxpaying Americans.

However, I know many on this committee, myself included, who are alarmed to learn that in the last two decades, the kind of penalties that could be applied to taxpayers have increased from 13 to well over 120.

At the same time, there has been a change in the interest structuring from simple interest on the original amount of delinquent taxes owed to interest that compounds daily, not only on the delinquent tax, but on the penalties as well.

The result of this has been that, inside two decades, dollars assessed in penalties have increased over ten-fold, and interest owed on taxes and penalties has more than doubled original liabilities. Many taxpayers are hit by aggressive assessments that pile several different penalties on top of a single delinquency.

This current state of affairs is the responsibility of Congress. In the 1980's and 1990's as concerns grew about the deficit and the need to put more money in the Treasury, Congress looked to penalties and interest as a way to raise revenue without raising taxes.

At the same time, the complexity in the Tax Code grew, creating a veritable mine field, where one agency employee stated that mistakes leading to the assessment of penalties and interest could be found in up to 99.9 percent of all returns.

While necessary to promote compliance, penalties and interest, some suggest, have gotten so out of hand that they actually thwart compliance by placing taxpayers under such a financial burden of unpayable assessments that individuals and companies either do not pay, fall out of the system, or claim bankruptcy for protection.

This is not the intent of Congress, and these problems, to the extent they exist, must be fixed. The IRS restructuring and reform legislation included a series of provisions relating to penalties and interest, and we knew at the time that our penalty and interest system needed a comprehensive overhaul.

Due to the need, Congress required Treasury and Joint Tax to each conduct studies and provide recommendations on penalties and interest in the Internal Revenue Code. These studies were due last July. The Joint Tax Committee completed its report on time and we received Treasury's report last October before Congress adjourned.

With these reports and information we gathered during the course of this hearing, we must take a comprehensive look at the penalty and interest problem. We can consider it a blessing that, as we enjoy budget surpluses, we also have the opportunity to provide real and meaningful reform.

The purpose of the hearing today is to hear testimony regarding the Treasury and Joint Tax penalty and interest reports and recommendations. Our hearing will also discuss the corporate tax shelter issue within the context of a penalty and interest system.

I believe that corporate tax shelters are a serious problem. The question is, how do we constructively fix it in a manner that does not unduly affect legitimate business transactions?

Since becoming chairman of the committee, I have worked diligently to shut down specific abusive transactions and will continue to do so in the future. The reason why is simple. Corporations that abuse the laws to shelter their income from taxation place an unfair burden on the backs of individual taxpayers, our families, and small businesses.

To remedy this, we must find a workable legislative solution. While there may be reasonable differences over definitions and specifics, I believe legislation should contemplate the following three issues.

First, there should be transparency through enhanced disclosure of abusive transactions by promoters and taxpayers. Second, Congress should look at when a taxpayer may rely on a tax opinion. Third, Congress should consider methods to discourage promoters and advisors of corporate tax shelters.

The IRS and Treasury must be held accountable. They are responsible for enforcing current law. Congress is serious about addressing problems. In 1997, Congress passed a law requiring promoters of confidential tax shelters to disclose the transaction.

The law would become effective when Treasury issued guidance. That was well over 2 years ago. It was only last week that the Treasury issued necessary guidance to allow the law to take effect. Now, I do not know why it took 2 years, but I intend to raise this question in these hearings.

We will begin that today as we also consider the need to address penalties and interest in the Tax Code. Towards finding real remedies, I look forward to a strong and willing bipartisan effort.

Senator Moynihan?

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Mr. Chairman, I think I can assure you that you will have the support of this side in these matters, as you have had for the last several years.

I think your point about transparency is elemental, particularly as we commence to find that there is a small industry growing up of people who devise tax shelters which are inexplicable to anyone save Lindy Paull.

I have a letter, sir, and I believe you do, too, from Secretary Summers about this morning's hearings. He says, "As you begin discussing the very important topics of corporate tax shelters and the penalty and interest regime in the Internal Revenue Code, I wanted to share some brief thoughts with you regarding corporate tax shelters."

He goes on and concludes, "The point I would like to make is simple. Specific statutory patches, regulations, administrative actions, and court victories, while enormously helpful, are not enough. Corporate tax shelter activity continues to proliferate.

"As you know, the administration has put forward in the fiscal 2001 budget legislative proposals aimed at curtailing corporate tax shelters.

"The details and rationale for these budget proposals are contained in the testimony being presented today by Acting Assistant Secretary Talisman." Might I interrupt to say, simply, welcome to our former Chief Tax Counsel in his first appearance before the committee.

The Secretary concludes, "We look forward to working with Congress to pass laws that will address this problem which I believe to be of great importance. Failure to address this issue in a meaningful way would put the fairness and efficacy of our tax system at risk."

That is no small statement, sir. I think it supports what you have said.

The CHAIRMAN. I would only make one comment. I do find the thrust of the statement a little peculiar, in light of the fact that it took 2 years to issue the regulations to put in effect the requirements of disclosure.

Senator MOYNIHAN. Perhaps we can hear from our witnesses on that. Perhaps we can put the full text of the Secretary's letter into the record.

The CHAIRMAN. Yes. Without objection.

[The letter appears in the appendix at page 133.]

The CHAIRMAN. It is now my pleasure to introduce our first panel of witnesses, who of course are very well known to us. We are delighted to have you before us. Mr. Jonathan Talisman, who is Acting Assistant Secretary for Tax Policy for the Treasury Department and, of course, as Senator Moynihan pointed out, was his chief tax counsel.

We are also very pleased to introduce Lindy Paull, who is chief of staff of the Joint Committee on Taxation. Before that, she, of course, was chief of staff of the Finance Committee.

It is a pleasure to welcome both of you. Your written statements will be included in the record, and we will start with you, Mr. Talisman, please.

STATEMENT OF JONATHAN TALISMAN, ACTING ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. TALISMAN. Thank you very much, Mr. Chairman. Mr. Chairman, Senator Moynihan, and members of this committee, it is a privilege for me to return to my roots and appear before you today.

When I worked for Senator Moynihan and sat through several hearings, I aspired to sit some day on this side of the rostrum before the committee. Now that I am here, I am not really sure why that was. [Laughter.]

I want to thank the Chairman for holding this hearing and am pleased today to discuss our penalty and interest study, as well as the problem of corporate tax shelters, and the Administration's proposals to address this important problem.

Let me begin with the proliferation of corporate tax shelters, a problem that affects the integrity of the tax system, and we believe merits immediate legislative attention.

When we started working on our corporate tax shelter white paper late in 1998, our goal was to raise awareness that there was a problem and to explore the nature of the problem. Now it is clear that there is widespread agreement and concern among tax professionals that the corporate tax shelter problem is large and growing.

For example, in testimony last year, the American Bar Association noted its "growing alarm" at the aggressive use by large corporate taxpayers of tax products that have little or no purpose other than the reduction of Federal income taxes. The staff of the Joint Committee, the New York State Bar Association Tax Section, TEI, and others have echoed those comments.

Why are we concerned? First, these tax shelters, frequently sold as products off the rack to produce a substantial reduction in a corporation's tax liability, erode the corporate tax base and thus raise the tax burden on other taxpayers.

Second, as the New York State Bar recently noted, "the corrosive effect of tax shelters breeds disrespect for the tax system, encouraging responsible corporate taxpayers to expect this type of activity to be the norm, and to follow the lead of other taxpayers who have engaged in tax advantage transactions."

This so-called race to the bottom, if unabated, will have long-term consequences to voluntary compliance, far more important than the short-term revenue loss we are currently experiencing.

Third, shelters complicate the Tax Code by forcing legislators to take remedial action. In the past few years alone, nearly 30 narrow statutory provisions have been adopted in response to abuses, further complicating the Code.

Finally, significant resources, both in the private sector and the government, are currently being wasted on this uneconomic activity. To date, attacks on corporate tax shelters have been targeted

at specific visible transactions and have occurred on an ad hoc, after-the-fact basis through legislative proposals, administrative guidance, and litigation.

It is suggestive of the scale of the problem that specific shelters that have been addressed over the last few years were estimated to have cost, collectively, close to $80 billion over 10 years.

For example, Congress recently passed a provision to eliminate the ability to avoid corporate level tax through the use of liquidating REITs. This provision was estimated, by itself, to have saved the tax system upwards of $30 billion over the next 10 years.

Mr. Chairman and the committee, we very much appreciate these efforts to promptly address specific corporate tax shelters that we or others have brought to your attention.

At the same time, the Treasury Department and IRS have taken a number of administrative actions to address corporate tax shelters. On the regulatory front, we have issued guidance on so-called step-down preferred stock transactions, lease strips, and foreign tax credit abuses.

We recently brought to light lease-in, lease-out transactions, or so-called LILO schemes. These transactions, through circular property and cash flows, purportedly offered participants millions of dollars in tax benefits with no real economic risk.

In these transactions, a U.S. multinational leased a town hall from a Swiss municipality, and then immediately leased it back to the municipality solely to produce tax benefits. This is surely odd on its face.

Most recently, we have closed so-called BOSS transactions and debt straddles, two tax engineered structures designed to produce artificial tax losses that could be used to offset other income without any economic risk to the participants.

Finally, we have won several important tax shelter cases after many years of litigation. What you find over time, however, is that addressing tax shelters transaction by transaction is like attempting to slay the mythological Hydra; you kill one over here, and two or three more appear over there.

We have shut down so-called "chutzpah trusts," which were similar to a structure shut down by Congress in 1997. The BOSS transaction that we shut down was a derivation of the Section 357(c) product previous addressed by this committee in legislation.

Promoters continue to search for defects in the Code to exploit, and taxpayers with an appetite for tax shelters will simply move on to new transactions.

Thus, it is our belief at Treasury that this after-the-fact, ad hoc approach is no longer tenable. Rather, a more global approach must be adopted to address these abusive tax engineered transactions before the fact to prevent most from occurring.

This requires that the tax shelter cost benefit analysis be changed in a manner that affects the dynamics on both the supply and demand side of this market, making it a less attractive one for all participants, merchants of abusive tax shelters, their customers, and those who facilitate the transactions.

The Treasury Department believes this global solution should include four mutually reinforcing parts: (1) increasing disclosure of corporate tax shelter activities; (2) administrative reforms within

the IRS and strengthened rules governing the practice of accountants and lawyers before the IRS; (3) new legislation to strengthen and better coordinate requirements and to increase penalties for abusive transactions, and to codify the economic substance doctrine; (4) providing consequences to all the parties to the transaction, promoters, advisors, and tax-indifferent accommodating parties.

Treasury and the IRS have come to understand new tax shelters only by capturing them on audit, picking up reports in the trade press, receiving anonymous tips, and finding irregularities on tax returns.

Obviously, what we see, we act upon. However, by definition, what we cannot see, we cannot act upon. Thus, a central element of our approach in curbing tax shelters is bringing these transactions to light and taking remedial action where appropriate.

To this end, Treasury and the IRS last week issued three new regulations to bring more corporate tax shelters into the open. By requiring companies to disclose any transactions that significantly reduce their liabilities, these guidelines will enhance disclosure and deter abusive shelters. They will not impose a burden on taxpayers engaging in legitimate transactions.

The second element of our approach is to increase the capacity of the IRS to act on this crucial issue and to enhance the capacity for self-regulation. As you know, under the leadership of Commissioner Rossotti, the IRS is undergoing a substantial restructuring to refocus the IRS along functional, as opposed to geographic, lines.

This restructuring will concentrate IRS resources relating to corporate tax shelters, enabling it to identify, focus on, and coordinate its efforts against corporate tax shelters in a more efficient manner while instituting and maintaining appropriate taxpayer safeguards.

For example, to prevent interference with legitimate business transactions, examining agents will refer corporate tax shelter issues to a centralized office of tax shelter analysis for consideration. We are also in the process of establishing a procedure whereby taxpayers could obtain an expedited ruling from the IRS regarding affected transactions.

The IRS, however, cannot be asked to shoulder the entire burden of compliance. If we are serious in our intention of curbing abusive shelters, we need to place more emphasis on professional conduct of those who participate in the industry.

To enhance self-regulation and compliance we are planning, within the next 6 months, to issue an updated version of Circular 230, the professional guidelines on conduct for those who practice before the IRS. This may include sanctions on firms that issue opinions on tax shelters, limits on contingent fee arrangements, and heightened opinion standards.

Our administrative efforts to require disclosure and to raise standards are important and necessary steps, but we do not believe they alone are sufficient. Disclosure only deters if abuse has consequences.

It is right that we require companies to disclose tax shelters in their IRS statements, but those companies need an incentive to comply with the new guidelines. That is why we are proposing leg-

islation in the budget that will give us greater tools to deter and to pursue the abusive shelters.

First, there must be effective disincentives to stop companies from violating reasonable standards of disclosure. These include a penalty of $100,000 for each failure to disclose a transaction with features common to corporate tax shelters, raising the penalty for substantial understatement from 20 to 40 percent where a taxpayer statement does not disclose a corporate tax shelter, and eliminating the reasonable cause exception for undisclosed transactions.

Second, we should impose penalties on the related entities. The creation of abusive shelters is a sophisticated process that encompasses a broad range of interested parties beyond the companies themselves.

These include the tax-indifferent entities such as foreign corporations, the promoters of shelters, and entities that profit from providing advice. Our proposals must, therefore, include measures to deter third parties from involvement in abusive shelters.

Third, we believe that the economic substance doctrine must be codified. It is surely more difficult, yet fundamental, that taxpayers be required to apply the doctrine and perform a careful analysis of the pre-tax effects of a potential transaction before they enter into it.

Let me be clear. This is not a new standard, but rather is intended as a coherent articulation of the economic substance doctrine first found in seminal case law such as *Gregory* v. *Helvering* and most recently utilized in cases such as *ACM*, *COMPAQ*, and *Winn-Dixie*.

The guiding principle of economic substance is that taxpayers should not be allowed to derive benefits from transactions that have no meaningful economic purpose, where the tax benefits from a transaction significantly outweigh any pre-tax profits.

Codification of the doctrine would bring a number of improvements. It would create a consistent standard so that taxpayers may not pick and choose between conflicting decisions to support their decision. It would also isolate the doctrine from the facts of cases so that taxpayers cannot simply distinguish the case before them based on the facts of the case that the court has ruled on.

In closing my discussion of corporate tax shelters, I would like to emphasize the substantial levels of similarities between the Treasury Department's proposals and other proposals to curb corporate tax shelters.

For example, the staff of the Joint Committee on Taxation agrees that there should be increased disclosure by participants, increased penalties on understatements attributable to undisclosed transactions, and sanctions on other parties to the transaction.

The major difference between us and the JCT staff is that the JCT staff would not recommend codification of the economic substance doctrine. However, the JCT proposal does incorporate a version of our standard in identifying corporate tax shelters.

Moreover, as discussed more fully in our white paper, the ABA Tax Section and the New York State Bar Tax Section, and H.R. 2255, as introduced by Mr. Doggett, also share common recommendations.

Mr. Chairman, let me shift to the Department of Treasury's study and recommendations with respect to the penalty and interest provisions of the Internal Revenue Code.

It has been 11 years since the Congress has undertaken a comprehensive look at these important and fundamental pieces of our tax system, and we thank you for starting and continuing this dialogue.

The study conducted by Treasury, and its report issued on October 25, 1999, as you stated, were mandated by the IRS Restructuring and Reform Act of 1998. In developing our report, we solicited, received, and studied comments from the general public and consulted closely with the Service.

The staff of the Joint Committee and the Taxpayer Advocate also conducted similar studies and have made recommendations. Although there are differences among these recommendations, these differences are a matter of degree and there is general agreement on the importance of the role of penalties and interest in our tax system.

For the sake of brevity, I will not repeat all the material in the Treasury study. Rather, I think it is important to focus on the nature of the penalty and interest provisions, how they are different, why they are important, and what should be our goals. It is within this framework that the penalty and interest provisions of the Code should be evaluated.

First, penalties. In general, our income tax system is one of self-assessment that imposes three general requirements on taxpayers: to timely file their returns, to report the correct amount of tax owed, and to timely pay the amount due and owing. The penalty regime acts as an inducement for compliance with these basic requirements by providing sanctions for non-compliance.

We focused our study on the principal civil penalty provisions that affect large numbers of taxpayers, account for the majority of penalty assessments and abatements, and for which we received the most comments. These penalties are the failure to file and the failure to pay penalties, the estimated tax penalties, accuracy-related penalties, and the deposit penalties.

In evaluating these penalties, we are mindful that achieving a fair and effective system of compliance involves striking a balance that fosters and maintains the current high degree of voluntary compliance among the vast majority of taxpayers; second, encourages taxpayers who are not compliant to quickly resolve non-compliance problems with the IRS; and third, imposes an adequate system of sanctions that are fair to taxpayers whose non-compliance may be due to diverse causes that involve different degrees of culpability but do not impose substantial additional complexity or burden.

Achieving such a balance, unfortunately, is difficult because a system of sanctions that accounts for these differences has to be complex, but a system that does not make adequate distinctions may be unfair.

At the same time, compliant taxpayers, the vast majority of taxpayers, deserve a tax system that recognizes their compliance. There is no perfect system of sanctions, and striking the appropriate balance involves trade-offs among competing concerns.

Treasury's study and recommendations reflect an effort to strike a reasonable balance, understanding that there is no single solution and that different approaches can be formulated to achieve the same goals.

With respect to interest, we also examined the respective roles of penalties and interest in our tax system with a view toward maintaining an appropriate distinction between the two.

We believe penalties or sanctions is for non-compliant conduct, while interest is a charge for the use of forbearance of money. Treasury recognizes that current law does not always make a clear or consistent distinction between interest and penalties. Many taxpayers may view interest as a penalty, and many penalties have a time value of money element to them.

Recognizing the distinction between interest and penalties, however, is important in crafting legislation and regulations that impose and abate penalty and interest charges.

Penalty provisions should be designed to influence compliance, whereas, again, we believe that interest provisions generally should be designed to make parties whole with respect to overpayments and underpayments.

Penalties generally can be abated for reasonable cause and other statutorily prescribed reasons that reflect their function as a sanction. By contrast, the grounds for abatement of interest is, properly, more narrowly drawn.

Any legislation or regulations in support of this distinction may cause further confusion among taxpayers regarding the different roles of the penalty and interest provisions.

Treasury also is mindful of the ongoing IRS reorganization and the implementation aspects of the new taxpayer rights provisions of RRA 1998. Considerable guidance has been issued by Treasury and the IRS in the past year relating to a number of these new provisions, and the IRS is engaged in a major overhaul of its structure and systems, as directed by Congress.

Time is required for the impact of these new provisions to be evaluated, and certain of the new provisions affect IRS programs and the penalties and interest, such as the offer-and-compromise program, that provide avenues other than abatement for relief from monetary impositions.

I will leave for my written testimony discussion of our more significant legislative recommendations. I would like to close and say, Mr. Chairman, thank you for holding this hearing.

We strongly support a penalty and interest regime that fosters and maintains the current high level of compliance, provides appropriate costs and sanctions for non-compliance, and provides a reasonable and administrable degree of latitude for individual taxpayers' circumstances and errors. We believe the proposals made in our report strike an appropriate balance among these objectives.

I also would like to, again, reiterate that we believe that the proliferation of corporate shelters presents an unacceptable and growing level of tax avoidance. We have laid out our rationale for our approach.

We look forward to working with you and the members of the committee to address both of these important issues, and I would

ask that my written testimony be included in the record. Thank you.

The CHAIRMAN. Thank you, Jon. The full statement will be included as if read.

Lindy, it is always a pleasure to welcome you. We look forward to your testimony.

[The prepared statement of Mr. Talisman appears in the appendix.]

STATEMENT OF LINDY PAULL, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION, WASHINGTON, DC

Ms. PAULL. It is great to be back before the committee. Thank you, Chairman Roth, Senator Moynihan, members of the committee.

We appreciate the opportunity to present the Joint Committee staff recommendations on interest, penalties, and corporate tax shelters.

I think it is fair to say that our study, which was, again, just like the Treasury study, a comprehensive look at the penalties and interest provisions of the Tax Code, builds on the work of the IRS Restructuring Commission, and the work of this committee, and the Ways and Means Committee, that led to the 1998 IRS restructuring legislation.

We have prepared for this hearing two side-by-side comparisons of our staff recommendations and the Treasury Department recommendations that are before you today. One deals with penalties and interest in general, and the other one deals with corporate tax shelters.

I would like to focus my initial remarks on the interest and penalty provisions in general, first, then turn to corporate tax shelters, in essence, the opposite of what Mr. Talisman just presented to you.

I would say that our interest recommendations in our study are much more significant, in our view, than the recommendations of the Treasury Department, and I would like to highlight a number of items. It will be in the order of the side-by-side, if that is of interest, or in the order of my written testimony.

The first provision that I would like to highlight, is that our recommendation is for there to be one interest rate for underpayment and overpayments for all taxpayers.

This policy is, in essence, the policy that the Congress established in 1998, but only in a half way. One interest rate was established for individual taxpayers on their overpayments and underpayments, and then for other taxpayers, namely corporate taxpayers, there was an interest netting rule. If you had overlapping periods where you had an overpayment and underpayment, the interest would be zero.

That regime, in our view, will be very complicated to administer and we would recommend that you move towards one interest rate for all taxpayers and eliminate that interest netting provision.

We also make a recommendation that the interest rate be set at the short-term, applicable Federal rate, plus 5 percent. That was after a lot of looking at a variety of factors of interest rates in the

marketplace for various types of taxpayers. There is a lot of balancing that will go in to the setting of a single interest rate.

In addition, with respect to individual taxpayers, the present law is that interest paid to the IRS is not deductible, interest paid by the IRS on a refund is includable in income. In the interest of fairness and equal treatment, we would recommend that that interest income be excluded for individuals, since they cannot deduct.

If you were to restore a deduction, we fear that it would give unequal treatment because, generally, it would be restored as an itemized deduction. In order to get it, you would have to itemize.

In addition, we would recommend that the ability of the IRS to abate interest, the IRS has a significant amount of ability to abate penalties, very limited authority to abate interest, only basically in the case of an unreasonable error or delay caused by an administerial or managerial act. We would recommend that you expand that to any unreasonable error or delay that is caused by the IRS, and also provide relief in the case where a taxpayer has relied on a written IRS statement.

Also, provide some ability of the IRS to look at very unusual circumstances where, and we use the words gross injustice, would result. Give the Commissioner some authority to abate interest in those kinds of unusual circumstances.

We also recommend the establishment of a new dispute reserve account within the Treasury Department that would allow taxpayers to deposit money with the Treasury Department to stop the running of interest when they know they have an item that is going to be in dispute with the IRS.

As you know, during the IRS restructuring bill, the hearings that led up to it, there were a lot of complaints about the inability to stop the running of interest or the inability to get interest abated when it was not the taxpayer's fault.

A couple of more interest-related items. One, would be to convert the estimated tax penalty into an interest charge, and we have a number of specific recommendations to simplify the computation of the estimated tax penalty, or in the case recommendation, interest charge.

We would also recommend that the failure to pay penalty be eliminated with the idea that, if you can get the interest charge to be correct, this is just a penalty that doubles up on a taxpayer who has not paid their taxes.

With respect to penalties, we have a few proposals. One relates to the accuracy of tax return positions. Our recommendation is that the standards that would apply to tax return preparers be conformed to the standards that apply to taxpayers. Right now, there is a lesser standard for tax return preparers. We would also recommend that the standards for taxpayers and preparers be elevated somewhat.

There were a number of proposals that the Treasury Department made with respect to penalties, one dealing with the failure to file penalty, one dealing with the frivolous return penalty, and one dealing with the failure to deposit penalties.

We made no recommendations on those penalties because we did look at them, and in the case of the failure to file penalty, we

thought that it was the first step for anybody to know what their correct tax liability is, is to file a return.

While you may think that penalty is too high—it is 5 percent a month based on the amount due on the return—there is no penalty if there is nothing, no amount due on the return. The Treasury Department has a recommendation on that. They have a recommendation to increase the penalty on frivolous returns from 500 to 1,500, and a recommendation relating to the failure to deposit payroll taxes.

With respect to the latter on payroll tax penalties, we did not think it was appropriate to change. There was a change made in the 1998 Act to correct these problems when you underpay on one deposit, then it carries over, and over, and over again.

We thought, since the Congress has recently worked on that particular provision, that you should let the law be a little bit more stable rather than make some changes, but the Treasury has some recommendations in that area.

That highlights our general penalties and interest recommendations, and now I would like to turn to the corporate tax shelter issue.

As we have said in our report in our testimony before the Ways and Means Committee and here, we do believe there is a serious corporate tax shelter problem. We are unable to quantify that problem with any sort of precision, and we would caution the committee from using the various aggregate data that is kind of in the public domain that people are throwing around.

We have provided as an attachment to our testimony our baseline data with respect to corporate income tax collections and with respect to the measurement of corporate profits that most people would look at.

But if you were to take a hard look at that data, you would see that it is very difficult to extrapolate any trends from it. It is because there are many factors involved in the data, it is not just one single item. There are a lot of items and factors that go into making up that data.

I would also just note, some people have recently highlighted that one of the reasons that corporate income tax receipts were, in essence flat—they went down slightly last year over the year before—is because there were higher refunds and that that cannot be a problem, because the Joint Committee on Taxation reviews all refunds over $1 million.

We do not review all refunds over $1 million. If a refund is shown with respect to a tax return and we do hear that a lot of corporations are overpaying their estimated taxes, that would be included in any refund kind of computation, and in the aggregate.

We looked at our refunds in the aggregate that we have been looking at that have been sent to us for review, and we do not see any big jump-up in those refunds.

So it is very difficult to look at any of this data and get any sort of meaningful or precise number out of them in terms of quantifying the problem, not to mention that the data is old. There is a huge time lag in getting corporate income tax data.

We are monitoring, with the cooperation of the Treasury Department and the IRS, the kinds of enforcement activities that the IRS

is undertaking, and we have provided you with some information in my written testimony with respect to some of the cases that Mr. Talisman made reference to, and tried to quantify what we think is kind of a basic estimate on what the outstanding backload on those three cases are, the *ACM* case, the *COMPAQ* case, and the *Winn-Dixie* case.

Those are the kinds of similar cases that are in the pipeline. We think there is over $7 billion of those kinds of cases out there, but they span more than one year. That is not an annual, year figure, and they go back into the early 1990's. They are likely to be a small fraction of the tax-motivated transactions.

So I do not know how important it is to quantify the problem. Obviously, we have to do our best judgment when we estimate the proposals that are before the Congress. But the important thing is the overall impact on our voluntary tax system.

To the extent that there are these kinds of transactions out there—and as Senator Moynihan said there is a whole industry; I am not sure how small that industry is—that has grown out there to produce these tax-motivated transactions, the impact on our voluntary tax system is a real concern and so I appreciate that the committee is looking at that.

We argue, after taking as hard a look as we could, considering that we look at so many things, and we really think there is not a sufficient disincentive to entering into these transactions. We think that these kinds of transactions produce very significant potential benefits with very little corresponding cost or down side.

We come to that conclusion because, while there are penalties in the Tax Code, we believe that they are very easily gotten out of. Either you can produce some sort of a third party opinion that you rely on, or in the case of a very large corporation, you have a huge fudge factor. You have to have an understatement of over 10 percent of your tax liability.

So we believe that the penalty regime, under current law, really needs to be improved in order to make a dent on this problem. I would recognize that the problem is a multi-faceted one, and that no single response is going to get you there.

I mean, the strong enforcement that Mr. Talisman mentioned, with the new developments that have occurred recently with the IRS centralizing an office and these new disclosure regulations, are a good step.

The continued use by the Treasury Department of their anti-abuse authority to shut down transactions like they did last week on a debt straddle transaction is good, and they have to continue that.

I would disagree with Mr. Talisman that you will not need to continue having a legislative response to specific transactions; I believe you will. You have done a good job in the past of fixing Tax Code glitches, and you will have to continue to be diligent about that in the future.

I think the legislative response that is appropriate here, after a lot of consideration of the issue, is that the down side, the disincentive, the penalty, if you will, on taxpayers and their advisors needs to be strengthened.

I would ask you to proceed cautiously with respect to any substantive changes of the law that are broad, like this attempt to codify the economic substance doctrine that was developed by the courts. Of course, they use a whole laundry list of doctrines to go after transactions that do not look like they should pass muster.

They do not just use the economic substance doctrine, they use the sham transaction, they use the step transaction, they use a lot of techniques. It is very difficult to codify the notion here, because every one of these transactions are going to turn on various facts and circumstances. I think that it is necessary for this body of law to be fluid and to be flexible, and to be able to be adjusted as you need it.

I think, when you try to legislate, the net will be drawn very broadly, then you are going to have to do exemptions from it, so there will be big holes in that net, too. Of course you are going to exempt ordinary course of business transactions, but you also have to get into some of the concepts that the Treasury Department has gotten into.

You have to have an exemption for transactions that the Congress intended to be clearly tax motivated; their concept is clearly contemplated by the law. For example, the low-income housing tax credit. The economics of those kinds of transactions are made by the tax benefits.

If you look at the legislative history behind the low-income housing tax credit, there is not anything clear in there saying that we clearly intended or we clearly contemplated that the economics would be made by the tax benefits. So, what it ultimately leads you down the road to, is a list of good transactions.

You also will put an extraordinary amount of pressure on the notion of ordinary course of business and conducted in the customary form, if that is the way out of the economic substance doctrine.

So I would just caution you, in terms of codifying this case law. I think it will be very difficult to do. I think it will lead you down the road of a very broad concept with lots of exceptions, broad exceptions, and I am not sure what advantage it gets you, because the courts have been very good at stepping up to the plate and utilizing these types of notions when needed.

So just to summarize on the corporate tax shelter subject, I would agree with Mr. Talisman that our approach is very similar, with the exception of the codification of the economic substance doctrine.

That would be a substantive rule of law that would be put in the Tax Code and I think it would be very difficult to draft, and it would be subject to lots of exemptions over time.

That concludes my testimony. I welcome any questions, now or in the future, that you may have.

[The prepared statement of Ms. Paull appears in the appendix.]

The CHAIRMAN. Well, thank you very much for your testimony, Lindy.

Let me start out by pointing out that both Treasury and the Joint Tax recommend harmonizing the minimum accuracy standards for individuals and tax practitioners. Joint Tax would raise the standards higher than proposed by Treasury.

Mr. Talisman, why did Treasury not propose raising the standards to the level proposed by Joint Tax? Then, in turn, Lindy, is the Treasury proposal appropriate? Mr. Talisman?

Mr. TALISMAN. Well, I think, obviously, choices have to be made, policy choices. We felt that, given that the penalty provisions applied to individual taxpayers who may be less sophisticated, that taking the position up to a stronger position than just an arguable basis, but a reasonable possibility of success, was an appropriate means of raising the penalty. But we did not feel that we could hold individual taxpayers necessarily to a more likely than not standard, as in the Joint Committee report.

We do agree with the coordination, and I think we both agree with the coordination, between preparer penalties and taxpayer penalties because of the fact that we think it is anomalous that preparers should be held to a lesser standard than the people they are advising.

The CHAIRMAN. Ms. Paull?

Ms. PAULL. I would just characterize, probably, our greater difference has to do with undisclosed positions on tax returns. I mean, we do have a difference—it is somewhat subtle—with respect to disclosed positions. We would recommend that you have substantial authority, whereas, the Treasury Department has a realistic possibility of success, generally it is 40 percent versus one-third.

But on an undisclosed position, and this is where I think it is really important for the committee to focus, these are the more aggressive kind of transactions, are in undisclosed form on the returns.

Our view was that people ought to be kind of more sure than not about those kinds of transactions, because they are hiding them, so to speak. They are not flagging them for consideration by the IRS.

So I would say that is where our biggest difference is, is on the standard for undisclosed return positions. You ought to be filing correct returns, the best you know it.

The CHAIRMAN. Let me turn to page 125 of the Treasury "Green Book," where Treasury states that, "Taxpayers are disregarding the judicially created doctrine, such as economic substance, substance-over-form, step transaction, Sham transaction, and business purpose that would otherwise deny such benefits."

The "Green Book" further provides, "The economic substance doctrine is the most objective of the judicially created doctrines that operate to deny tax benefits from abusive transactions. As such, it is a doctrine that is most easily, objectively, and consistently applied by taxpayers and the IRS.

"The Administration's proposal is not intended to create a new doctrine, rather, it is intended to provide a coherent standard derived from the economic substance doctrine as enunciated in the body of case law, to the exclusion of less-developed, inconsistent positions."

Now, if this doctrine is the most objective doctrine that is easily and consistently applied by taxpayers and the IRS, why does Treasury want to change it? Despite your arguments, Treasury really is creating a new standard, is it not?

And if you change the standard, how will current law be affected? We, I think, heard Lindy make an extensive statement in

her opening on this problem, but we would be interested in any further comments she might want to make.

Jon?

Mr. TALISMAN. Chairman Roth, we believe that the economic substance doctrine has to be elevated so that taxpayers are applying it before the fact rather than waiting for years of litigation to have a court decide what the economic substance doctrine is.

What we are finding is that taxpayers are assuming away business purpose and economic substance in engaging in these transactions. The opinions often assume away these issues.

What we need to do is elevate the doctrine into the statute so that taxpayers will apply a meaningful economic substance doctrine to each tax-motivated transactions before they enter into the transaction.

As Tax Court Judge Laro recently acknowledged, while there may be an opportunity for the courts to make the economic substance doctrine more clear in case law, judges decide cases one at a time, and Congress should be making tax policy.

It is our view that what we need to do is espouse a consistent, clear articulation of the doctrine so that taxpayers can not rely on the lowest common denominator cases that basically say a mere peppercorn of economic substance is enough.

The CHAIRMAN. Lindy, would you like to comment further?

Ms. PAULL. I do not want to beat this horse too much, because I think that this is a really important issue. It is one that I think everybody needs to struggle with.

I would note, though, that what Mr. Talisman is saying is that, in essence, he is going to pick the highest court case standard, and that is the standard, maybe, that is going to be used. Maybe even the standard that both of us have embraced as a reasonable standard for determining economic substance might well be higher than most of the case law, I would just note.

Now, we embraced it for purposes of determining whether or not you would be hit by a penalty. The Treasury Department would embrace it for purposes of determining what your underlying tax liability is, and that puts a lot of pressure on it.

So I come down on the side where I think the courts do the rights things in the right cases, and cases tend to be facts and circumstances. We are dealing with very complicated transactions, and that is why these promoters and advisors get paid so much money for them. It is very hard to find one test that is going to catch them all.

Our staff did a lengthy kind of round table meeting of almost all of our professional staff, went through all of the transactions that the Congress has recently shut down and the administration has recently shut down in recent times, and analyzed them. We came up with five different tests. This is not any simple matter, let me just say.

Again, that is when we concluded that these tests would be more useful in determining, once the courts have found that the transaction did not work, that a penalty should be imposed on them rather than determining the underlying law.

The CHAIRMAN. Joint Tax requires an understatement before its proposal applies. What are Treasury's concerns with this approach?

Mr. TALISMAN. Well, again, under current law there are two reasons why corporate tax shelters could be proliferating, in a sense. One, is that taxpayers do not believe they have a substantial understatement to begin with, and the second, is that they are relying on the reasonable cause standard under section 6664 as a way out.

The Joint Committee and we both believe that the reasonable cause standard has to be strengthened, that there has to be strict liability for non-disclosed transactions. We believe that that will, at least, remove one of the two potential reasons for why corporate tax shelters are proliferating.

However, the substantial understatement penalty only applies to tax shelters and only is applied by taxpayers up front if they believe they have a substantial understatement.

If they are not applying the economic substance doctrine up front, they will go forward with the transaction. It is only after many years of litigation that we then can impose a sanction. Therefore, the sanction, the substantial understatement penalty, is not having its deterrent effect.

The CHAIRMAN. Lindy, do you have any comment?

Ms. PAULL. No, sir.

The CHAIRMAN. Let me ask this question. What safeguards are included in the Administrations proposal to ensure that IRS agents would not improperly apply Treasury's economic substance test? Should IRS auditors be required to have a reasonable basis for a tax shelter assessment? If not, why?

Mr. TALISMAN. Mr. Chairman, we have, as I stated in my testimony, created a centralized review process for these determinations. Because the IRS is being restructured along functional lines, it has enabled us to create a coordinated review process within the large- and mid-sized business unit for review of these tax shelter items in these tax shelter cases.

We believe that will provide a significant safeguard for taxpayers. It is similar to the approach we have applied in the partnership anti-abuse regulation area. We also would again provide advance ruling procedures and fast track procedures for resolution of cases.

As far as holding IRS agents culpable, because of the coordination effort and the fact that this has to be elevated to a higher level, we do not believe that that sort of step is necessary. Also, I would point out that the IRS has been winning the cases where they have been raising the economic substance doctrine.

Ms. PAULL. Mr. Chairman, I would just say that, as we recommended in our report to elevate the standards on tax return preparers and taxpayers, we also recommended that these standards be elevated for IRS agents as well.

The CHAIRMAN. Across the board then. My time is up.

Senator Moynihan?

Senator MOYNIHAN. Mr. Chairman, what a fine hour we have just had. I want to congratulate Acting Assistant Secretary Talisman on his maiden testimony, brilliantly carried forward, and Lindy Paull, as ever, for her wisdom and patience with the imperfect world.

I would call attention to the statement in Mr. Talisman's testimony of the New York State Bar Association. It says that, "The

constant promotion of these frequently artificial transactions breeds significant disrespect for the tax system, encouraging responsible corporate taxpayers to expect this type of activity to be the norm."

What they are saying, I think, Mr. Chairman, is that the law firms that would say to a client, no, you cannot do this, no, do not do this, they are finding the clients will go down the street to someone who says, we can work it out. Advise of counsel is being degraded as well.

There are some mysterious things going on, and I would like to ask Acting Assistant Secretary Talisman about this. The Joint Tax Committee reports that there has been a 2.1 percent drop in corporate tax receipts from 1998 to 1999. At the same time, there was a 3.6 percent increase in corporate income before taxes.

Now, that needs to be explained, does it not, sir? Those are the facts. What do you make of them?

Mr. TALISMAN. Well, again, if you are asking the question in relation to the corporate tax shelter problem, I think we agree with Lindy that it is very hard to isolate the corporate tax shelter problem from aggregate data.

The fact that corporate tax receipts fell is attributable to a number of circumstances, including increased investment, and probably the fact that compensation is growing at a faster level than other elements of corporate profits, so that can be explained.

However, we do not think the lack of the ability to separate out the aggregate data is also not indicative of a corporate tax shelter problem in that it certainly is consistent with the fact that book income is growing at a faster rate than tax income, that corporate tax shelters could be a growing problem based on that. We also, as we have stated, have shut down innumerable shelters over the last several years.

Senator MOYNIHAN. That is a very careful and prudent explanation, but may I caution against the word "innumerable?" There is a number, you just have not counted. That is all right.

Mr. TALISMAN. Fair enough.

Senator MOYNIHAN. One other thing, just topical. The New York Times reports that U.S. insurance companies have been moving to Bermuda to escape U.S. tax, and that U.S. companies that have not, or have not yet moved, are complaining that they are at a competitive disadvantage because the Bermuda companies are not subject to U.S. tax, even though they are reinsuring U.S. risks.

Should we be concerned about this, and if so, what should we do about it? Are we entering an era of, my goodness, corporate expatriation? Lindy, would you comment, and then would Acting Assistant Secretary Talisman? You have read the story.

Ms. PAULL. Yes, I did read the story. I think it is a matter of concern, certainly. I guess this is the issue dealing with the property and casualty insurance companies that are insuring U.S. risk. Basically, what you have is devices to locate their investment income in Bermuda or overseas, where they are underwriting losses occurring in the United States.

The investment of their assets and their investment income is a very movable kind of property, but it is hard to disconnect it from their other operations. In the case of reinsurance, that is even more

movable around the world; they get subject to a very small excise tax on their premiums relating to the U.S. operations.

So it is a matter of concern, and we have been meeting with some of these companies. I wish I had a solution for you. I cannot say that I do. But we have been looking at the issue and we will continue to look at it.

Senator MOYNIHAN. Yes. That is all we can ask.

Mr. Assistant Secretary?

Mr. TALISMAN. Senator, we agree that this is a problem that we are concerned about as well. The migration of income from the U.S. to Bermuda is something we are concerned about. It is similar to a concern we have expressed in the context of the active financing exception to Subpart F.

But I think we have to be cautious and be fairly clear about the nature and the scope of the problem before we address it. There are potential treaty override issues that we have to be concerned about, and we are currently meeting with the affected groups as well, and have met with the tax writing staffs as well, to hopefully come to some sort of common solution to the problem.

Senator MOYNIHAN. If you have any proposals for us, we will pass them on.

Ms. PAULL. All right.

Senator MOYNIHAN. I just want to thank you both. Mr. Chairman, I think there is an important bill here, not the least that you have to deal with in this Congress. But you have shown you can do it before, and you will do it again.

Thank you, both.

The CHAIRMAN. Thank you, Senator Moynihan.

Senator Breaux?

Senator BREAUX. Thank you, Mr. Chairman, Senator Moynihan, for once again having this hearing and helping us to learn more about the potential problem.

Just to start off with some generalities, are tax shelters legal or are tax shelters illegal?

Mr. TALISMAN. I think we would argue that they are illegitimate. Illegality is a term that does not apply very well to the tax area. I think we think it is improper tax avoidance. There could be situations where the transaction does rise to criminal behavior, but again, I would not attribute that to most of these transactions.

Senator BREAUX. If I follow the rules of the law that allowed me to create a tax shelter as the law specifies it be constructed, is that legal or is that illegal?

Ms. PAULL. Well, sometimes, Senator Breaux, what you do have are some of these transactions that are based upon a glitch in the tax law. As I mentioned in my testimony, this committee has addressed those kind of issues in the past, and will have to continue to address them in the future.

So, those kinds of transactions, to be honest with you, we would welcome the opportunity to get some sort of early warning about a glitch in the tax law, that you can rely on the law, produce a particular result in a transaction, but it was not what was intended when the law was done.

Senator BREAUX. Suppose I am a person down in Louisiana, and I am not a tax lawyer, but I have got a reasonably good education

and I read it. Am I supposed to know as a taxpayer that, well, I do not think that is really what Congress intended way up in Washington?

Mr. TALISMAN. But our system has an overlay of rules and standards. Again, there are these important established doctrines, the economic substance doctrine and step transaction doctrine. There are anti-abuse rules, obviously, throughout the Code that require taxpayers to apply these doctrines, as well as the defined rules that are in the Code.

Senator BREAUX. I was interested in that economic substance doctrine. I was just wondering, suppose an individual or a young couple starting out decides to buy a condominium and borrows most of the money to do so, and thereby creates an interest deduction which eliminates any income tax. Is that a shelter?

Mr. TALISMAN. I am not sure I follow your hypothetical.

Senator BREAUX. I just wanted to know, if a couple pays so much in interest that it offsets their income, they end up paying no taxes at all because they were able to make a real estate transaction which created high interest.

Mr. TALISMAN. Again, the interest deduction generally would be following from economics, so would not be subject to these doctrines.

Senator BREAUX. So that is all right then.

Mr. TALISMAN. Yes, that is correct. It would be all right.

Senator BREAUX. I am trying to understand the nature of the problem, too, because Senator Moynihan talked about the 2.1 percent drop in corporate income tax which alerted people that there may be a problem.

One of the gentlemen that will testify later, who used to wear the same hat as Lindy, but now wears a much more expensive hat, will point out that, since 1992, corporate Federal income tax payments have grown by 84 percent, from $100.3 billion in 1992 to $184 billion in 1999, and that corporate income taxes in fiscal year 1999 were 10 percent of the total Federal receipts, which were higher than the average 9 percent for the previous 1981–1999 period.

Is this 1 year an anomaly? You had talked, I think, Jon, about it, maybe because of corporate salaries, depreciation, investment. Is that it, potentially?

Mr. TALISMAN. Looking at aggregate data to try and ascertain the scope of the shelter problem is difficult. There are indications, however, despite the growth in corporate tax receipts, corporate tax receipts are not growing at the same rate, generally, as, book income.

So book income and taxable income are not growing at a consistent rate. It is hard to correlate those aggregate data with corporate tax shelters. What we have done is disaggregate one of the potential causes of that growth, which is the difference between book and tax depreciation, and that is relatively flat so that that would not be one of the causes. However, the only thing we can say is that the difference between book and tax income is consistent with a growth in corporate tax shelters.

Ms. PAULL. Senator Breaux, just to interject a little bit. We only have underlying data up to the year 1996, so 1997 is just really speculation on anybody's part here as to what might be going on.

Senator BREAUX. There is not enough of a trend, I think, to make a definitive determination.

Ms. PAULL. No. No.

Senator BREAUX. One final question. I am trying to find out the nature of the problem. I notice that, Mr. Talisman, in your answer to Senator Moynihan's question, you said that tax shelters could be a growing problem. Secretary Summers recently said that it is the most serious compliance issue threatening the American tax system today. It seems like there is a big difference between your perspectives on how serious this problem is. Can you comment on that?

Mr. TALISMAN. I am not sure that is exactly what I said, but obviously——

Senator BREAUX. No, I wrote it down.

Mr. TALISMAN. I will take it on faith that that is what I said.

Senator BREAUX. I wrote it down. "Could be a growing problem."

Mr. TALISMAN. I think it is. We believe that the proliferation of shelters is a very serious problem.

Senator BREAUX. Is it the most serious one we have got?

Mr. TALISMAN. Again, I think the Secretary's words speak for themselves. It is the most serious problem of which we are presently aware, that is correct.

Senator BREAUX. My final point is, I am not for tax shelters. I just wanted to take the other side to see what we can do with it and just have a good discussion. Thank you very much.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

The question that comes to my mind, I guess, Mr. Talisman, is you made four different recommendations. I know this is difficult, but could you give us a sense of the proportionate weight or value of each of those four? That is, how much is each of those four, do you think, is going to solve the problem?

Mr. TALISMAN. Well, again, Senator, I do not know that you can weight them, in part because we think that it is a comprehensive package and therefore they are all important, as I pointed out in Chairman Roth's question.

One of the reasons that we think that this shelter activity is continuing, despite strengthening of the substantial understatement penalty in 1997, is because of the fact that taxpayers either do not believe they have a substantial understatement or they believe they have a reasonable cause out under Section 6664. That is why we think those two things have to work in parallel in order to resolve the problem. I am not sure that one is more important than the other.

Obviously, the solution to this problem is a difficult one, and we believe that, certainly, disclosure, increases in penalties, strengthening opinion standards, and the steps we took with respect to the regulations, and then shutting down individual shelters and proceeding in court, are all very important steps to address this problem.

We honestly believe that the fourth and necessary step, is codification of the economic substance doctrine. So that is where we differ from the Joint Committee staff, but we believe that all of these steps are an essential component to solve the problem.

Senator BAUCUS. All right. Now, let us say we are not to codify economic substance. In your judgment, basically, how much would we, therefore, not get at? What percentage of shelters, roughly? How much of the problem, in your judgment, is the failure to codify the economic substance doctrine?

Mr. TALISMAN. I think it is a significant element to the solution. I think that adopting the other three approaches would have a significant impact on the shelter industry. I am not sure how much.

I would hope that if we did that, we would not have to come back here in 2 years and do more and find that the problem has grown and that the integrity of the tax system, frankly, has been undermined by other taxpayers racing to the bottom.

Senator BAUCUS. I did not hear, Ms. Paull. Do you agree about the third party provision, namely that third parties have to be liable? It is the promoters and the advisors.

Ms. PAULL. The advisors, right.

Senator BAUCUS. And the offshore entities, and so forth.

Ms. PAULL. Yes, we do make recommendations on penalties, injunctive relief, et cetera with respect to advisors, too.

Senator BAUCUS. Do you basically agree with Treasury's position?

Ms. PAULL. Yes, we are very similar. Some details might be different.

I would note that, right now, the penalty regime, which is where we focused a lot of our attention, is, in our view, flawed. There is not a meaningful penalty facing somebody when they enter into these transactions. I think we would agree on that.

So if you could shift the cost benefit analysis on the entering of some of these transactions to enacting a very meaningful penalty, I think it would make a big difference here. Right now, the time value of money erodes any interest charge that has occurred if you got caught with one of these underpayments.

Senator BAUCUS. Putting aside for a moment the question of whether economic substance is codified, just put that aside, can the two of you reach a general agreement as to what the standard should be, and if so, can you tell us, generally, what is it? As I understand it, there are various court cases that basically enumerate or outline what it is, but I understand there are some differences in opinions. One of the reasons, I guess, Treasury wants to codify it is because companies might forum shop, I do not know.

But putting aside whether it should be codified, can you agree, or do you agree, on generally what the standard should be? If so, what is it?

Ms. PAULL. I do not think we do.

Senator BAUCUS. And where is the main difference?

Ms. PAULL. Well, I think that if you only focus on the comparison of the net profits versus the tax benefits, which is what the Treasury test does at the moment, you will not catch a lot of transactions that we think ought to be caught. In particular, we are con-

cerned about transaction with tax-indifferent parties. These are the parties that are either tax-exempt or foreign entities.

We have tried, I can assure you. We have had meetings. Our staff has tried to come up with a meaningful definition, and I think we are pretty far apart, I would guess.

Senator BAUCUS. Mr. Talisman, do you want to comment on that?

Mr. TALISMAN. I think Lindy is the first one to argue that our standard is too narrow.

Senator BAUCUS. That is an interesting development.

Mr. TALISMAN. The only thing I would say is, what we are trying to do is to codify a meaningful standard. We obviously would want to work with the Joint Committee and other Hill tax writing staffs to ensure that the standard is an agreed standard.

Representative Doggett has introduced a bill that has a very similar approach to the approach we have taken, but his approach attacks both situations where you are attempting to gain a pre-tax profit and situations where you are actually engaged in the transaction with an expectation of having an economic loss from the outset, situations like the development of a hybrid vehicle or something like that where you do not ever expect it to come to market.

The issue of economic substance is, again, a difficult one. I think we do believe that the standard needs to be codified and heightened in a way that would provide an up-front incentive for taxpayers to apply the doctrine.

I would note, as I did in my testimony, that the Joint Committee does use our standard for purposes of defining the transactions that are subject to their penalties, so at least that component of our tests, they agree with that piece of it. The question, is whether we need to broaden it to make sure we capture other transactions as well.

Just one last thing. We do address the issue of tax-indifferent parties with respect to financing transactions separately from the sort of pre-tax profits.

Senator BAUCUS. I know my time has expired, Mr. Chairman, but I think we are on an interesting subject here. If I might, Mr. Talisman, why do you not want to tighten up more in the way that Joint Tax suggests?

Mr. TALISMAN. Again, we are not arguing that codification of the economic substance doctrine alone is the panacea to all of the transactions that we have seen. What we have seen is a number of the transactions that we have shut down do lack economic substance. What we found is that taxpayers are not applying the doctrine before the fact.

What we believe is necessary is that we take this case law that is developed, we put it in the Code, and we make sure that taxpayers are applying that standard. We believe the standard we have articulated is consistent with that case law.

Senator BAUCUS. My time has expired. But I have to tell you, the mere fact that the two of you cannot agree indicates some problem here.

Ms. PAULL. It is a very complicated problem.

Senator BAUCUS. Well, a deep problem. I think it may well go to the root of the problem, the major discussion of this hearing, name-

ly shelters and what is the appropriate way to crack down on shelters. I do not know what the answer is, but I have a better sense of the problem just by the mere fact that the two of you do not agree on what an improper economic substance transaction would be.

Ms. PAULL. May I make an observation?

Senator BAUCUS. Yes.

Ms. PAULL. If you are going to change the underlying substantive law versus using a definition of whatever transaction for penalties, which is the approach we do, you might think that you could use somewhat of a broader definition of corporate tax shelter for the penalty purposes than you would be able to do for the substantive underlying law, because you have to be extremely careful if you are going to change the law about ordinary course of business transactions. It is really difficult.

Senator BAUCUS. My time has expired, but I thank you both very much.

Mr. TALISMAN. Thank you.

Senator BAUCUS. Thank you, Mr. Chairman.

The CHAIRMAN. Let me just ask you one further question. Since we have been emphasizing where you disagree, where do you agree?

Ms. PAULL. Well, we certainly agree about the need for more disclosure. I have a concern about over disclosure and flooding the IRS, but I think there are two goals that you can achieve with disclosure. One, is to try to get this early warning about these Tax Code glitches. I think that would be very helpful.

Also, to provide somewhat of an audit trail for the IRS, so that would be the taxpayer disclosure when the IRS comes in and audits. So I think, on disclosure, we are pretty close.

You need some sanctions. The Treasury is unable to really have a meaningful sanction to back up the regulations they just issued, so you need sanctions on that.

We also have, I think, some fair agreement that the penalty regime needs to be enhanced, toughened, strengthened, both with respect to the corporate taxpayers and with respect to their advisors.

Mr. TALISMAN. And we all believe that there should be incentives in the Code for other parties to the transaction to make sure that it comports with established norms. I think that we have differences in approaches as to how we do that, but we both would impose sanctions on promoters and advisors who participate.

Ms. PAULL. Right.

Senator MOYNIHAN. Mr. Chairman, we are hearing differences of nuance between serious persons, carefully informed, and a careful debate. We welcome it. We are fortunate to have both of you.

The CHAIRMAN. Before we turn to the next panel, because I did say in my opening statement, I have been concerned by the lack of action on the part of Treasury with respect to issuing regulations on disclosure.

We got a letter from the Secretary emphasizing the importance of the problem, the urgency of necessary action. But here we are, basically, and it took two years. It does raise, at least in some people's minds, that there is an effort being made to politicize this.

I think this is a very serious problem, and I think one we want to address. I agree with the comment that Lindy made earlier. We want to proceed carefully, because implications can be extraordinarily serious if we do not.

But I just want to thank both of you. This is only the beginning—well, not even the beginning—of the dialogue. We will want to work with both of you as we proceed.

Thank you very much for being here today.

Senator MOYNIHAN. Thank you.

Mr. TALISMAN. Thank you.

Ms. PAULL. Thank you.

The CHAIRMAN. We will now call forward our second panel. Mr. Peter Faber, who is a partner in McDermott, Will & Emery of New York, and, Mr. Ken Kies, who is the managing partner of Washington National Tax Services at PricewaterhouseCoopers in Washington, DC.

It is a pleasure to welcome both of you. Mr. Faber, I understand this is a very important day for you. You and your wife are celebrating your first date 43 years ago.

Mr. FABER. That is correct, Mr. Chairman.

The CHAIRMAN. My question to you is, did you order flowers on time?

Mr. FABER. I did, indeed. I made arrangements before I left for the airport this morning, and I thank you for the reminder, Mr. Chairman.

Senator MOYNIHAN. Well, congratulations.

The CHAIRMAN. Mr. Kies, I understand that you just flew back from London to be with us. I thank you both for your efforts.

Your written statements will be included in the record, and we will begin with you, Mr. Faber.

STATEMENT OF PETER L. FABER, PARTNER, McDERMOTT, WILL & EMERY, NEW YORK, NY

Mr. FABER. Thank you, Mr. Chairman.

I am a partner in the law firm of McDermott, Will & Emery in New York. I have chaired the Tax Sections of the American and New York State Bar Associations, and I currently chair the Tax Committee of the New York City Partnership and Chamber of Commerce, an organization that Senator Moynihan knows well, but I appear before you today as an individual and not on behalf of any organization.

My perspective is that of a person who has been practicing corporate tax law for 37 years and who advises tax managers of large corporations every day. Our firm advises over 50 of the Fortune 100 companies on tax matters on a regular basis, and we often advise them about aggressive tax strategies that are brought to their attention by investment banking firms and, more recently, by accounting firms. So, here is a view from the trenches.

Mr. Chairman, there is a tax shelter problem, make no mistake about that. Tax shelters are being mass marketed to corporations, and many of them are buying. Now, I am not an economist and I have no idea whether corporate tax revenues are going up or down. I do know enough to know that you can make numbers do about anything you want them to do.

But I do not think the issue is whether corporate tax revenues are up or down. The issue is whether they would be higher but for the existence of overly-aggressive transactions, and I am here to tell you that they would be.

What I see is people, initially at investment banking firms, now increasingly at accounting firms, occasionally at law firms, under internal pressure to develop and sell tax ideas. Partners are encouraged to develop tax products for which they can charge a percentage of tax savings and not merely an hourly rate the way all the rest of us do.

The firms have people whose jobs are to develop tax products, and other people whose jobs are to sell them. I suspect that their job performance ratings are based on sales volume and not on whether their ideas are any good.

Now, people who are under pressure to sell ideas and to generate the new tax saving idea of the month are going to cut corners. Certainly, the firms will tell you that they have rigorous internal review procedures for every new tax product, but I can tell you, Mr. Chairman, that some ideas have emerged recently that never should have seen the light of day.

The result is that tax ideas, many of them doubtful, some of them actually garbage, are being marketed and mass marketed like toothpaste and light beer.

On the buyer side, corporate tax managers are under pressure to buy tax products. The CFOs want the tax burdens reduced, and the sellers of the products now know that they can go to the CFO, who is not a sophisticated tax person and has never heard of business purpose or economic substance, convince the CFO that Company X down the street has cut their taxes by 10 percent by going into aggressive tax strategies, and then get the CFO to put pressure on the tax people to go along.

I gave a talk on corporate tax shelters at a meeting in San Antonio last week, and three tax managers came up afterwards and complained about the pressure they are being subjected to by their financial people to go into aggressive tax shelters that they, the tax people, think are no good.

Indeed, I was flying back from Chicago the other night and I was at the bar at the United Airlines Club at O'Hare, and a corporate tax manager who had recognized me from a speech I gave came up to me and said, you have got to stop this; the CFOs are killing us and pressuring us to buy all this stuff.

Now, it takes a tough tax manager to stand up to that kind of pressure. So from my perspective, there is, indeed, a problem.

Doing something about it is not that easy. I think there is nothing wrong with a corporation structuring transactions to minimize the tax bite. Judge Learned Hand told us that in *Gregory v. Helvering* 65 years ago.

Similarly, I am very sympathetic with the notion that you ought to be able to read a statute or a regulation, as Senator Breaux has raised, and do what it tells you to do and not have to psychoanalyze the guys who drafted it 15 years ago to figure out what they may have had in mind.

Nevertheless, Mr. Chairman, a corporation should not be allowed to engage in a fictitious transaction with no economic reality for

the sole purpose of inventing a tax deduction. That is the kind of thing that I think we have to stop.

Now, I share Lindy's concern about the drafting process and what we can do by legislation. I am not sure that we can draft a definition of "tax shelter" that works. I am not sure we can codify the economic substance doctrine. You do not want a legislative fix that is so broad that it hits good transactions as well as bad ones.

Some problems are best left to the IRS and to the courts. This is an area where I think all three branches of government have to work together.

One approach is certainly to require increased disclosure. The Treasury proposals that were released last week, I think, would have stopped a lot of the transactions that we have seen recently had they been in force.

Finally, we have to give the IRS the tools it needs to enforce the laws. All the laws and all the regulations in the world are not going to do any good at all unless the IRS has the personnel and the resources to detect the abusive tax shelters and to stamp them out.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Faber.

Ken, welcome. It is nice to have you back.

[The prepared statement of Mr. Faber appears in the appendix.]

STATEMENT OF KENNETH J. KIES, MANAGING PARTNER, WASHINGTON NATIONAL TAX SERVICES, PRICEWATERHOUSECOOPERS, LLP, WASHINGTON, DC

Mr. KIES. Thank you, Senator. I sent my wife flowers because I went to London, so I think I am all right there. [Laughter.]

Let me thank you for the opportunity to appear here today. The question I have been asked to address, is whether there is any demonstrated problem with corporate tax shelters that would require sweeping legislative change.

The Treasury Department and other proponents of so-called corporate tax shelter legislation suggest that an alarming and historic erosion of the corporate income tax base is under way. This assertion is totally without support.

Referring to my charts, you will note that, other than a slight dip in 1999, corporate income tax receipts have grown rapidly over the past decade. While the economy has grown by 47 percent since 1992, corporate income taxes have grown by 84 percent. In fact, over the past 5 years, corporate income tax revenues have been at their highest level as a percent of GDP than at any time since 1980.

Some have suggested that the slight decline in corporate income tax receipts in 1999 may be attributable to corporate tax shelters. There is no basis for this assertion.

This modest drop is largely attributable to greater depreciation deductions flowing from increased capital investment, and was actually projected by OMB at the beginning of last year. Such a decline is hardly a first. In fact, there have been 15 instances since 1950 where corporate tax receipts have dropped from 1 year to the next.

The sole piece of statistical information Treasury has identified to support its view is data concerning the difference between taxable corporate income and book income, or profits, that corporations report to their shareholders.

Treasury has taken tax returns of 811 corporations over the 1991–1996 period and has analyzed those differences. Specifically, Treasury looked at Schedule M–1 of these corporate returns, where taxpayers provide details as to what accounts for the difference between book and tax income.

Treasury's methodology raises a couple of interesting questions. First, what were the differences listed by these taxpayers? Treasury has access to this data, but it has failed to identify these differences to date. It simply concludes that corporate tax shelters are part of the story.

Second, these differences were actually reported and described by taxpayers on their M–1s. All of the companies studied were part of the IRS Coordinated Exam Program. In these examinations, these differences are among the first items examined by IRS auditors. In other words, there is nothing secret about these differences; Treasury and the IRS are aware of what they are.

While PricewaterhouseCoopers does not have access to specific returns studied by Treasury, we have analyzed differences between book and tax income and we can explain much of the difference in quantifiable terms that have nothing to do with corporate tax shelters.

Over the 1992 to 1996 period, differences between book and tax depreciation may explain $19–$28 billion of this difference, while differences in the treatment of foreign earnings may account for $43 billion.

Stock options also account for part of the difference. While it is difficult to estimate the magnitude of the book tax differences attributable to stock options, it is likely to be quite large, given the dramatic run-up in the stock market which has taken place in recent years.

Thus, our study shows that differences between book and taxable income really are attributable to such mundane activities as investing in new equipment, doing business in a global economy, and incentivizing employees with stock compensation.

Moreover, recent data that we have analyzed involving the Commerce Department's Bureau of Economic Analysis' Measure of Book Income reveals a trend for the period 1991 to 1996 which is the opposite of which Treasury has concluded, specifically, that the percentage of taxable income to book income has actually gone up, not down.

Effective tax rates provide yet another measure that you can look to in considering whether there is any economic evidence of increasing corporate tax shelter activity. My firm has undertaken a study that found that effective tax rates have been relatively constant over the past 10 years.

A Treasury economist presented a similar study last year and found a slight drop in effective corporate tax rates over the 1990 to 1998 period. However, this economist found that this decline was largely unrelated to corporate tax shelters.

The Treasury economist concluded, "Rather than shelters, it is the decline in corporate losses that accounts for most of the decline in the average tax rate in the 1990's."

In assessing the need for legislative action in this area, like the codification of the so-called economic substance doctrine proposed by Treasury, it is also important to note that two things have happened since Treasury's initial proposals from February of 1999.

First, Treasury, last week, as the Chairman noted, finally found time to implement corporate tax shelter reporting requirements that Congress enacted in 1997. Congress at that time, really almost 3 years ago, stated that this reporting requirement would deter inappropriate transactions.

Second, the IRS, over the past year, has won an historic string of victories in the courts in cases involving perceived corporate shelters. In these cases, the government successfully used economic substance and other common law doctrines to attack shelter-like transactions.

These government wins have had a profound effect on corporate taxpayers and their advisors and their willingness to even entertain aggressive transactions.

Let me just close by saying that Treasury Secretary Summers' recent assertion that "corporate tax shelters may be the most serious compliance issue threatening our tax system" is unsustainable based on the facts.

One need look no further than the recently-released IRS audit by the GAO to see real and serious compliance problems. That report revealed that the IRS fails to collect many tens of billions of dollars each year where there is no question that taxes are, in fact, owed.

If you look at these charts, you will see that the IRS had $231 billion in unpaid assessments in fiscal 1999. Of this amount, $127 billion was simply written off. These are real compliance issues, deserving of serious attention, as compared to the corporate tax shelter one which makes for good headlines, but fails to withstand careful scrutiny.

Thank you, Mr. Chairman, and thank you members of the committee.

[The prepared statement of Mr. Kies appears in the appendix.]

The CHAIRMAN. Mr. Faber, you have heard about the letter written by Larry Summers in which he says, "The Administration has put forward in the fiscal year 2001 Budget legislative proposals aimed at curtailing tax shelters . . . Failure to address this issue in a meaningful way would put the fairness and efficacy of our tax system at risk."

Now, I just heard Mr. Kies say there is not a problem here. What are your comments with respect to that? I have been concerned, as far as the Treasury is concerned, that it took 2 years to issue disclosure regulations. One wonders why it suddenly becomes such a hot issue if it were not before. You heard me say, I think there is a problem. My real problem is, what do we do about it?

Would you please comment?

Mr. FABER. Well, it is hard to quantify the problem. As I said in my testimony, I am not enough of an economist to analyze the figures that Ken has presented. What I see is corporations on a daily basis being presented with ideas, some of them very aggressive and

63-714 00 - 2

many of which they are going into, notwithstanding the trend in recent court cases.

I would point out that, in one of those court cases, *ACM*, the vote was 2:1. It could very nearly have gone the other way in the Third Circuit Court of Appeals.

So I think while the litigation process is obviously having an impact on the willingness of companies to go into tax shelters it probably has not eliminated that willingness completely.

So I think there is still a problem. Now, whether it is the most important tax compliance problem we are facing, who knows, but certainly it is a problem.

The CHAIRMAN. I do not think that is the issue.

Mr. FABER. It is a problem, and I do not think one can extrapolate from the numbers and conclude that it is not.

The CHAIRMAN. I think it is a matter of concern when any group that owes money is not paying its taxes.

Mr. FABER. I do not know why it took them 2 years to come out with the regulations. It would have been better if they could have come out earlier, but I cannot respond to that.

The CHAIRMAN. Mr. Kies, is Mr. Faber wrong to believe there is a tax shelter problem? How do you respond to the American Institute of Certified Public Accountants, the American Bar Association, the New York Bar Association, the Tax Executive Institute, and the various other groups that believe there is a corporate tax shelter problem?

Mr. KIES. Well, Mr. Chairman, I think I would have several comments. I do not believe that there are not aggressive taxpayers that need to be reined in by the Internal Revenue Service occasionally.

Part of the point of my testimony, was to say that the current situation is really not different from 10 years ago. The revenue stream coming from corporations is quite vibrant.

Yes, there are problems that, from time to time, need to be dealt with. The Service has at its disposal a vast array of tools to deal with that, the audit process, the subpoena process, the ability to require reporting, and our view is that those tools can be deployed very effectively to deal with those problems that do exist.

I would point out to you that, just if you go back to the Ways and Means hearing of last fall, the group of experts that you just alluded to were all asked, what was the current level of corporate revenues?

The current level of corporate revenues is around $180–$200 billion. The closest guess from anybody on the panel was $100 billion, which, to me, is evidence they really do not understand the macroeconomic picture, they understand some anecdotal experience.

The point that we are trying to make to the committee, is the balance of power between IRS and taxpayers is currently appropriate and problems, as they arise, are appropriately dealt with.

The court decisions of the past 12 months are ample evidence of that, and the ability of the IRS to shut down problem transactions through procedural pronouncements has been quite effective.

The CHAIRMAN. Mr. Faber, your written testimony seemed to focus on the promotion of products by the Big Five accounting firms. Are they the biggest promoters? What about investment bankers, what about lawyers? And let me ask you this question, if

I may just follow through. Particularly in the case of certified public accountants, is there a potential conflict of interest there?

Mr. FABER. Well, there are a number of questions wrapped up in that question, Mr. Chairman. I think that 15 years ago you did not see the CPA firms marketing aggressive tax strategies; now we do. I think there has been a change within the firms, and they have basically identified this as an area where they can make some money.

So I would say that most of what we are seeing recently has been from the accounting firms, but certainly not all of it, whereas 15 years ago it was all from the investment banking firms. And there are some law firms that are doing them, too, do not misunderstand me, but I think it is primarily the accounting firms and it is a relatively new phenomenon.

What was the second part of your question, sir? I am sorry.

The CHAIRMAN. Well, let me ask you this. Should there be a penalty for those who are promoting tax shelters?

Mr. FABER. I think it is hard to pin down and define the kind of strategy for which you would impose a penalty, and that is why I am nervous. Is a leveraged lease a tax shelter? Well, under some definitions it would be. Is someone who suggests to a company that it could reduce its tax rate by leasing property rather than owning it a promoter of a tax shelter?

I think it is very easy to look at some of the abusive transactions and say, yes, that was a tax shelter and that was promoted by some guy who was getting a big fee for it, but it is very hard to draw the line.

While, in principle, I think, yes, it is a good idea to put penalties on the promoters, I am not sure how one does it in practice.

The CHAIRMAN. Let me go back. Is there a conflict of interest?

Mr. FABER. Oh, I am sorry. Yes, you did ask that.

I think we very often see a conflict if the firm is auditing the financial statements and then also advising on aggressive tax shelters. There is a potential conflict there which is difficult.

One conflict I have been concerned about, and I guess it is a conflict, is the ambiguity in the role of the promoter of a tax shelter. If you are a law firm or an accounting firm and you go to a corporation with a tax shelter and you are going to get a fee based on a percentage of the tax savings, then you are not really acting as a professional advisor. In my view, you are acting as a commission salesman.

I think there is a conflict if a professional firm, a law firm or an accounting firm, represents that it is giving an "opinion," whereas, in fact, what it purports to say is an opinion is really a sales document. That, in my view, is the most serious conflict in this whole area.

The CHAIRMAN. Ken, would you like to comment?

Mr. KIES. Well, Mr. Chairman, just a couple of comments. Whether there is a conflict of interest really goes to the issue of whether any individual item is material with respect to the financial statements.

Typically, even significant transactions are not material to the overall financial statement, so that the conflict of interest issue is one that has to be looked at, but it rarely actually arises.

In terms of who is responsible for pushing aggressive transactions, much of what has been written recently has been directed at the Big Five accounting firms, of which I am a member.

But, frankly, if one goes back just to my tenure as Chief of Staff of the Joint Committee in which, when I served in that position, we shut down 32 different loopholes, if you went through each one of those you would find in many instances they arose from law firms. The New York State Bar members were largely responsible for step-down preferred transactions, it did not emanate from accounting firms.

I do not think there is much to be gained from trying to point the finger at one side of the profession or the other here. I think the more constructive thing to do, is figure out if the Service has adequate resources to deal with existing problems.

The caution that I would leave with you, is do not take action that will penalize the 95 percent of taxpayers, corporate and otherwise, who are trying to comply with the law to try and get at the 5 percent who are engaging in actions that are actually overly aggressive.

I think you have to be careful that, as you examine this balance of power between IRS and taxpayers, that you do not tilt too far in the direction of the IRS and, therefore, put in their hands tools that will be used against legitimate taxpayers.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Thank you, both. Once again, Mr. Faber, I can attest to the role of the New York State Bar Association and the City Bar Association have played in my quarter century here. You were invaluable in the 1986 legislation.

You raise a question, and Mr. Chairman, it is one of the mysteries of our society, and a wonderful mystery, about professionalism. We do not have any laws about professionalism, it is internal. Doctors decide who is a doctor, lawyers lawyers. There are examinations and all, but they are inside a profession which is set apart from the society as a whole.

You have come to us, and I do not mean to make any difficulty for the Big Five. You seem to represent three of them. Or maybe it was Big Eight, and now there are only five.

Mr. KIES. Well, we will be down to one, eventually. It will be a very long name, though.

Senator MOYNIHAN. In your testimony, Mr. Faber, you say that, "This raises issues of professionalism that perhaps go beyond the scope of these hearings but that are of concern to me.

"The accounting firms, for years, have acted as professional advisors to their clients—professional advisors to their clients—and the clients have come to expect that of them.

"If a firm presents a tax product to a company for which it expects to be paid a fee based on a percentage of expected tax savings, it is functioning as a commission salesman and not as a professional advisor.

"A firm that presents a client with a 20-page opinion and attaches a product that it is selling for a percentage of tax savings is deceiving the client and misrepresenting its role."

Well, that is a very troubling statement. What does the Committee on Finance do about professional standards?

Mr. FABER. Senator Moynihan, I think that was more in the nature of an aside. I think the Treasury has indicated they will be revising Circular 230, which deals with the professional standards of tax advisors. I think the courts oversee, certainly, the legal profession. The AICPA and the Bar Associations, I think, should be imposing appropriate standards of ethics on the members of their professions.

Senator MOYNIHAN. But you are saying a professional group creates professional standards. But the Congress does not, nor do I think it should.

Mr. FABER. Yes. I think it goes back to the question of who enforces different parts of this whole spectrum of the problem, and I think that professionalism is one which I mentioned in the prepared statement. I am not sure that it falls within the province of this committee of the Congress to deal with.

Senator MOYNIHAN. But it is a large fact out there, and not perhaps often enough noticed.

Mr. FABER. It is very much part of the landscape.

Senator MOYNIHAN. The culture.

Mr. FABER. Of the culture. Incidentally, do not misunderstand me, Senator. I think it is perfectly all right for a law firm or an accounting firm to go to a client and say, look, we have a product here, we have developed it, we think it can save you tax money, we think it is good, we stand behind it, and we think our fee should be value-based and not hourly-based.

As long as it is clear what they are doing, in other words, if they make it very clear that they are presenting it as an idea, they are going to joint venture it with the client, and they think that the client ought to have somebody else who has no stake in the outcome take a look at it, I think that is perfectly appropriate.

Senator MOYNIHAN. That is what professionals try to do.

Mr. FABER. As long as your role is articulated.

Senator MOYNIHAN. Get a second opinion.

Mr. FABER. Yes, exactly. Incidentally, I have friends at all five accounting firms. The young lady Senator Roth referred to whom I first took out 43 years ago works for one, so I have a great deal of respect for the Big Five firms.

Senator MOYNIHAN. Good.

Mr. FABER. I think they are highly professional organizations. I think the critical thing is that an accounting firm, a law firm, or any other entity that brings a tax saving idea to a prospective client ought to be up front about exactly what its relationship is and should not in any way suggest that it is acting in a different way.

Senator MOYNIHAN. Right. It is sort of beyond the purview of statute, but absolutely essential to the working of the statute and the system.

Mr. FABER. Exactly right. Exactly right.

Senator MOYNIHAN. I wish you well. But you feel that things are not getting better, they are developing in a direction you would wish they had not.

Mr. FABER. Well, it is hard to say, Senator. The increased disclosure may well have a very positive impact on this tendency.

Senator MOYNIHAN. Yes.

Mr. FABER. The court cases are all very recent. It is early to tell what impact they will have on the willingness of corporations to get into aggressive tax strategies.

So it may well be that, even if Congress does nothing, the tax shelter world will be a lot better 2 years from now than it is today. It is awfully hard—these developments are so recent—to put them in perspective.

Senator MOYNIHAN. I appreciate that. It is a refreshing subject, and a baffling and mysterious one, and meant to be. Is that not the case?

Mr. FABER. Yes, sir.

Senator MOYNIHAN. Thank you very much. Thank you, Ken.

The CHAIRMAN. Gentlemen, thank you very much for being here today. We appreciate your testimony.

Mr. FABER. Thank you.

Mr. KIES. Thank you, Mr. Chairman.

The CHAIRMAN. The committee is in recess.

[Whereupon, at 12:04 p.m., the hearing was recessed.]

PENALTY AND INTEREST PROVISIONS IN THE INTERNAL REVENUE CODE

THURSDAY, MARCH 9, 2000

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:16 a.m., in room SD-215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators Nickles and Moynihan.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will please be in order.

Today is the second day of a series of hearings relating to the Treasury and Joint Committee on Taxation penalty and interest studies.

Yesterday, the Treasury Department and the Joint Tax Committee staff discussed their respective recommendations relating to Internal Revenue Code penalties and interest, including corporate tax shelters.

We also heard testimony discussing whether there is a corporate tax shelter problem. As I said yesterday, I believe there is a serious corporate tax shelter problem. The question becomes, how should we address the issue?

Today, we will hear from two panels. The first panel will consist of various tax practitioner groups who will provide their views on the penalty and interest proposals, including the corporate tax shelter proposals. I welcome their testimony.

However, members of these groups should be accountable. I believe part of the solution to the corporate tax shelter problem requires holding taxpayers, advisors, and promoters accountable for their actions.

Our second panel today will focus on the penalty and interest recommendations made by the Joint Committee on Taxation and Treasury. I look forward to hearing from our witnesses on these important issues.

Senator Moynihan?

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Mr. Chairman, once again, you are ahead of the curve here, although Secretary Summers is very much sup-

portive of what you are doing. We have a problem of complexity here which chases the ingenuity of practitioners.

I have spent 24 years in this committee wondering, why is the Tax Code so complex? I think I have come to the conclusion that it is because the lawyers are so clever, and the accountants.

We have had penalties in the Tax Code since the Civil War. In 1986, when we thought we were cleaning out and simplifying, and we did get rid of so many of the tax avoidance arrangements that we were able to lower rates we added 100 penalties to the Code.

Yesterday, as you will recall, sir, and our distinguished panelists may not know, we had some very disturbing testimony about the practices in the professions.

Mr. Faber, an attorney from New York who is a member of the New York State Bar Association Tax Section, described the dilemma of attorneys who traditionally, as a professional matter, would be very careful about conforming to the Code as they understood it in their advice to clients, now are dealing with accountants who come along and do your books and offer you an enormous tax shelter that goes with it for which they would maybe get 20 percent of the return, which is not professional, or was not thought to be.

Of course, the professions are singular in our society. They regulate themselves, they define their own standards and enforce them, such that we need help and advice, and I look forward to your testimony.

Thank you, sir.

The CHAIRMAN. Thank you, Senator Moynihan.

I am pleased to introduce our first panel, which includes Judith Akin, who is an enrolled agent, testifying on behalf of the National Association of Enrolled Agents; David A. Lifson, who is chair of the Tax Executive Committee of the American Institute of Certified Public Accountants. I believe you testified before our committee last year. Welcome.

Paul J. Sax, who is the new chair of the Section of Taxation of the American Bar Association; Robert H. Scarborough, who is chair of the Tax Section, New York State Bar Association; and finally, Charles W. Shewbridge, III, who is the president of the Tax Executives Institute, and chief tax executive of BellSouth Corporation.

Senator MOYNIHAN. Mr. Chairman, the political season having commenced so riotously, I observe that Mr. Lifson had a large red button. Is that on behalf of any candidate? [Laughter.]

Mr. LIFSON. It is actually on behalf of all candidates. Simplification.

Senator MOYNIHAN. Oh, I see. You are here to simplify.

Mr. LIFSON. And now we can both wear them.

The CHAIRMAN. Well, I think we can all agree on that and wear your button. We will do it tomorrow. [Laughter.]

Ms. AKIN, WE WILL BEGIN WITH YOU. I would say to each of you, your full statements, of course, will be included as if read.

STATEMENT OF JUDITH AKIN, EA, NATIONAL ASSOCIATION OF ENROLLED AGENTS, OKLAHOMA CITY, OK

Ms. AKIN. Mr. Chairman, members of the Finance Committee, I am Judy Akin, enrolled agent and the immediate past chair of the

IRS Information Reporting Program Advisory Committee, and an officer and member of the board of directors of the National Association of Enrolled Agents.

I have been an enrolled agent for more than 25 years and maintain private practice in Oklahoma City, where I work with individuals and small business taxpayers.

Today, I am representing NAEA, whose more than 10,000 members are tax professionals licensed by the Department of Treasury to represent taxpayers before all administrative levels of the IRS.

I am pleased to have this opportunity to present our views on the penalty and interest recommendations of Treasury and the Joint Committee on Taxation as they affect individuals and small business taxpayers.

We have also attached some case studies to our testimony which we believe will help you better understand the problems that we are facing on a daily basis.

Without objection, I would like to summarize my testimony and submit my written statement for the record.

Generally speaking, NAEA supports those recommendations, whether they come from Treasury or the Joint Committee, which lead to simplification for this overall complicated area.

We believe the government has the right to collect interest for the time value of money used. However, we also believe that penalties that are perceived as harsh as they are applied to taxpayers who make honest errors or to taxpayers who are trying to come into compliance with the tax law are ultimately counterproductive.

We are particularly pleased with recommendations in the area of interest and failure to pay estimated tax penalties. We believe they address many situations which demand immediate relief.

We applaud the proposal to eliminate the $43 user fee for an installment agreement and feel that it is a fair exchange for an automated withdrawal of installment payments.

NAEA would like to see the accuracy-related penalties strengthened and applied equally to taxpayers and practitioners. While we believe return preparer penalties should be strengthened, we do not believe that fee-based preparer penalties are workable.

We are pleased by the Joint Tax suggestion for penalty abatement for inadvertent failures when a taxpayer changes to a different deposit schedule.

One case that comes to mind involves a retailer with an impeccable payroll tax deposit history. They were not aware that, effective 1/1/99, they would be required to make semi-weekly deposits. By the time the error was caught, the penalty due was $2,000, even though the taxpayer had deposited all payments timely under the old system.

We endorse the Joint Tax staff recommendation to consolidate the three penalties for failure to file forms 5500, and that these consolidated penalties be administered by the IRS.

We would like to make you aware of recent steps by the IRS to improve its administration of penalties and interest. These include permitting taxpayers to designate the application of tax deposits to minimize tax deposit penalties, the resolution of crediting payroll and self-employment taxes in certain non-filing situations, and the

continuation of problem solving days which allows for fast resolution to taxpayer problems, limiting penalties and interest.

The IRS will soon be expanding the ability for small business and individual taxpayers to warehouse tax payments under the Electronic Federal Tax Payment system. While the system will not be up and running until after July 1, we believe it will go a long ways towards limiting penalties for taxpayers and small business.

We received many comments about taxpayers, particularly senior citizens, being caught up in penalties where they truly do not understand the law or the situation. Steps need to be taken immediately to lessen the impact of penalties and interest on taxpayers who make innocent mistakes.

As our society moves more towards self-managed retirement plans such as IRAs and 401(k)s with required distributions, there will be many opportunities for senior citizens and the average taxpayer to run afoul of the rules and have their savings taxed away. These cases are not out of the ordinary, and we are dealing with them on a daily basis.

Finally, with respect to the issue of corporate tax shelters, we would respectfully urge that the members of the committee bear in mind the impact of these devices on the compliance of the average taxpayer.

Our system is based on voluntary assessment. If the average taxpayer believes that people who faithfully pay their taxes are foolhardy, then you will see greater non-compliance.

I would like to thank you for this opportunity to present our views, and would be happy to answer any questions.

The CHAIRMAN. Thank you.

[The prepared statement of Ms. Akin appears in the appendix.]

Mr. Lifson?

STATEMENT OF DAVID A. LIFSON, CHAIR, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, NEW YORK, NY

Mr. LIFSON. My name is David Lifson, and I chair the Tax Executive Committee of the American Institute of CPAs.

The AICPA is a national professional association with more than 330,000 members who are from professional service firms of all sizes from business, from education, and from government.

Our members work regularly with the tax laws that you write, and we have a strong interest in making the tax law fair, simple, and administrable.

I thank you for entering my written remarks into the record. It is a mighty tax to summarize all of this for you in just 5 minutes, but we will give it a try in an overview.

I would like to start by commending this committee for properly incorporating the public debate on so-called corporate tax shelters within the government's lesser-known overall evaluation of the role of tax penalties and interest charges in our tax system.

After all, are corporate tax shelters not more serious transgressions by more sophisticated taxpayers that perhaps should be subject to higher penalties?

With respect to corporate tax shelters, the increasing litany of cases outlining overreaching tax savings generation from an overly

literal reading of the tax law is alarming to many in the tax community; that these cases are now public knowledge is proof that the system is working to identify and punish those that cross the line.

As with any other popular public issue under consideration, there are countless possible solutions. I do not envy you for being responsible for picking the best one.

The Treasury Department has summarized their solution, indicating that it has four parts: increased disclosure, changes to the substantial understatement penalty, sanctions on other parties to the transaction, and codification of the economic substance doctrine.

We believe that the Treasury's proposed penalty structure is much too broad and will adversely affect too many innocent taxpayers. We suggest improvements in this area, and also with respect to disclosure and sanctions.

Legislative changes, including increased disclosure, increased penalties for activities in the shelter area, and sanctions to parties that were hitherto not sanctionable, are all areas where legislation would at least accelerate, if not improve, overall compliance with our tax laws.

We vigorously disagree with the fourth part of Treasury's solution, codification of the economic substance doctrine. Such an action would be a serious, serious mistake. Codification would invariably entrap millions of innocent main street taxpayers.

Instead, we believe the fourth part of the government's action plan should include enhanced enforcement by the Internal Revenue Service.

We note that the IRS has worked diligently in the last year to provide the appropriate level of enforcement that will encourage voluntary tax compliance, the cornerstone of our income tax system.

We hope you share our optimism for the promise of most recent developments, including the in-process reorganization of the IRS, recent court cases, and at long last, public exposure of various tax shelter regulations.

We hope you will continue to monitor the progress which is possible, in part, by your recent legislative action, the IRS Restructuring and Reform Act of 1998, and by modernization efforts currently under way. Let these changes take hold.

With respect to penalties and interest in general, such penalties should be designed to encourage compliance, not to raise money. Our citizens react to tax traps the same way they react to speed traps: with disrespect. Uncertainty does not protect the FSC. Uncertainty does not encourage tax compliance.

From my perspective, it discourages tax compliance. There is a long history in this country of people disobeying laws they do not understand, while clear rules are more frequently obeyed when properly enforced.

Simplification encourages taxpayers to be honest, it encourages voluntary compliance. For example, corporate tax shelter penalties should be reserved for big businesses that should know better. These business typically have controversies involving over $10 million in tax, and they have paid over $1 million to advisors to minimize their tax liabilities. Develop a sensible deminimus rule.

The disclosure area also provides a helpful example. An appropriate reporting threshold must be designed. Massive over-reporting by millions of businesses would only provide the IRS with a sea of useless information and taxpayers with an annoying, expensive responsibility.

Requirements on everyday, ordinary taxpayers to, in effect, audit themselves, disclose issues, and be subject to the threat of unduly severe penalties and interest could potentially undermine respect for our self-assessment system of taxation just as much as the unpublished abusive behavior by a few corporate taxpayers. These are areas of delicate balance.

Thank you for your time.

The CHAIRMAN. Thank you, Mr. Lifson.

Mr. Sax?

[The prepared statement of Mr. Lifson appears in the appendix.]

STATEMENT OF PAUL J. SAX, CHAIR, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, SAN FRANCISCO, CA

Mr. SAX. Good morning, Mr. Chairman and members of the committee. My name is Paul Sax. I am a partner in the law firm of Orrick, Harrington & Sutcliffe in San Francisco, and appear today as chair of the Section of Taxation of the American Bar Association. Thank you for the opportunity to testify today.

First, let me speak briefly to penalties and interest. We are impressed by the serious work devoted by the Treasury and the Joint Committee staff and welcome the intention of the Congress toward improving this aspect of the Tax Code.

We commend coordination of the accuracy-related and preparer penalties at the essential authority standard. We support raising the standard for positions in a return that are fully disclosed to realistic possibility of being sustained, as Treasury has suggested.

We support elimination of the interest rate differential using a market rate of interest, and we agree with the Joint Committee study recommending repeal of the failure to pay penalty, and support the Treasury's proposal of a lower failure to file penalty imposed over a longer period.

On the important subject of tax shelters, my testimony today is consistent with the testimony of my predecessor last spring, and my testimony before the House Ways and Means Committee in November.

Our message has been the same. The Tax Section views itself as counsel to the tax system, and this generation of corporate tax shelters seriously threatens that system. Certainly, revenue loss is a major issue, but perhaps more important than revenue loss is the potential for lost confidence in the tax system.

The reason this large corporate tax shelter activity is so threatening, is that the promoters are selling a new product. That product is well-calculated defiance of the tax collector.

The promoters explain that the chance of audit, detection, and challenge is minuscule, the penalties are small and usually avoidable, and the arithmetic of the odds favoring a multi-million dollar tax saving is compelling.

Given that, whether the deal would withstand scrutiny is not relevant. Recent judicial decisions do not materially change those odds. The game has become "catch me if you can."

Mr. Chairman, you may hear that, after the administration's recent announcement, there is no need for Congress to act. We welcome those actions and commend their balanced attempt to distinguish between abusive tax shelter activity and ordinary business transactions.

But do not be misled, Mr. Chairman. The Internal Revenue Service is severely limited as to what it can do. The existing penalty structure does not support an adequate response to current tax shelter activity.

The new investor list requirement is supported by a penalty of $50 per investor query the deterrence of that penalty to a promoter who stands to reap profits of millions per investor.

The tax shelter registration requirement, promoters maintain, is easily circumvented and no specific penalty at all lies for failure to comply with the new disclosure requirements.

The key to our proposal is meaningful disclosure with corporate and personal accountability. Large tax shelters—we use $10 million—must disclose the facts and the basis for their claimed tax saving. Failure to disclose would be backed by a new penalty based solely on failure to disclose.

Because the only consequence to legitimate transactions would be disclosure, the effect to legitimate business would be minimal. After all, there is no right to hide facts from the tax collector.

The key provision would elevate the visibility within the company requiring the chief financial officer or a comparable senior financial officer with knowledge of the facts to attest to the facts of the transaction.

Under our proposal, the existing understatement penalty would be extended to what I refer to as the aider and abettor circle, the promoters, tax-indifferent parties, and, yes, the tax professionals.

Last, in our view, there would be a very narrow codification with respect to the economic substance doctrine, not an attempt to codify the doctrine itself, but only to eliminate the promoter's argument that deminimus economic attributes are enough.

What we would have said, is that when the courts choose to apply the economic substance doctrine and are weighing economic attributes against tax benefits, those economic attributes must be substantial in relation to tax benefits, not deminimus.

Mr. Chairman, if the Congress acts, we believe the current threat to the tax system will be abated. If you do not, we fear the reaction of individual taxpayers when they learn what was allowed to happen.

Thank you again. That concludes my remarks. As counsel to the tax system, the Tax Section would be pleased to help. Please do not hesitate to call upon us. I would be pleased to respond to your questions.

The CHAIRMAN. Thank you, Mr. Sax.

[The prepared statement of Mr. Sax appears in the appendix.]

Mr. Scarborough?

STATEMENT OF ROBERT H. SCARBOROUGH, CHAIR, TAX SECTION, NEW YORK STATE BAR ASSOCIATION, NEW YORK, NY

Mr. SCARBOROUGH. My name is Robert Scarborough. I am a lawyer in private practice in New York City, but I appear today in my capacity as chair of the Tax Section of the New York State Bar Association.

We believe that the subjects of today's hearing, penalty reform and corporate tax shelters, are closely related. Changes to the current penalty rules can play an important part in addressing the serious issues that corporate tax shelters present for the tax system.

Last year, the New York State Bar Tax Section submitted two reports on proposals dealing with corporate tax shelters in the President's fiscal 2000 budget. In our reports, we expressed our view that there are serious and growing problems with aggressive, sophisticated, and in many cases purely artificial, transactions that are designed almost entirely to achieve a particular tax benefit. We also supported changes to current accuracy-related penalty rules as a partial response.

In my statement today, I will be restating positions that the Tax Section took in these reports, but I will also take into account more recent developments. These include the release of studies by both the staff of the Joint Committee on Taxation and the Treasury Department, the administration's fiscal 2001 budget, and most recently, issuance by the Internal Revenue Service on February 28 of regulations imposing new disclosure requirements on tax shelters.

Corporate tax shelters take many forms, but in general they are transactions that are entered into to reduce tax without meaningful economic risk or potential for profit by exploiting non-economic features of the tax law in unintended ways. They often involve shifting income to foreign or tax-exempt parties, they are often marketed to a number of different corporations.

The roots of the corporate tax shelter phenomenon are complex and varied. Only one of the causes on which I will focus today is the cost benefit analysis that corporate executives face when they are considering entering into shelter transactions.

In weighing expected costs, taxpayers must, of course, consider the risk that the Internal Revenue Service will detect the transaction and successfully dispute the interpretation of the law on which it relies. Taxpayers recognize, however, that the government faces significant resource constraints in detecting and challenge tax-motivated, very complex transactions.

Even if a shelter transaction is detected and successfully challenged, there is unlikely to be any down side to the corporation other than denial of the tax benefit sought and interest at a slightly increased rate. The risk of a penalty is generally seen as slight by corporations considering entering into these transactions.

Although Code Section 6662 imposes a 20 percent penalty on substantial understatements of tax, this penalty does not apply to the extent that the taxpayer had reasonable cause and acted in good faith.

Under current law, this standard would generally be considered met if the corporation relies on the opinion of a professional tax advisors that concludes that there is more than a 50 percent chance that the taxpayer's position would be upheld if challenged.

Both the Joint Committee staff and the Treasury, in their studies, concluded that the penalty is not a significant deterrent under current law because of reliance on these more-likely-than-not opinions.

Now, because the cost benefit calculation faced by corporations considering entering into corporate tax shelters is a very important cause of the tax shelter phenomenon, we believe that measures to change this calculation must play an important part in dealing with the problem.

Now, there are several different ways that the calculation could be changed. One, is by increasing the risk that a shelter transaction will be identified for challenge by the IRS, but the calculation can also be changed by increasing penalties that are imposed if a transaction is successfully challenged, and by making it more difficult to avoid these penalties.

The measures announced by the Internal Revenue Service at the end of February will certainly facilitate its efforts to detect and, where appropriate, challenge tax shelters. These measures include: 1) tax shelter registration requirements; 2) requirements that corporations entering into shelters file disclosures with their returns; 3) requirements that promoters maintain lists of investors.

The Internal Revenue Service cannot, of course, increase penalties or impose strict liability without Congressional action. The Treasury Department, thus, has proposed legislation that would raise the substantial understatement penalty to 40 percent for corporate tax shelters, and which would impose strict liability.

The penalty would be reduced to 20 percent if the taxpayer has satisfied certain disclosure requirements, and the 20 percent penalty for disclosed items could be completely avoided in some cases.

The Tax Section supports the approach of the Treasury Department proposal. Let me say that again. The New York State Bar Tax Section supports the approach of this proposal. It is very similar to an approach that we endorsed in a report that we submitted to the government last April.

Now, we acknowledge that increasing accuracy-related penalties and narrowing or eliminating exceptions will put considerable pressure on the definition of corporate tax shelter transactions, and it may increase the leverage of IRS agents in audits of corporate taxpayers.

We have concluded, however, on balance, that increasing the risk associated with corporate tax shelters is sufficiently important to justify these two effects, provided that several conditions are met.

An important condition, is that corporate tax shelters be appropriately defined to distinguish legitimate business transactions which may rely on aggressive tax planning from shelters. We would be pleased to work with the Congress to refine a definition of a transaction subject to heightened sanctions.

Thank you very much, Mr. Chairman, Mr. Moynihan.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Scarborough appears in the appendix.]

Mr. Shewbridge?

STATEMENT OF CHARLES W. SHEWBRIDGE, III, PRESIDENT, TAX EXECUTIVES INSTITUTE, INC., AND CHIEF TAX EXECUTIVE, BELLSOUTH CORPORATION, ATLANTA, GA

Mr. SHEWBRIDGE. Thank you, Mr. Chairman. I am chief tax executive for BellSouth Corporation in Atlanta, GA. I am here today as president of Tax Executives Institute, the preeminent group of in-house tax professionals.

TEI agrees that it is time for an in-depth review of the Code's interest and penalty provisions. The Joint Committee and Treasury studies contain many sound recommendations for reforming the Code's interest and penalty provisions.

TEI's comments on these studies are summarized on pages 5 and 6 of our written statement. I want to highlight just a few.

The current interest rules operate in an unfair manner and are difficult to administer. In many cases, the rules have served as an inappropriate penalty, such as with the estimated tax penalty, rather than as compensation for the time value of money.

The different interest rates for over- and under-payments have themselves spawned a major complexity: interest netting. The interest netting provision enacted in 1998 does not provide a full measure of relief. It is also extremely complex to administer.

TEI, thus, urges Congress to complete the reform effort it began 2 years ago by adopting the Joint Committee's recommendation to eliminate the interest rate differential.

Speaking broadly, we need to move back to the principle that penalties should be applied only in cases of willful non-compliance and not for every error or omission.

That leads me to the more controversial issue before the committee today, corporate tax shelters. Mr. Chairman, TEI's perspective differs from that of other organizations represented on this panel.

The institute does not represent the so-called tax shelter promoters and developers who either sell or facilitate the transactions, and we do not represent the professional advisors who opine on the illegitimacy of the arrangements or defend them when they go awry.

Rather, TEI members work directly for the corporations that enter into business transactions that require an analysis of their tax benefits and burdens. I have been a tax professional for nearly 30 years, and have been employed by BellSouth for half of that period. Last year, my company filed more than 55,000 returns and paid approximately $4 billion in taxes.

Given the size of those numbers and the fact that I sign BellSouth's tax returns under penalties of perjury, it should go without saying that I take my job, including my duty to the tax system, seriously. So do my colleagues at TEI.

Mr. Chairman, the institute agrees that disclosure is the key to fighting abusive corporate shelters. Thus, TEI applauds the Treasury Department's action activating the tax shelter registration provision enacted in 1997. Although we have not fully analyzed the regulations released last week, we are convinced that they will help the IRS obtain useful information about corporate transactions and then take appropriate action.

Care must be taken, however, not to enact far-reaching legislation without assessing whether administrative and tax enforcement actions are producing the desired results.

TEI believes the recent disclosure regulations, especially those involving promoters, go a long way to addressing the gaps in the current law. Thus, TEI does not support the proposal to codify the economic substance doctrine. As Ms. Paull testified yesterday, a statutory test would be difficult to draft and likely generate significant unintended consequences.

Nor do we believe that doubling the accuracy-related penalty for corporate tax shelters is the answer. Indeed, we suggest that the current 20 percent penalty is so high, that it is rarely asserted against corporate taxpayers.

Disproportionate penalties may inhibit agents from assessing them, and believe me, a 20 percent penalty that is fairly and swiftly administered will get the attention of both tax executives and their companies.

Finally, I wish to discuss the proposal that the chief financial officer or another senior officer be required to certify that the facts disclosed about a tax shelter transaction are true and correct.

The proposal misapprehends the role of a tax department, as well as the CFO. It impugns the integrity and professionalism of both and it ignores how the provision would adversely affect the examination process.

The proposal proceeds from the faulty premise that companies unknowingly enter into major transactions and that the people who prepare and sign billion dollar corporate returns do so lightly. We do not.

I believe it is wrong to assert that a company's senior officers would permit abusive transactions to go forward, but for the sanctions that would flow from the proposal.

Equally important, the proposal poses a serious threat to tax administration. If enacted, it could lead to focusing not on the underlying transaction, but on the CFO's statement. We believe the proposal could easily spawn suspicion and disrupt the audit process.

Mr. Chairman, we commend you for calling this hearing. We would be pleased to respond to any questions.

[The prepared statement of Mr. Shewbridge appears in the appendix.]

The CHAIRMAN. Thank you.

Let me start out with a question relating to the estimated tax penalty. I am very much concerned with its complexity. Some, if not all of you, appear to support the Joint Tax proposal to simplify and convert the estimated tax penalty into an interest charge.

Would you please briefly describe your views and any concerns you have on this issue? Ms. Akin?

Ms. AKIN. The estimated tax penalty or underpayment of tax penalty is one of the most complicated penalties to administer or to properly calculate. If a taxpayer pays in equal to or exceeding their prior year's liability, they may avoid the penalty unless they have had a significant increase in income. Then it may raise to 110 percent of last year's tax.

You are penalizing the taxpayer twice. You are penalizing them for the complexity of the law and you are penalizing them for hav-

ing to pay a tax advisor twice, once to have their taxes prepared and once to see if they can avoid this other penalty. It is a very difficult penalty to administer, and definitely needs simplification.

The CHAIRMAN. Mr. Lifson?

Mr. LIFSON. This is an area that causes ire and confusion for most taxpayers, for two reasons. First of all, the concept of it being a penalty versus an interest charge is, to them, a misnomer.

We spend hours explaining to each taxpayer, well, it is really an interest charge, but the government calls it a penalty. It is almost an embarrassment to be representing the system and explain what that charge is. It is a time value of money charge for not paying your taxes as you earned your income. Call it like it is, they will understand it, they will pay it, and they will try to reduce the cost if they can.

The second part, is over the last five, 8 years, the safe harbor for estimated taxes has hopscotched around from being, well, you have paid enough tax year if you paid 100 percent of last year's tax, and then for a while it was if you paid 110 percent of last year's tax, and then for a while it is if you pay 105 percent. This week, it is 108.6 percent.

So every time the client comes and visits you and tries to understand, because we prepare these estimated tax vouchers and say, all right, Mr. and Mrs. Jones, this is how much you have to pay every quarter, and every year I have to explain to them a new rule.

I really do not think it is a good idea. It creates a huge level of complexity that affects millions and millions of taxpayers that generally do not have a chance to sit here and talk to you folks.

The CHAIRMAN. Any further comment on this? Mr. Sax?

Mr. SAX. The estimated tax penalty, Mr. Chairman, works as interest. It enhances the credibility of the system to call it interest. The Tax Section purports changing it to interest. We would note that the benefit of the change would inure largely to corporate taxpayers who cannot presently deduct the penalty but could deduct interest, whereas, individual taxpayers are not generally able to deduct interest, as you know.

The CHAIRMAN. Let me turn to another question.

Mr. SHEWBRIDGE. I would just add one comment to the discussion. We certainly agree that it should be changed to an interest charge rather than a penalty, because the current regime forces corporations to overpay their taxes, which I do not think is what the intent of the Code or the intent of Congress is.

The other thing that we would suggest, is that there is no safe harbor for corporations, and that we also would strongly urge you to take a look at establishing a safe harbor for corporations as there is for individuals.

The CHAIRMAN. Let me turn to a Joint Tax staff proposal which would require an understatement before its corporate tax shelter proposals apply. What is your reaction to this approach? Mr. Shewbridge, do you want to start?

Mr. SHEWBRIDGE. I am sorry. Could you repeat your question?

The CHAIRMAN. Yes. The Joint Tax staff proposal requires an understatement before its corporate tax shelter proposals apply. What is your reaction to this approach?

Mr. SHEWBRIDGE. An understatement of tax itself?

The CHAIRMAN. Yes.

Mr. SHEWBRIDGE. Well, I certainly think that that would be most appropriate. I do not think that there should be any application unless you are understating your taxes.

The CHAIRMAN. Mr. Scarborough?

Mr. SCARBOROUGH. I agree with Mr. Shewbridge. We think that penalties should not be imposed unless the taxpayer loses as a matter of substantive law. We oppose at this time proposals to change substantive law to deal with corporate tax shelters. By substantive law, I mean the law that determines whether or not the taxpayer would win or lose if the issues were litigated in court.

The CHAIRMAN. Mr. Sax?

Mr. SAX. In our proposal, the expansion of the understatement penalty to the aiders and abettors and promoters in the transaction would be based upon an understatement.

But we have proposed separately and distinct from that a penalty that would not require an understatement, and that is the penalty for trying to hide. Our proposal requiring disclosure would impose a new penalty imposed upon failures to disclose without regard to success or failure of the transaction solely as an inducement to extract disclosure.

The CHAIRMAN. Mr. Lifson?

Mr. LIFSON. Well, if a taxpayer has paid their proper tax, we do not see any requirement for them to be penalized for how they came about it. I would say that is how, in summary.

The CHAIRMAN. Ms. Akin?

Ms. AKIN. No comment on that.

The CHAIRMAN. Reference has been made to the fact that the Treasury finally, after 2 years, issued its regulations that put the disclosure requirements into effect. Some of you have mentioned that, of course, it is important that the agency, IRS, have adequate resources.

Do you think that this will be a major step forward in enabling IRS to address the problem with tax shelters, disclosure plus adequate resources?

Ms. AKIN. Well, definitely the IRS is in need of resources. Without the resources, they cannot do enforcement, and if they cannot do enforcement, your abuses go on continually. So, they definitely do need the resources.

The CHAIRMAN. What difference, Mr. Lifson, do you see the disclosure making?

Mr. LIFSON. That, in connection with the reformation of the IRS into four operating divisions and their recent announcement of setting up a center to ferret out corporate tax shelters, should go a long way, along with publicity created by hearings like this and general news articles.

It is alerting people, we believe, to the fact that, one, it is not as easy to hide, and two, you have a greater responsibility to disclose. We are reviewing those regulations and will be providing you with detailed comments. There is no silver bullet here. It all has to be taken with several different approaches to the same end.

The CHAIRMAN. Mr. Sax?

Mr. SAX. Mr. Chairman, the Tax Section certainly supports adequate funding for the Internal Revenue Service to do its job. As to

whether these announcements are a major step forward, I would characterize them as a necessary step.

The Internal Revenue Service had to act on the corporate tax shelter problem, but whether it is a major step, I do not know. For example, with respect to disclosure itself, there is no specific penalty in the Code for failure to make these disclosures.

The enterorum effect of failure might have been that not making the disclosures would have rendered the return a nullity; no return would have been filed, penalties would follow.

But the Service has, I think quite rightly, announced that failure to make these disclosures would not invoke the failure to file penalties and cause the return not to be a nullity. So, I puzzle over whether there is any great effect to the disclosure requirement without support from the Congress.

The CHAIRMAN. Mr. Scarborough?

Mr. SCARBOROUGH. I think the most interesting, and potentially most useful, of the measures that the IRS announced is the creation of the new Office of Tax Shelter Analysis.

I think, without that sort of office to coordinate analysis of the information that the IRS gets, the new reporting requirements may not do the IRS much good in enforcing the law.

I would also note that this new office will help taxpayers as well as the service by ensuring consistent application by examining agents of IRS rules on corporate tax shelters.

The CHAIRMAN. Mr. Shewbridge?

Mr. SHEWBRIDGE. TEI has always supported, I think, as you know, adequate funding for the Internal Revenue Service to do its job. We have always felt that both Treasury and the IRS needed to take steps to address the corporate tax shelter issue.

I think the thing that we are going to see from the regulations that were issued and the new office that has been set up within IRS, is that they will now be able to develop some empirical data to determine how big the problem is.

I think that has been one of the big issues with this, is I think we all know that a lot of products are out there being marketed and what have you, but nobody admits to buying them. Leastwise, I cannot find anybody.

So the question is, how big of a problem is it, really? I think that this will go a long way to developing some data to make a determination as to whether it is a major problem or not, which is one reason why we urge restraint, I guess, with respect to legislation until some data can be developed to see what it is that needs to be addressed.

The CHAIRMAN. As I am sure you are aware, much of yesterday's hearing focused on Treasury's proposal to codify the economic substance test. Now, I have a considerable concern that Treasury is actually setting a new standard rather than merely codifying the common law. I would be interested in what your views are. If the Treasury standard is codified, what will happen to the common law that has evolved over the years?

Would you care to comment, Ms. Akin?

Ms. AKIN. Mr. Chairman, I am really not involved with that. We generally represent real small taxpayers and small business.

The CHAIRMAN. Sure. Thank you.

Mr. Lifson?

Mr. LIFSON. Well, I am concerned with those small taxpayers because I think that, once codified and then put in the arms of revenue agents who examine a broad variety of taxpayers, that it would create new things that they might think of to attack everyday transactions with.

As with any new standard, if you change what was into something new and you do it by code rather than by judicial precedent, which gives you an elaboration of the facts and circumstances on which the logic was built, you perhaps create fine lines which are the same types of fine lines that created corporate tax shelters in the first place.

I would be concerned that codification could, in fact, increase complexity and provide a greater road map for avoidance of the rules. I think the judges have done a darned good job over the last 50 years of defining economic substance. It is so particular, often to the particular facts in a particular case, that it needs to have a very broad level of understanding to be properly applied.

The CHAIRMAN. Mr. Sax?

Mr. SAX. Mr. Chairman, we, too, share the concern for the unintended effects of an attempt to codify the economic substance doctrine and would discourage that attempt. We have thought long and hard about it and do not think it can be well done.

We do not think it is possible to know how a codification would play out over time. We do not know what the effects upon the well-developed case law would be. We are not confident the change would be for the better, and we again are very concerned for the potential for misuse.

It is for that reason that we have advocated only the very narrowest codification, which is to eliminate the promoter's argument that deminimus economic attributes are enough.

Again, what we would say is that, where a court chooses to apply the economic substance doctrine and engages in the balancing of economic attributes against tax benefits, that the economic benefits must be substantial in relation to the tax. That is the only codification we think practicable in these circumstances.

The CHAIRMAN. Mr. Scarborough?

Mr. SCARBOROUGH. We do not support codification of the economic substance doctrine at this time, for several reasons. One, we do not think there is any evidence that the common law economic substance doctrine as has been applied by the courts is not adequate to deal with the problem of corporate tax shelters. That is something you might not have been able to say a year or two ago.

There have been some very important court decisions in the last year or two relying on the economic substance doctrine that I think have had a perceptible effect on the willingness of taxpayers to enter into very aggressive shelter transactions.

The second point, is that codifying the economic substance doctrine is a very difficult thing to do. The situations are so varied and so nuanced, there are so many factors that need to be taken into account, that I am very skeptical as to whether it can be done.

The CHAIRMAN. Thank you.

Mr. Shewbridge?

Mr. SHEWBRIDGE. Well, we have also gone on record as not supporting codification of economic substance. We think, as has already been commented, that trying to draft such language would be next to impossible, and would produce unintended consequences. We think the courts have already done a good job of interpreting them.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Well, sir, have we not had superb testimony? We are very grateful to you and to your respective callings which you are here representing.

I noticed that several of you used terms that resonate from yesterday. Mr. Sax, I believe you referred to aiders and abettors, and Mr. Shewbridge spoke of people with products in the area of tax shelters.

Yesterday, Peter Faber, who is a tax lawyer from New York, testified about the marketing of corporate tax shelters. He said, "It raises issues of professionalism that perhaps go beyond the scope of these hearings, but are of concern to me. The accounting firms, for years, have acted as professional advisors to their clients and the clients have come to expect that of them.

If a firm presents a tax product to a company for which it expects to be paid a fee based on a percentage of expected tax savings, it is functioning as a commission salesman, not a professional advisor."

This is something beyond the reach of statute. We do not legislate professional standards. Do you have a sense somehow of something new having appeared or having appeared at a level that is new of aiders and abettors of products, of commission salesmen? Is that part of what we are dealing with here?

Ms. AKIN. Well, enrolled agents are governed under Treasury Circular 230, and for us to offer any type of a tax shelter would be a definite conflict of interest.

Senator MOYNIHAN. But obviously there are those that do.

Ms. AKIN. There are those that do, and hopefully they are doing the proper disclosure. But it is not under the realm of Circular 230.

Senator MOYNIHAN. Right.

Mr. Lifson?

Mr. LIFSON. A great deal of the changes in the professions emanate from actions by the Federal Trade Commission in the 1970's which required professional firms to offer contingent fees so that they would be competitive with each other. The ability to accept a commission and the ability to get involved in this area did not exist prior to the 1970's for major professional firms.

Senator MOYNIHAN. And this was the Federal Trade Commission.

Mr. LIFSON. Right.

Senator MOYNIHAN. How we ever get anything straight, I do not know.

Mr. LIFSON. Life is often a balancing act between the need to have competitive professional services offered to the general public on a fair and just basis, and perhaps the law of unintended consequences that may have somewhat contributed to the corporate tax shelter issue.

I, frankly, do not think that that is the driving factor behind corporate tax shelters. I believe that the economy, and simply the way business is done, equally contributes to them.

I think that this panel has offered, and the courts and the IRS have offered, many solutions to this very complicated problem. As I said before, I think there is no silver bullet, nor do I think is there any single answer that created all this.

Senator MOYNIHAN. Mr. Sax?

Mr. SAX. Senator Moynihan, you get into some very difficult territory; I much admire Peter Faber's courage for venturing into it.

At one level, this corporate tax shelter generation is marked by an ethical failing of professionals. That is clear. We acknowledge that. We have tried to address our end as tax lawyers, in October, proposing an amendment to Circular 230 to end the practice of penalty protection tax opinions based on a factual disconnect in this shelter generation.

That is to say, promoters would put a product together based on one set as factual assumptions and provide an opinion on that set of factual assumptions. But the deal could not be done that way, it would be done another way. That difference, that factual disconnect, would be hidden.

In our proposal to Treasury, we would render practitioners subject to discipline and disbarment if they gave opinions that failed to accurately address the facts, and so forth.

In another sense, our proposal to subject promoters and their advisors, including their lawyers, to penalties addresses the ethical failing. There, in a sense, a race to the bottom going on here.

One way to deal with that race to the bottom, is to eliminate the opportunity by a penalty structure that makes it not so attractive to do so. That is why our proposal contains as an essential element a penalty imposed upon our own people.

In a larger sense, we get into subjects beyond the scope of corporate tax shelters, and that is the changing nature of professional practice in America and marketing of tax products.

I do not know that I am prepared to comment fully on that, other than to acknowledge that the marketing of these products is done, in small part, by law firms, but I think our learning is that they are not very good at it. It is the investment bankers, the insurance companies, Big-5 professional services firms that are good marketers and they have become very adept at the promotion of these products.

Senator MOYNIHAN. We heard something to that effect yesterday, and it was the accounting firms. But they have professional standards, too. Perhaps you could write to us about this. Think about it on the way home.

Mr. SAX. We would be pleased to do that, Senator Moynihan.

Senator MOYNIHAN. We very much are in your debt.

Mr. Scarborough?

Mr. SCARBOROUGH. Your question about marketing tax shelter products raises several different questions. One relates to the role of investment banks, one relates to the role of big accounting firms, and another relates to the role of law firms. I am really best equipped to speak to the third of those.

As Mr. Sax said, law firms are not the primary marketers of tax shelter products and, frankly, are not as good at it as the others. The role of tax lawyers, generally, is limited to providing an opinion that a proposed product works.

I think eliminating the exception from current penalty rules, more likely than not, for opinions from professionals would address the role of tax lawyers in marketing tax shelter products.

Senator MOYNIHAN. Yes. Yes.

Mr. Shewbridge?

Mr. SHEWBRIDGE. Well, I also think that, aside from the promoters and developers of these products, you have also got to look at the purchasers of these products. I believe that they have a certain level of ethical standards that they should adhere to.

I do not think you want to get into the business of trying to legislate ethical standards for the different professions.

Senator MOYNIHAN. No. No.

Mr. SHEWBRIDGE. But I do think that the proposal for increased disclosure will help get at the problem, and perhaps shore up, if you will, some of the ethical behavior that people should be exhibiting.

The test that I use in looking at transactions, whether they be abusive corporate tax shelters or simply just legitimate business transactions, is would you want to see BellSouth's name on the front page of the Wall Street Journal associated with this transaction?

Senator MOYNIHAN. There speaks the integrity of the Bar.

Mr. Lifson, perhaps you could think about this for us, too, because you represent accounting firms.

I would just say, Mr. Chairman, that I think we have an obligation, if we can, to reinforce the integrity of the professions such that a partner in a law firm can say to a client, no, you cannot do that, and not have the client find someone who will say yes. Those standards are respected.

We depend much more than perhaps we know on these guilds. The lawyers, and doctors, and accountants are people set apart by their own standards which they police themselves, and society has a great interest in maintaining the vigor and vitality of those professions.

If anybody had any thoughts on this matter, I do hope you would write us, because I certainly am, and I know the Chairman is, very interested.

Thank you.

The CHAIRMAN. Thank you, Senator Moynihan. Let me just underscore what you said. I would appreciate you, Mr. Lifson, Mr. Sax, and all of you, give this further thought and advise us in writing as to your thoughts.

I want to thank you for being here today. I think we have to address a very serious problem, and I think your testimony has been very helpful. We look forward to working with you in the future. Thank you very much.

Senator MOYNIHAN. Thank you all.

The CHAIRMAN. We will now turn to our second panel, which will concentrate on penalties and interest from their unique perspectives.

It is a great pleasure for me to welcome Mr. Mark A. Ernst, who is the president and chief operating officer of H&R Block, Inc., Kansas City, MO.

And it is a great pleasure to welcome Ms. Nina E. Olson. Ms. Olson is the executive director of the Community Tax Law Project in Richmond. We are not only delighted to see you, Ms. Olson, but indebted to you for the very excellent testimony you provided us when we were considering restructuring the IRS.

So let me say that both of your written statements will be included as if read. Ms. Olson, we would be pleased to begin with you.

STATEMENT OF NINA E. OLSON, EXECUTIVE DIRECTOR, COMMUNITY TAX LAW PROJECT, RICHMOND, VA

Ms. OLSON. Thank you, Mr. Chairman and members of the committee. My name is Nina Olson and I am executive director of the Community Tax Law Project, a low-income taxpayer clinic serving Virginia taxpayers.

Thank you for inviting me today to discuss the impact of tax penalties and interest on low- and moderate-income taxpayers. This population includes the thousands of participants in welfare-to-work programs, increasing numbers of self-employed, and individuals who speak English as a second language.

These taxpayers usually rely on unenrolled return preparers for preparation of their income tax returns. My clients are not able to determine on their own what facts or information are relevant for return preparation, much less whether the correct positions are being taken on their returns.

We often find that, because of inadequate factual development at the return preparation stage, penalties are automatically imposed on these taxpayers through service center correspondence audits, even where the return is signed by a preparer.

The Joint Committee's proposal to repeal the reasonable cause exception to accuracy-related penalties will create greater discrepancies in penalty administration between low-income and more affluent taxpayers, with penalties being levied against the former simply because they did not have adequate return preparation.

We recommend retention of the reasonable cause exception, and even its expansion, to include significant mitigating factors such as compliance history or events beyond the taxpayer's control.

The restraints of the preparer's own professional standards, professional liability exposure, and the director of practice are meaningless to our clients, since their preparers are, for the most part, unregulated. These preparers usually operate out of storefronts, car dealerships, or kitchens. They are not the institutional unenrolled preparers such as H&R Block.

The Service simply must develop a regulatory framework for unenrolled preparers, imposing an annual continuing education requirement, including ethics training, with systematic enforcement and real sanctions levied against preparers who fail in their dual duty to taxpayers and to the tax system. I say this, having been an unenrolled preparer for 16 years prior to becoming an attorney.

True, my proposal may increase the cost of return preparation. However, our clients incur hidden costs in the absence of regulation. Our clients lose time, credit, money, and peace of mind.

We need a grant program—yes, another grant program—providing administration and translation expenses for VITA sites located in underserved areas, for example, enterprise zones, low-income housing developments, and immigrant communities.

We support replacing the late payment penalty with an annual service charge in conjunction with a market rate for interest and monthly, not daily, compounding.

In the current collection process, compounding penalty and interest overwhelm the taxpayer's desire to pay. I suggest a more flexible timetable for obtaining an installment agreement before applying the 5 percent service charge, perhaps 6 months instead of 4 months, with frequent IRS contact during this period. We can learn a lot from catalog retailers about the marketing of a deal.

Taxpayers in currently not collectible status should be offered the incentive of penalty abatement if, at some future time, they successfully pay all taxes and interest. We want these taxpayers to remain in the system. We oppose the imposition of a service charge on late-filed refund or no balance due returns, since it will function as a road block to compliance.

Further, we suggest that underpayment interest be abated to the extent that a non-filer also has outstanding returns showing refunds barred by the statute of limitations.

This proposal will encourage non-filer reentry but will not reduce the amount of tax or the failure to file penalty. We recommend a separate form and instructions for penalty and interest abatement to guide taxpayers through the process.

Penalty and interest abatement should also be expressly mentioned as a relevant issue that may be raised in a collection due process hearing, thereby granting judicial review in the CDP context.

We support the Joint Committee's proposal that the Secretary of Treasury have authority to abate interest in certain situations and believe it should be extended to penalties.

We prefer the language of Section 6015(f), where relief may be awarded from joint and several liability if, "Taking into account all the facts and circumstances, it is inequitable to hold the individual liable."

I can find no other use in the Code of JCT's proposed gross injustice term. Frankly, I do not know what that term means.

There is, however, a growing body of law regarding inequitable circumstances as well as a centuries-old history of equity jurisprudence in Anglo-American courts. Equity jurisprudence is particularly appropriate in a code-based practice such as the Internal Revenue Code, where remedies are often inadequate in light of all the facts and circumstances.

Providing judicial oversight of the Secretary's equitable determinations of penalties—and interest abatement, or 6015 relief which, if it is denied functions as a penalty, will not undermine the Secretary's discretion.

Instead, it will reassure all taxpayers that equitable relief is being fairly administered and according to clearly enunciated equi-

table principles. The bright light of day can only have a beneficial effect on tax administration.

I thank you for this opportunity to raise these concerns, and I will be glad to answer any questions.

The CHAIRMAN. Thank you, Ms. Olson.

[The prepared statement of Ms. Olson appears in the appendix.]

Mr. Ernst?

STATEMENT OF MARK A. ERNST, PRESIDENT AND CHIEF OPERATING OFFICER, H&R BLOCK, INC., KANSAS CITY, MO

Mr. ERNST. Thank you, Mr. Chairman and members of the committee. I appreciate the opportunity to discuss the recommendations of the Joint Committee on Taxation and those of the Department of Treasury. Both studies, we believe, are very well done. We are pleased to contribute to the Joint Committee's study.

H&R Block is America's largest tax preparation company. At nearly 9,000 U.S. offices, we helped over 16 million individual clients file tax returns in 1999, which is about 1 in 7 received by the IRS, including 46,000 in Delaware and 781,000 clients in New York.

We are also active in tax education, tax preparation software, electronic filing and Internet filing, including free 1040EZs.

H&R Block tax service guarantees clients that we will pay any penalties and interest resulting from any error that we commit. We also assist taxpayers whose returns we have not prepared in understanding penalty assessments and seeking abatements when appropriate.

My full testimony includes an appendix with our specific recommendations, and charts illustrating the large number and complexity of penalties, especially for retirement accounts.

While we serve clients across the income spectrum, and businesses as well as individuals, my comments will focus primarily from the perspective of average, middle class taxpayers.

We agree that penalty and interest provisions need reform. We would go even further in urging overall consolidation and clarification.

Briefly, let me comment on a couple of things. We believe that the failure to pay penalty should be eliminated, and the failure to file penalty simplified. Rules for retirement plan rollovers and distributions should be simplified.

Penalty calculations for underpayment of estimated tax should be simplified. Penalties for small business employment tax deposits should be simplified and eased. Preparer penalties should be strengthened and equalized for taxpayers and preparers, and the IRS's authority to abate interest should be expanded to add more equitable relief.

The present penalty and interest system is overly complex, inflexible, and sometimes harsh and inconsistently administered. Penalty and interest notices confuse average taxpayers; those who make an innocent mistake are sometimes entangled beyond their ability to recover. IRS administrative delays, combined with interest compounding, can create nightmare scenarios.

The GAO reports that 64 percent of the amounts shown as owed to the IRS by taxpayers are for penalties and interest, and only 36 percent are for the original tax still due.

A system intended to encourage compliance may in some cases actually end up discouraging it. Let me highlight a couple of areas of concern.

First, failure to file and pay. Circumstances sometimes prevent taxpayers from filing. While penalty and interest on overdue funds is appropriate, present penalties are overly complex. Most average taxpayers cannot understand or calculate the consequences of failing to file or pay, and have only a basic understanding that a penalty even exists.

Even when taxpayers pay their underlying tax debt, the penalties and interest can take on a compounding life of their own as interest accrues on the penalties and interest due. Many individuals who fall out of compliance can find their liability doubled or tripled. That discourages many non-filers from reentering the system.

Moreover, IRS communications are not helpful. They can cite the penalty code section, but provide no additional information about the reason for application and the possibilities for abatement.

Second, retirement plan penalties. Retirement plan rules on rollovers and distributions illustrate how misunderstanding a complex underlying law can snag taxpayers in a maze of complex penalties.

The penalties and tax can exhaust a substantial portion of an average person's retirement savings, a result we do not believe Congress intended. We support the administration's proposal to allow the roll-over of after-tax contributions following a recommendation we and others have made. We also believe taxpayers should be allowed to correct inadvertent errors to roll-over contributions and distributions.

Third, on the failure to pay estimated taxes, the requirement to pay these estimated taxes is particularly complex. Higher income taxpayers have to pay a higher percentage of last year's tax to avoid the penalty. The percentages go up in some years, and down in others.

The multiple calculations needed to determine the underpayment penalty in Form 2210 challenges taxpayers and preparers. Quarterly changes in interest rates and underpayment periods add immense complexity.

Because these periods do not coincide, underpayments in one period must sometimes be allocated between two or three different rates. Those without benefit of tax preparation software often flounder in the calculations. We join in recommending simplification.

Fourth, around small business withholding deposits, the rules for small businesses who must deposit payroll taxes for their employees are extremely complex, and we encourage review for simplification in that area.

We also believe there are opportunities for changes in simplification, both to preparer penalties where we would encourage a stronger compliance or stronger penalties for preparers who fail to adequately provide for appropriate preparation of their clients' re-

turns, and we believe that there are opportunities to improve the abatement authority that the IRS has.

In conclusion, Mr. Chairman, penalties and interest have an important role to play in ensuring compliance, but most taxpayers want to comply with the law. They are afraid of making a mistake on their returns, less for fear of penalties than for fear of receiving an IRS contact letter, and the present system is so needlessly complex, it may be counterproductive.

Thank you. We would be happy to answer any questions.

[The prepared statement of Mr. Ernst appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Ernst.

I would like to ask both of you, from your perspective, what is the most important recommendation included in either the Joint Tax or Treasury penalty and interest study? Do you have any recommendations that were not included in the studies? Ms. Olson?

Ms. OLSON. I think that the Joint Committee's recommendation about the failure to pay penalty is very important. My taxpayers see, when they are unable to pay their taxes in a timely fashion, the penalties and interest just spiraling out of control and it defeats their desire to make payments.

So I think that shepherding taxpayers to an installment agreement and holding off on a late payment charge encourages them to do that and will bring about greater compliance. It will also do what we need, which is making them pay sooner rather than later. I think the sooner we can collect the taxes, the greater our likelihood of collecting them.

I have spoken at the end of my oral comments, and certainly addressed this in my written comments, that I think that Tax Court jurisdiction over penalties and interest is very important. These are a major part of our tax system and I think that the judiciary needs to play a role in looking at them.

Part of the Restructuring Act focused on the problem of my taxpayers not being able to necessarily get into Tax Court, and we created the collection due process procedure to give them a second chance, in a way. I think that that is a very viable route for the Tax Court to look at penalties and interest.

The CHAIRMAN. Mr. Ernst?

Mr. ERNST. I would echo Ms. Olson's comment, and add one more. I believe, of all the proposals that are out there, there are probably two that we believe can have the greatest impact on ensuring that average Americans continue to comply with our taxation system and stay in that system.

The failure to pay and the failure to file rules can have the unintended consequence quite often of encouraging people to exit the system and stay out of the system because penalties become so large, so onerous, and there are limits on what the IRS can do to waive or abate those penalties.

We believe that a simpler system around failure to pay/failure to file, and a greater ability to actually encourage people back into the system, will have a long-term benefit both in terms of people staying in the system, as well as people believing that the system is, in fact, fair.

The other area that I would underline that I believe there is an opportunity to encourage average Americans to take advantage of

some of the benefits that exist in our system, is around the whole area of penalties and issues related to retirement plans.

As people become far more responsible for their own retirement savings, many of the rules that apply today make it very, very complex for people to understand exactly what benefits they have and how to take advantage of those benefits.

Quite often, we see people becoming ensnared in issues that they did not intend to as it relates to moving money in and out of qualified accounts. We believe that the rules around those provisions offer an opportunity to help average Americans and to bring more people into the voluntary savings program as well.

The CHAIRMAN. The number of penalties in the IRS Code has grown to well over 120 over the years and helps create incredible complexity. Do you have any recommendations to reverse this trend and reform the penalty system? Ms. Olson?

Ms. OLSON. I think that you can roll a number of the existing penalties into broader language of an accuracy-related penalty. I have not really thought about what that language would be, but it seems to me that there is a great deal of overlap there; perhaps with appropriate regulations, more generalized language could make one penalty work for more situations than having the numbers.

Certainly, the simplification of the failure to pay and the failure to file will be a simplification. For our clients, when they get a notice where the interest and the penalties are calculated and it takes three pages just to spell out those calculations for the taxpayer, you can see people throwing those pages away and just walking away from the system. That is system overload, for sure.

The CHAIRMAN. Mr. Ernst?

Mr. ERNST. I believe there are a couple of things that I would highlight that I think can certainly improve the system. The opportunity to consolidate many of the penalty provisions and have them apply more broadly rather than having individual penalty provisions, we believe, would go a long way to helping people better understand how they work.

We also believe that the work that the IRS has been instructed to do related to disclosure of how penalties are being calculated beginning next year is an important step to helping taxpayers understand what is going on.

I would also offer that we believe that the IRS's move to encourage more digitization and more electronic filing has a benefit, in that through that process many of the calculations of penalties are done through software and other means before they get to the IRS, and in many cases taxpayers find themselves complying with relatively complex provisions because the software is now doing it for them.

So anything that encourages electronic filing has, perhaps, the unintended benefit of helping people better comply with both the laws, as well as any penalty provisions that may apply.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Yes. First of all, may I just say in memorium, as it were, the tax season is upon us. For any number of years, I had the joy, if you will, of receiving a letter from a revered friend, Erwin Griswald, who was former dean of the Harvard

Law School and former Solicitor-General, who later practiced law in Washington, and he would make out his own returns.

In the last letter I got from him in 1994, he estimated it would take him just under 100 hours. At the rate Jones, Day, Reavis & Pogue charge their clients, I think H&R Block would have done it much more effectively for him. But he wanted us to know how long it took, how it was involved. It is dismaying.

I am going to ask, Mr. Chairman, if I might just take the liberty of putting his four-page letter in the record. It is a treasure of what a great mind has to do with an overpowering system.

[The letter appears in the appendix at page 134.]

Senator MOYNIHAN. But then could I ask, because we are going to be on the floor with this, both Ms. Olson and Mr. Ernst, we are going to be dealing with a marriage penalty issue fairly shortly. I am wondering if you can help us understand how low-income taxpayers are affected by the marriage penalty, particularly in the Earned Income Tax Credit.

Ms. OLSON. Well, as you know, if you are married, filing separately, first of all, you are not eligible for the Earned Income Credit at all. I will come back to that in a moment.

If you are married, filing jointly and you both work, your credit is going to be reduced because the Earned Income Credit really does not go by the number of working taxpayers in the family, it looks at your overall earned income in the taxable unit.

So it is beneficial for individuals to not marry, so that if they are living together then perhaps one would qualify as head of household with a qualifying child, and the other person would be single.

The head of household would be able to obtain an Earned Income Credit, and the single person may very well be able to get an Earned Income Credit for childless workers. Whereas, if they married, perhaps the combined income of that marital unit would cause them to be over the limit for receiving an Earned Income Credit.

Now, there is also a hidden marriage penalty in the filing status of married, filing separately. Many of my low-income clients are separated. They may be separated legally, certainly by the definition of the Commonwealth of Virginia they are separated in the eyes of the Commonwealth. They may not have a qualifying child living with them.

There is a provision in the Internal Revenue Code that allows a person who is living separate from their spouse for the last 6 months of the year and has a child for whom they are maintaining a home for more than half the year, the last 6 months of the year, that they will be considered not married and, therefore, they would be eligible for the head of household, and then they would be eligible for the Earned Income Credit.

But for the individual who is not divorced, if they do not have a child or they do not live the last six months of the year, they just get separated in the last 4 months of the year, they are stuck filing married, filing separately and they cannot claim the Earned Income Credit, and they cannot even claim the beneficial rates of being single.

I think that our Tax Code needs to take into consideration that there are plenty of people legally separated, but do not have a de-

cree of divorce or divorce by bread and board, and that the Tax Code is penalizing them in their filing status.

Senator MOYNIHAN. We will be in touch with you on that. It is important.

Mr. Ernst?

Mr. ERNST. Yes. I am not sure I have a lot to add to that. I think it is a very good description. We see this all the time that there is clearly a penalty or disincentive at the lowest income levels in this country for people to be married when they have children because of the interaction of the Earned Income Credit, and the inability to qualify for it if someone is actually married. We believe that this is actually having an effect on people's choices at those income levels.

The challenge I believe we have with our system, however, is that there is at one time a call for simplification and making tax provisions simpler and at the same time fairer, and the determination of fairer is not always simple.

The proposals that I have seen all suggest that there is a particular need to offer relief for the marriage penalty, but all of the proposals that I have seen, or most of the proposals I have seen, provide that relief, certainly, at middle- and upper-income levels as opposed to people who are the lowest income levels in this country.

Senator MOYNIHAN. Not to denigrate our friends from the other body, and not to engage in any dispute of my revered Chairman, but the table that came out of the Committee on Ways and Means in this regard looks like the periodic table of the elements, if you will remember, that baffled you when you were a freshman, and baffles me to this day.

But, just to conclude, we did have a philosophical witness some while ago who said, a tax code can be fair or it can be simple, it cannot be both.

Thank you very much for excellent testimony.

The CHAIRMAN. Unfortunately, I think that has been our experience.

Again, let me thank both of you for being here. We appreciate your testimony, and we look forward to working with you in the future.

The committee is in recess.

[Whereupon, at 11:43 a.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Judith Akin, EA

Mr. Chairman and members of the committee, I am Judith Akin, Enrolled Agent. I am the immediate past chair of the IRS Information Reporting Program Advisory Committee (IRPAC) and I am an officer and member of the Board of Directors of the National Association of Enrolled Agents. I have been an EA for more than 25 years and maintain a private practice in Oklahoma City, Oklahoma where I work with individual and small business taxpayers.

Today I am representing the National Association of Enrolled Agents whose more than 10,000 members are tax professionals licensed by the U.S. Department of the Treasury to represent taxpayers before all administrative levels of the Internal Revenue Service. I am pleased to have this opportunity to testify before you on the subject of penalty and interest reform and to provide you with NAEA's recommendations.

As you know, Enrolled Agents were created in 1884 to ensure ethical and professional representation of claims brought to the Treasury Department. Members of NAEA ascribe to a Code of Ethics and Rules of Professional Conduct and adhere to annual Continuing Professional Education standards that exceed IRS requirements. Like attorneys and Certified Public Accountants, we are governed by Treasury Circular 230 in our practice before the Internal Revenue Service. We are the only tax professionals who are tested by the IRS on our knowledge of tax law. Each year we collectively work with millions of individual and small business taxpayers. Consequently, Enrolled Agents are uniquely positioned to observe and comment on the average American taxpayer's experience with our system of tax administration.

Since our testimony before the Commission on Restructuring the IRS in 1997, NAEA members have frequently spoken out on the need for penalty and interest reform. We are pleased to see this issue addressed by the Joint Committee on Taxation and the Treasury. We offer our views on their recommendations and will comment on various Treasury and JCT proposals as they affect individual and small business taxpayers. In addition, we are providing you with penalty and interest cases involving individuals, small businesses, and nonprofit organizations that will provide insight on the impact of present law.

CORPORATE TAX SHELTERS

Our only comment on the issue of corporate tax shelters is that we respectfully request that the members of this committee consider the impact of these devices on the compliance of average taxpayers. Our tax system is based on voluntary assessment. If average taxpayers believe that those who faithfully pay their taxes are being foolhardy, then you will see a commensurate increase in noncompliance.

You may recall that one motivating factor for the Tax Reform Act of 1986 was that large corporations were "zeroing out" on their taxes. Middle class taxpayers realized they were paying more in taxes than corporate giants. Were the tax breaks of the time legal? Yes, but they undermined our tax system. Its perceived fairness is critical to its success. Speaking as someone from the heartland, I urge you to maintain taxpayer confidence in the integrity of our tax system.

63-714 00-3

NAEA POSITIONS ON PENALTY AND INTEREST REFORM PROPOSALS

1. Interest Rates—Sections 6601–6621

NAEA supports the Treasury position retaining present law with respect to individuals who are generally required to include overpayment interest received in income and for whom no deduction is allowed for underpayment interest paid.

In the area of abatement of interest, NAEA supports the JCT staff position that would permit abatement of interest if attributable to any unreasonable error or delay by IRS. It is our view that the taxpayer should not be penalized for an IRS error.

NAEA supports the JCT staff position that interest may be abated in the case of erroneous refunds not caused by the taxpayer.

NAEA supports the JCT staff position that where a taxpayer relies on the written statement of the IRS, then taxpayer owes tax but no penalties or interest should be imposed.

NAEA also supports the JCT staff position with respect to other abatements. Specifically, retaining current law but permitting abatement of interest if a gross injustice would result if interest were charged.

NAEA supports the JCT staff recommendation with respect to Dispute Reserve Accounts. This strikes us as a good way to balance taxpayer and government interests.

2. Failure to Pay Estimated Tax—Sections 6654 and 6655

NAEA strongly endorses the JCT staff recommendations in this area, particularly repealing the penalty and replacing it with an interest provision.

We also support increasing the threshold to $2,000 and looking to estimated tax payments made in four equal installments in determining whether the threshold is met.

We also endorse repealing the modified safe harbor so that all taxpayers making estimated payments on prior year's tax would do so based on 100% of the prior year's tax.

Finally, applying only one interest rate per estimated tax underpayment would greatly simplify this area.

As an aside, starting July 1, 2000, individual taxpayers will be able to warehouse estimated tax payments for up to one year under the Electronic Federal Tax Payment System (EFTPS) while businesses will be able to do so for 90 days. Taken together, these developments will help simplify one of the most confusing and burdensome areas in the law.

We would support the JCT staff and Treasury recommendations with respect to calculation of underpayment balances for individuals and corporations. This area is in need of major rework and simplification.

NAEA supports the Treasury provision that general computational simplifications are needed in the area of estimated tax underpayments extending from leap year to nonleap year for individuals and corporations.

NAEA supports the Treasury recommendation permitting a reasonable cause waiver for first-time payers of estimated tax, provided the balance due on the return is below a threshold amount and is paid with a timely-filed return.

With respect to the waiver of de minimis penalties for individuals and corporations, NAEA would support the Treasury recommendation that would waive penalties below a de minimis amount. As a practitioner, I would comment that the amount of work required to calculate a de minimis penalty of $2 is not economically beneficial to the taxpayer who must pay to have the calculation done and is a burden to the practitioner.

3. Penalty for Failure to Pay Taxes—Section 6651(a)(2)

Section 6651(a)(2): NAEA supports retention of current law. However, we would urge simplification of the calculation of penalty and interest due. NAEA has long opposed the $43 user fee for an installment agreement. Taxpayers feel this is an additional penalty. NAEA believes the automated withdrawal of installment payments is an acceptable trade-off for eliminating the user fee.

4. Penalty for Failure to File Tax Returns—Section 6651(a)(1)

Section 6651(a)(1): NAEA opposes the Treasury recommendation to impose a service charge for failure to file a "no balance due" return. It contradicts a recent IRS initiative called Reduce Unnecessary Filings (RUF) which advises certain taxpayers—senior citizens, students—that they may not need to file returns.

5. Tax Return Accuracy Penalties—Sections 6662, 6694

NAEA agrees with the Treasury view that the penalty may apply—and should be the same for both taxpayers and practitioners—where there is no realistic possibility of success on the merits in the case of a disclosed positions.

NAEA agrees with Treasury that the penalty may apply—and should again be the same for both taxpayers and practitioners—if there is no substantial authority for an undisclosed position.

6. Return Prepare Penalties—Section 6694

NAEA opposes fee-based preparer penalties for non-shelter items. We do, however, believe that the current penalty of $250 for an understatement due to a position for which there was no realistic possibility of its being sustained on the merits needs to be substantially increased. For those practitioners dealing with individual and small business taxpayers, an increase in the penalty to an amount not to exceed $500 would be significant.

NAEA also opposes fee-based preparer penalties for willful and reckless conduct. However, we agree that this penalty should be substantially increased. Given the current low rate of IRS audits we know there are unscrupulous individuals who are willing to play audit roulette. We would suggest that the penalty be increased to an amount not to exceed $1,500.

7. Penalty for Filing a Frivolous Tax Return—Section 6702

NAEA supports the Treasury proposal to increase the penalty from $500 to an amount not to exceed $1,500. The current penalty is a slap on the wrist and an insult to honest taxpayers who make every effort to comply with the law.

8. Penalty for Failure to Deposit Taxes—Section 6656

NAEA strongly supports the Joint Tax staff suggestion calling for penalty abatement for inadvertent failures when the taxpayer changes to a different deposit schedule. A case which came to our attention involved a retail store owner in New Hampshire who had an impeccable record of making timely—even early—deposits of payroll taxes stretching back 20 years. He was not aware that effective 1/1/99 he would be required to make semi-weekly deposits. By the time the error was caught, the penalty due was $2,000 even though he was still making timely deposits under the old schedule.

9. Penalties for Failure to File Form 5500 Series Annual Return for Pension and other Deferred Compensation

NAEA endorses the JCT staff recommendation that the three penalties should be consolidated into one penalty and that IRS should be the administrator.

NAEA CASE STUDIES

More than half of NAEA's members are online. As a result, NAEA regularly surveys its members for their views and experience on various issues. The survey on penalty and interest reform generated scores of replies. They break down into several areas: those affecting small business, those affecting senior citizens, and those affecting small nonprofit organizations. We are including them in our testimony as reference points. If the recommendations we have endorsed were adopted, we believe many of these cases would be resolved.

1. Small Business

It is a frequent assertion that small business is the least compliant part of the taxpayer community. However, as frontline tax practitioners, we find that noncompliance is often due to a lack of information and understanding of the tax code. We are very pleased that IRS is working to overcome this through outreach programs to the small business community. However, there remain many other areas of concern.

- A young businessman in Virginia was advised to set up his small company, in which he was the sole person involved, as an S Corporation but did not know he was supposed to pay himself a salary. A couple of years went by and this individual did not withhold taxes on the amounts he withdrew from the corporation. An accountant, upon finding this error, went back through the records and grossed up his pay, filed the necessary payroll tax reports, and told the client how much in tax he had to pay. The client agreed this was reasonable and began paying the back taxes on installments and kept current with the reporting. The IRS came in and assessed the 100% penalty on the back taxes, refusing to abate any of the penalties and interest. The young man was forced into bankruptcy. This was a clear example of a good person who was trying to do the

right thing and was not trying to "beat the government." A reasonable penalty and interest charge in this situation would have been warranted but not the 100% penalty.

- In 1983, a small businessman in Texas, faced with his wife leaving him and his son being sent to prison for murder, became a non-filer. He had had his tax return prepared but in the midst of the family tragedy, neglected to sign and send it in. When contacted by the IRS in 1990, he filed his returns from 1986 forward but, wanting to be completely honest, he volunteered to file for 1983, 1984 and 1985. The years he volunteered to file were then chosen for audit. He was assessed $19,000 in additional income and self-employment taxes and $75,000 in penalties and interest. IRS refused to accept an offer in compromise. He was forced into bankruptcy. When he sold his business he owed $31,000 in income tax. The funds from selling the business were put into bankruptcy and the IRS would not release the funds to pay the tax. When they finally released the funds, IRS assessed him penalties and interest for not paying his taxes on time.
- A cabinetmaker in California tried to get back in business after declaring bankruptcy in the early 1990s. Faced with cash flow problems, he made payroll deposits late. Penalties and interest on his account now total 52.6% of his tax liability, although he has made every effort to get current. When asked about penalty abatement, IRS declined, even though the taxpayer has kept his account current and recently made a $3,000 lump sum payment.
- Taxpayer owed $989.70 on a 941 payroll return. Taxpayer has paid the original amount but still owes $2,165.65, which is more than twice the original tax.
- In a trust fund recovery case, the penalties and interest assessed have gone way beyond the point of paying the outstanding payroll taxes due. Taxpayer owed in excess of $10,000 in payroll taxes from 1991 and 1992. They were paid in full as part of an Installment Agreement from 12/92 through 6/93. Taxpayer went through bankruptcy in 1994 but IRS was not represented. Taxpayer today owes almost $90,000, has lost his business, has major health problems and has no way to pay the IRS.
- A client who does her own payroll did not do the "look back" on tax deposit frequency. The four-quarter deposits in that "look back" totaled $50,005, $5 over the amount that required her to pay semi-monthly. IRS has discontinued sending notices and thus she continued her monthly deposits in 1999. The penalty for first quarter was in excess of $500, with the same true for the second quarter. She sought professional help and the penalties were finally abated but the process was quite time consuming.
- Taxpayer died last December 25, 1998 after a lengthy illness. His wife was unable to get the 941 (payroll tax deposit) taxes paid on time. IRS said she would have to pay the penalties and interest first, in order to be considered for the abatement. If she could pay the penalties and interest, she would, obviously, not have to request any assistance. Because of the penalties, she cannot pay the taxes owed and it keeps growing faster than she can pay.

2. Small Nonprofits

Understanding of the tax laws as they apply to nonprofits is a perennial issue for those of us who work with small nonprofit organizations. Often, community-based organizations have volunteer leadership, which changes from year to year. Frequently we find they have no permanent staff, no records, or if they have them, they are very spotty and incomplete. Sometimes the leader is a visionary who is focused upon the mission of the organization and fails to think about taxes at all. There is a widely held view at the grassroots level that nonprofits are exempt from all taxes. Imagine the surprise when a tax notice is received.

- A social club in Alabama was penalized $440 for late filing of the Form 990EZ. It was due May 15, 1998 and was filed 22 days late.
- A small nonprofit received a penalty for late filing totaling $1,640 when the administrator, in attempting to obtain an extension to file the return, used the guidelines for the individual extension. He sent in the request but neglected to give a "reason" for the request. When IRS notified the nonprofit that the extension was not accepted, the nonprofit quickly sent in the return so that it was only 2 weeks late. However the penalty was assessed anyway.
- Two payroll tax checks were inadvertently buried on the desk of the pastor of a small church. The payments were mailed in but, of course, were late. IRS assessed a penalty. Abatement was requested on the grounds that payroll tax deposits had not been late in over 5 years and that although the circumstances may not be "reasonable cause" in nature they were certainly not a case of "willful neglect." Penalty abatement denied.

- The pastor of a small church in Florida applied for and received recognition as a not for profit more than a dozen years ago. Pastor believed organization did not need to file any tax returns because of its nonprofit status. IRS wiped the client from its records because a return has never been filed. When the church sought an EA to put together financial records for a bank loan, they were asked for copies of their tax return. In the words of the EA, they hadn't a clue. The pastor decided to file all returns that had never been filed. Meanwhile, IRS could find no record of their being approved as a not for profit but fortunately, the taxpayer had held onto that document so it was sent to IRS. Information is being reconstructed for tax years 1995–1998. IRS has assessed a penalty of $5,000 for 1995 but has yet to bill for the other years. True, the client was negligent but so was the IRS for not following up when the nonprofit did not file originally.

3. Individual Taxpayers

We received many comments about taxpayers—particularly senior citizens—being assessed penalties where they truly did not understand the situation and were caught unaware. Steps need to be taken immediately to lessen the impact on taxpayers who are completely in the dark about the penalties and interest they face if they try to come back into compliance after an innocent mistake.

Furthermore, as our society moves toward self-managed retirement plans such as IRAs and 401(k)s, there will be many more opportunities for individuals to inadvertently run afoul of the system with disastrous consequences.

Some examples of the problems senior citizens face are cited below:

- A senior citizen is drawing out his IRA, using the minimum distribution. In November 1998 his wife was sick with pneumonia and she was hospitalized for 9 days. With his stress, he forgot, and the bank neglected to remind him, to take out his minimum distribution of $1,692. When he realized his mistake, he withdrew it on February 1, 1999. When he did the return on March 6th, the EA had to prepare a Form 5329 and he paid the $846 (50%) penalty. Without the penalty, he owed $15. As directed in Publication 590, a letter was included explaining the situation but apparently it was never read. Nothing was heard from the IRS for 6 months. About 3 weeks ago his EA followed up with a Power of Attorney, a letter and copies of all documents. The most aggravating thing about this is he is a retired person who is trying to comply with the tax law and gets hit with a 50% penalty. If he had committed civil fraud and willfully understated his taxes by the same $1,692, his penalty would have been 25% or $423.
- Taxpayer is a widow in her late seventies who is still working as a secretary in a federal agency. She has a small IRA in the agency's credit union. In August, the credit union sent her a form stating that because she was past 70-1/2 years of age, she must withdraw a certain amount. If she agreed to the withdrawal, she merely had to check a box and return the form. She suffered a heart attack and was hospitalized for several weeks. Consequently she failed to return the form. The penalty for failing to make the required withdrawal is 50%. A request that the penalty be waived has been made, but this is an example of the type of circumstance affecting potentially millions of taxpayers of ordinary means.
- Taxpayers, age 78 and 76 years old, have an outstanding tax liability from 1967 and 1968. Thirty years later, it's still open as the IRS has threatened action on these retired people and had repeated statute extensions signed. For tax year 1967, original debt was assessed at $27,015.25 in 1975. Current debt is now at $236,255.26 after more than $40,000 has already been paid on the debt. For 1968, liability was assessed at $9,813.28 as of 1975. $14,000 was paid in 1975 with a current balance due of $13,130.07. Both the 1967 and 1968 returns were filed timely. They are paying off the debt at the rate of $150 to $300 per month with no hope of ever paying it off. Each payment made shows an equal amount of interest assessed each month so no progress is ever made and then the additional interest that they couldn't pay is incurred. This couple has few assets: a 1987 Chevy, a little life insurance. They owe $15,000 in credit card bills; they pay $900 per month for medical care and are in very poor health. They have lived with this situation hanging over their heads all these years.

Increasingly complicated estimated tax rules are making it difficult, if not impossible, for taxpayers to stay in compliance. Just one example of several that were sent in:

- Taxpayer's liability for the 1998 1040 was $9,000 which was satisfied with estimated payments of $5,800 made before the submission of the return and $3,200 paid with the submission of the return. IRS null and voided her Form 4868 Re-

quest for Automatic Extension of Time to File, charging a penalty of $676. The interest tab was $106.99. The taxpayer managed to find herself in this situation despite having overpaid (paid in advance) her estimated tax, even through the 4th quarter.

We are finding that once taxpayers fall behind, they may never be able to catch up. A typical example:

- In 1989, a low wage individual went to work for a company. He did not realize taxes were not being withheld. He was given a 1099–MISC at year-end but had no money to pay taxes. His 1989 tax debt is now $17,262 of which $1,598 is penalty and $9,079—one-third more than the tax owed—is interest. Given his spotty work history, he owes from 1990 and also 1997 and 1998. Most low-income taxpayers do not question employers. They want the work and just don't understand when employers hand them a 1099–MISC instead of a W–2 at the end of the year. This is particularly true for low-income workers who are often very naive about employment taxes and who are not in a position of strength to bargain with a prospective employer.

CONCLUSION

I would like to thank you, Mr. Chairman and the members of the Finance Committee, for the invitation to share our members' views with you today. It is our belief that if Congress will act upon the recommendations made today, taxpayers will have greater confidence in the fairness of our tax system and a number of the cases cited above would be resolved quickly.

PREPARED STATEMENT OF HON. PAUL COVERDELL

Mr. Chairman, let me take this opportunity to thank you for holding this hearing on interest and penalties. It is shocking to realize there are roughly 120 penalties on the books. When combined with interest payments, a modest taxpayer can very quickly find himself in real trouble before he or she is aware anything is wrong. It is important that we do everything we can to ensure tax compliance, but we also need to ensure sufficient clarity and flexibility that we do not inadvertently drive otherwise innocent taxpayers out of compliance with the tax system.

I look forward to hearing more about this subject and to working with you on solutions that will help to restore the balance between responsible enforcement for taxpayer compliance and taxpayers' rights. The paramount right in this regard is that every taxpayer that wants to accurately and correctly pay their taxes should able to do so—in good faith—under the tax code without fear of arbitrary or capricious penalties.

PREPARED STATEMENT OF MARK A. ERNST

Mr. Chairman and Members of the Committee:

I'm Mark Ernst, President and Chief Operating Officer of H&R Block, Inc., headquartered in Kansas City.

H&R Block, founded in 1955, is America's largest tax return preparation company. At more than 8,900 U.S. offices, we handled over 16.5 million individual returns in 1999, which is one in seven received by the IRS and about 330,000 per state.

We author the annual H&R Block Income Tax Guide and are leaders in tax education, tax preparation software, individual tax filing via the Internet, and practitioner electronic filing. Over 120,000 individuals take our tax training courses annually. We publish Kiplinger TaxCut® tax preparation software, which has over 1.5 million users. We provide tax preparation and e-filing on our Internet site including free service for those using the Form 1040EZ. And we originate about half the practitioner e-filed returns that the IRS receives.

We also offer our clients mortgages, financial planning, and investment services. We are building a national accounting practice to expand our business services. And we prepare tax returns at over 1,200 offices in Canada, Australia, and the United Kingdom.

At H&R Block, we guarantee our clients that we will pay penalties and interest resulting from any error we may commit. We also assist taxpayers whose returns we haven't prepared in understanding penalty assessments and seeking abatements when appropriate.

PENALTY AND INTEREST STUDIES

I appreciate the opportunity to discuss the recommendations of the Joint Committee on Taxation and those of the Department of the Treasury. Both studies were very well done and we applaud their efforts. Our Tax Training and Research Departments provided informal comments during the course of the study to the Joint Committee staff.

I'd like to comment generally on the need for reform and highlight several items. I've attached an appendix with our comments on specific recommendations and two charts we've prepared to illustrate the large number and complexity of penalties, especially for retirement accounts. While we serve clients across the income spectrum and businesses as well as individuals, our comments are primarily from the perspective of average middle-class taxpayers.

In summary, we believe penalty and interest provisions can be consolidated and clarified:

- The failure to pay penalty should be eliminated and the failure to file penalty simplified.
- Rules for retirement plan rollovers and distributions should be simplified.
- The calculation of penalties for underpayment of estimated tax should be simplified.
- Deposit rules for small businesses employment taxes should be simplified and eased to reduce or waive penalties for failure to follow the correct deposit method.
- Preparer penalties should be strengthened and equalized for taxpayers and tax preparers.
- IRS authority to abate interest should be expanded to cover equitable relief.

PROBLEMS ARE SERIOUS

The present penalty and interest system is overly complex, inflexible, and sometimes harsh and inconsistently administered. Penalty and interest notices confuse average taxpayers. Those who make an innocent mistake are sometimes entangled beyond their ability to recover. And IRS administrative delays combined with interest compounding can create some nightmare scenarios.

Commissioner Rossotti cites a General Accounting Office study that found 64 percent of the amounts shown as owed to the IRS by taxpayers were for penalties and interest, and only 36 percent were for the original tax due.[1] A majority of IRS resources were spent addressing taxpayer errors or issues that arose three to seven years earlier. Delays by the IRS can contribute to penalty and interest burdens.

The result is that a system intended to encourage compliance may in some cases actually end up discouraging it. We support your efforts to design a system that is simpler, fairer, and easier to understand and administer. Voluntary compliance can be improved and noncompliance deterred with more flexibility.

AREAS OF PARTICULAR CONCERN

Let me highlight six areas of concern:

Failure to File and Pay. Circumstances sometimes prevent taxpayers from filing. While a penalty or interest on overdue funds is appropriate, present penalties are overly complex. For example:

- The penalty for failure to file certain returns is 5 percent of the tax due for each month or fraction of a month, with a maximum of 25 percent.
- The penalty for failure to pay certain taxes is one-half of one percent of the tax due per month or fraction of a month the tax remains unpaid, with a maximum of 25 percent.
- The coordinated failure to file and failure to pay penalties are limited to 25 percent, but the coordinated penalty adds complexity and makes it difficult for taxpayers to calculate the additional amount that must be paid to satisfy the underpayment.
- The penalty for willful failure to file within 60 days is not less than the lesser of $100 or 100 percent of the amount required to be shown as tax. This minimum penalty does not apply if it can be shown that such failure is due to reasonable cause and not due to willful neglect.
- The penalty for fraudulent failure to file is 15 percent per month with a maximum of 75 percent.

Most average taxpayers cannot understand or calculate the consequences of failing to file or pay and have only a basic understanding that a penalty exists. In

[1] *Modernizing America's Tax Agency*, p. 19.

many cases, it is difficult to compute the proper penalty without the assistance of computer software.

Even when taxpayers pay their underlying tax debt, the penalties and interest can take on a compounding life of their own in which interest accrues on the penalties and interest due. Many individuals who fall out of compliance can find their liability doubled or tripled which discourages many nonfilers from reentering the system.

Moreover, IRS communications are not helpful. They can cite the penalty code section but provide no additional information about the reason for application and the possibilities for abatement. Congress has addressed this for notices of penalties assessed after December 31, 2000, by requiring the IRS to include the name of the penalty, the code section under which it is imposed, and a computation of the penalty.[2] We recommend that IRS communications also provide information on why the penalty is applied, procedures for appealing, and possible reasons for abatement or waiver. The information should be reader-friendly, not simply a reproduction of code and regulations.

We agree with the Joint Committee's view that the failure to pay penalty could be removed with market interest rates continuing to apply. The Taxpayer Advocate also supports this.

Retirement Plan Penalties. Penalties on retirement plan rollovers and distributions are particularly complex. The penalties and tax can exhaust a substantial portion of the retirement savings. One client rolled over after-tax contributions from her employer plan into an IRA, which is considered an improper excess contribution. The problem was not discovered until a couple of years after the rollover. Her excess contribution to her IRA was subject to a 6 percent excise tax for each year the excess remained in the IRA. When the problem was corrected by distributing the excess (originally an after-tax contribution), the corrective distribution became subject to income tax and a 10 percent early distribution penalty.

We don't believe Congress really intended that an innocent error of this type would deplete a substantial portion of an average person's retirement savings. We are pleased that the Administration has proposed allowing the rollover of after-tax contributions, following a recommendation we and others have made. We also believe taxpayers should be allowed to correct inadvertent errors in rollovers, contributions, and distributions.

Retirement plan rules illustrate how difficulties in understanding a complex underlying law can snag taxpayers in a maze of complex penalties.

Failure to Pay Estimated Taxes. The requirement to pay estimated taxes is particularly complex. Generally, taxpayers may escape the estimated tax penalty on the current-year return if at least 100 percent of the prior year's tax was paid in estimated taxes. But the safe harbor rules were modified in the Taxpayer Relief Act of 1997 so that in 1999 and after taxpayers with adjusted gross incomes in the preceding year's return exceeding $150,000 ($75,000 MFS) had to pay a higher percentage of last year's tax to avoid the penalty. This rule holds higher income taxpayers to an unnecessarily strict standard. To complicate matters further, the required percentage increases to 112 percent in 2002 and then decreases to 110 percent for 2003 and later.

Form 2210, used by taxpayers for the multiple calculations needed to determine the penalty owed for underpayment, is among the most challenging faced by taxpayers and preparers. Changing interest rates and underpayment periods add immense complexity. The underpayment periods run from April 15, June 15, September 15 and January 15. Interest rates on underpayments are subject to change at the beginning of each calendar quarter. Because these periods don't coincide, underpayments in one period must sometimes be allocated between two or three different rates.

Those without benefit of tax preparation software often flounder in the calculation. We agree with both the General Accounting Office and IRS's Taxpayer Advocate who have recommended simplification.[3] Taxpayers need to be able to understand how the penalty is calculated not only to help them feel good about complying with the law, but also so that they can be assured that the IRS calculation is correct.

Small Business Withholding Deposits. The rules for small businesses who must deposit payroll taxes for employees are extremely complex. Many taxpayers ask us to help them determine when to deposit their employment taxes. Many new small

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[2] IRC §6751 was added by Sec. 3306(a) of the IRS Restructuring and Reform Act of 1998. The Act makes many other helpful changes to improve compliance.

[3] *Tax Administration, Ways to Simplify the Estimated Tax Penalty Calculation*, GAO Report (GAO/GGD–98–96); *National Taxpayer Advocate's Annual Report to Congress, FY 1966.*

business owners are unaware of the need to withhold and pay employment taxes. By the time they have their taxes prepared and are told about the deposit requirements, they are several deposits behind. These taxpayers should be granted a one-time waiver of the penalty that will allow them to come into compliance without undue burden.

The rules regarding the deposit method are designed to ease the administrative burden at the IRS. Assessing penalties for using the wrong deposit method seems needlessly harsh. Given the complexity of the deposit rules, the Joint Committee's suggestion allowing abatement of the penalty when a taxpayer changes his deposit schedule is reasonable. We also support the Treasury recommendation to reduce the penalty to two percent for failure to use the correct deposit method. From the trust fund perspective, it is more important that the deposits be made than the method by which they are made.

Preparer Penalties. We agree that professional tax preparers should be held to a high standard and that increased penalties can improve compliance in cases where unrealistic positions are taken or willful or reckless conduct occurs.

To sustain undisclosed positions, taxpayers are currently held to a 40 percent likelihood-of-success-if-challenged standard and preparers are held to a 33-1/3 percent standard. The Joint Committee staff recommends increasing both to 50 percent. We prefer the more reasonable Treasury recommendation of 40 percent. But likelihood of success is difficult to quantify or administer, especially in situations in which there is little or no authoritative guidance.[4]

Abatements. In some cases, taxpayers who have liabilities that have grown because of compounding interest and penalties are left struggling to become compliant. Often, delinquent taxpayers must seek an Offer in Compromise to alleviate an overwhelming tax burden. We believe allowing the IRS to abate interest for "gross injustice" would increase compliance. A somewhat more flexible equitable standard should also be considered. The interest lost can be offset by tax collected from increasing compliance and by lowering costs of administering the taxpayer's case. This abatement authority could be an effective alternative to a time-consuming Offer in Compromise process. Interest on erroneous refunds should be abated if the taxpayer repays the amount within 10 days of IRS's request.

CONCLUSION

Mr. Chairman, most taxpayers want to comply with the law. Most taxpayers who seek the assistance of a tax practitioner do so to ensure that a correct return is filed. Taxpayers are afraid of making a mistake on their returns, less for fear of penalties than for fear of receiving an IRS contact letter. Penalties and interest have an important role to play in ensuring compliance. But the present system is needlessly complex and may be counterproductive.

For all of these reasons, we support your efforts to reform the system and make it a more effective tool of tax administration.

[4] The testimony of Charles W. Shrewbridge, III, president of Tax Executives Institute, before the Jan. 27, 2000, Way & Means Oversight Subcommittee hearing on penalties and interest, illustrates the difficulty. He noted that "The clarity suggested by the use of mathematical probabilities, however, is a false one, for the tax law is marked by many things, but mathematical precision is rarely one of them. . . . We submit that it would be almost impossible to analyze a proposed transaction with such precision. More troublesome, we foresee situations in which a taxpayer's (or practitioner's) good faith judgment that a position satisfies the higher (40 percent) standard could be second-guessed by a revenue agent who concludes, also in good faith, that the possibility of success was 6.5 percentage points lower." At p.7 and footnote 16.

H&R BLOCK'S COMMENTS ON STUDIES OF PENALTY AND INTEREST PROVISIONS IN THE INTERNAL REVENUE CODE

Executive Summary

- The IRS Restructuring and Reform Act of 1998 mandated separate studies by the Treasury Department and Congress' Joint Committee on Taxation of the penalty and interest provisions in the Internal Revenue Code. The last major revision occurred in 1989.
- The studies focus on whether current provisions encourage voluntary compliance, operate fairly, are effective deterrents, and promote efficient tax administration.
- The studies are well done. Our comments focus on how current rules and proposed changes affect average middle-income taxpayers.
- Present provisions are inconsistent, convoluted, and sometimes discourage compliance. Many average taxpayers find themselves unable to understand the calculation or consequence of penalties and interest assessed against them.
- To encourage compliance, we support significant simplification of penalty and interest provisions and increased IRS authority to abate interest.
- Our comments on specific proposals follow sections in the comparative chart (prepared by the Joint Committee on Taxation) attached. Our own charts illustrate the large number and complexity of penalties, especially for retirement accounts.

Founded in 1955, H&R Block is a diversified company with subsidiaries providing a wide range of financial products and services. H&R Block Tax Services Inc. served 18.9 million taxpayers in more than 10,000 offices located primarily in the United States, Canada, Australia, and the United Kingdom in 1999. H&R Block Financial Advisors and Olde Financial Corporation provide consumers with financial planning and investment products. Option One Mortgage Corporation, Assurance Mortgage Corporation of America, and H&R Block Mortgage Company offer a full range of home mortgage products. Through RSM McGladrey Inc. and HRB Business Services Inc., the company has built a national accounting, tax, and consulting firm. Block Financial Corporation offers consumer financial products and services. Quarterly results and other information regarding H&R Block are available on the company's Web site at www.hrblock.com.

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H&R BLOCK'S COMMENTS ON THE JOINT COMMITTEE STAFF AND TREASURY RECOMMENDATIONS RELATING TO PENALTY AND INTEREST PROVISIONS OF THE INTERNAL REVENUE CODE

I. INTEREST (secs. 6601-6621)

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
A. Rates on Underpayments and Overpayments	Different interest rates apply to overpayments and underpayments and depending on whether the taxpayer is a corporation. For individuals and other non-corporate taxpayers, the interest rate on both overpayments and underpayments is equal to the short-term Applicable Federal Rate ("AFR") plus three percentage points. For corporations, the interest rate on overpayments equals the short-term AFR plus two percentage points, unless the overpayment exceeds $10,000 in which case the interest rate equals the short-term AFR plus one-half a percentage point. For corporations, the interest rate on underpayments equals the short-term AFR plus three percentage points, unless the underpayment exceeds $100,000 in which case the interest rate equals the short-term AFR plus five percentage points.	Provide a single interest rate equal to the short-term AFR plus five percentage points for underpayments and overpayments of all taxpayers.	Retain present law; rates should be in range of AFR plus two to five percentage points.

HRB Comment: Unifying the underpayment and overpayment interest rates is a simplification, but JCT's recommendation to set the rate at the AFR plus five percent seems unnecessarily harsh to most taxpayers who have underpaid their tax and unnecessarily generous to taxpayers who have overpaid their tax.

We recommend that one interest rate be applied to overpayments, perhaps set at the AFR plus three percent. To encourage compliance, the current law regarding underpayments could be set at the AFR plus three percent for most underpayments, but at AFR plus five percent for gross underpayments.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
B. Federal Income Tax of Interest on Underpayments and Overpayments			
1. Individuals	Individuals are generally required to include overpayment interest received in income, but *no* deduction is allowed for underpayment interest paid.	Exclude overpayment interest from individuals' gross income.	Retain present law.
2. Corporations	Corporations are generally required to include overpayment interest received in income and allowed to deduct underpayment interest paid.	No recommendation.	No recommendation.

HRB Comment: The JCT Staff recommendation to exclude the interest on overpayments is in the taxpayer's favor. However, such a provision may encourage overpayment and *discourage* compliance by providing a nontaxable benefit for failure to timely claim a refund.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
C. Interest Netting	A special rule provides for a net interest rate of zero to the extent interest is both payable by and allowable to a taxpayer on equivalent amounts of underpayment and overpayment.	Interest netting would not be necessary on a prospective basis, because under the JCT staff recommendation the Federal income tax treatment and interest rate on underpayments and overpayments would be the same.	Retain present law.

HRB Comment: If present law providing for different rates on overpayments and underpayments is retained, we strongly support interest netting provisions.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
D. Abatement of Interest Charges			
1. Unreasonable error or delay by IRS	Interest may be abated if attributable to unreasonable error or delay by IRS in the performance of a ministerial or managerial act.	Allow abatement if interest is attributable to *any* unreasonable error or delay by IRS.	Retain present law.
2. Erroneous refunds Interest must be abated if erroneous refunds the taxpayer did not cause.	Interest must be abated if refund did not exceed $50,000 and taxpayer did not cause the refund.	Allow abatement for all erroneous refunds the taxpayer did not cause.	Consider modification only in concert with assuring that the IRS has adequate means to recover erroneous refunds.
3. Taxpayer reliance on written IRS statements	If an underpayment results from taxpayer reliance on written IRS statements penalties, but not interest, may be abated.	Abate *both* penalties and interest if underpayment results from taxpayer reliance on written IRS statements.	Same as JCT staff recommendations, with same restrictions for interest abatement as under present law for penalty abatement.
4. Other abatements	Abatement of interest is also allowed (and under certain circumstances is required) if the taxpayer is serving in a combat zone or located in a designated disaster area. For individuals, the accrual of interest is suspended if the IRS does not provide notice of the taxpayer's liability within one year (18 months for taxable years beginning before 2004).	Retain present law and also allow abatement if a gross injustice would otherwise result if interest were to be charged.	Retain present law.

HRB Comments:

(1) We support the JCT staff recommendation to allow abatement of interest to prevent gross injustice and to mitigate economic harm when the interest expense was caused by unreasonable IRS error or delay.

(2) We recommend abating interest on erroneous refunds if the funds are repaid within 10 days of IRS's request.

(3) We support the JCT staff recommendation to abate both penalties and interest on underpayments resulting on reliance on written IRS statements. It is inequitable to do otherwise.

(4) We support the JCT Staff recommendation allowing abatement in the case of a "gross injustice."

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
E. Dispute Reserve Accounts	In order to avoid the accrual of interest on a disputed item, the taxpayer may make a non-interest bearing deposit in the nature of a cash bond (as described in Rev. Proc. 84-58).	Permit deposits to be made to an interest bearing account within Treasury to cover tax underpayments related to issues potentially subject to dispute with the IRS. Funds deposited would be treated as a payment of tax if an underpayment of tax is ultimately found. If there is no resulting underpayment or, at the election of the taxpayer, the deposit is withdrawn prior to resolution of the IRS dispute, interest would be paid by the Treasury at a rate equal to the short-term AFR.	No recommendation.

HRB Comment: The JCT Staff recommendation is reasonable. From a financial standpoint, taxpayer deposits should be invested while in the custody of the Treasury. If the taxpayer is ultimately successful in an appeal or Tax Court case, he or she should receive some compensation for the period of time the Treasury had use of the funds. If the IRS is ultimately successful, the income on the deposit is properly attributable to the Treasury.

II. FAILURE TO PAY ESTIMATED TAX (secs.6654 and 6655)

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
	Individuals generally are required to make estimated tax payments at least equal to (1) 90 percent of current year's tax or (2) 100 percent of prior year's tax. Corporations generally are required to make estimated tax payments at least equal to (1) 100 percent of the current year's tax or (2) 100 percent of the prior year's tax.		
A. Penalty for Individuals and Corporations (secs. 6654 and 6655)	A penalty is imposed by applying the underpayment interest rate to the amount of the underpayment for the period of underpayment.	Repeal penalty and replace with an interest provision.	Retain present law.

HRB Comment: We support the JCT Staff recommendation to repeal the penalty and charge interest on the unpaid balance.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
B. Exception to Penalty for Individuals (sec.-6654(e)(1))	There is no penalty if the tax shown on the return, reduced by withholding, is less than $1,000. Estimated tax is not considered in determining whether the threshold is satisfied.	Increase threshold to $2,000, and consider estimated tax payments made in four equal installments in determining whether the threshold is satisfied.	Retain present law threshold of $1,000, and consider estimated tax payments made under a new proposed simplified averaging method in determining whether the threshold is satisfied.

HRB Comment: We support the Treasury recommendation.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
C. Modified Safe Harbor for Certain Individuals (sec. 6654(d)(1))	Individuals with prior year's AGI above $150,000 ($75,000 for married individuals filing separately) who make estimated payments based on prior year's tax generally must do so based on 110 percent of prior year's tax.	Repeal the modified safe harbor; thus, all taxpayers making estimated payments based on prior year's tax would do so based on 100 percent of prior year's tax.	No recommendation.

HRB Comment: We support the JCT Staff recommendation to repeal the modified safe harbor. The current provision adds needless complexity and holds higher-income taxpayers to an unnecessarily high standard.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
D. Applicable Interest Rate for Individuals and Corporations (secs. 6621, 6654(a)(1), and 655(a)(1))	The underpayment interest rate is subject to change on the first day of each calendar quarter. A change in rates requires the use of multiple interest rates when calculating the interest on an underpayment of estimated tax.	Apply only one interest rate per estimated tax underpayment.	No recommendation, but consider general computational simplifications.

HRB Comments: It is reasonable that the adjustment of the underpayment percentage and the estimated tax periods should coincide. This change would simplify an otherwise complex calculation.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
E. Calculation of Underpayment Balances for Individuals and Corporations (secs. 6654(a) and 6655(a))	Penalty is equal to the underpayment interest rate multiplied by the number of days the underpayment is outstanding, which is the number of days between when the taxpayer should have made the payment and the earlier of (1) actual date of payment or (2) the following April 15 (for calendar-year taxpayers).	Provide that underpayment balances are cumulative; thus, taxpayers would calculate a cumulative estimated tax underpayment for each period.	No recommendation, but consider general computational simplifications.

HRB Comment: We support general simplification of the calculation.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
F. Estimated Tax Underpayments Extending from Leap Year to Non-Leap Year for Individuals and Corporations	Under IRS procedures, taxpayers with outstanding underpayment balances that extend from a leap year through a non-leap year must make separate calculations to account for the different number of days in each year.	Require 365-day year for all estimated tax penalty calculations.	No recommendation, but consider general computational simplifications.

HRB Comment: We support the JCT Staff recommendation. The proposed change would simplify the calculation without significant loss of revenue. We support general simplification of the calculation.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
G. Waiver of Penalty for Failure to Pay Estimated Tax for Individuals (sec. 6654(e)(3))	A waiver is available to the extent the Treasury Secretary determines that a taxpayer suffered a casualty (e.g., fire or disaster) or other unusual circumstance if imposition of a penalty would be against equity and good conscience. There is no general reasonable cause waiver for the failure to pay estimated tax.	See JCT staff recommendations regarding abatements of interest (pages 4-5).	Permit a reasonable cause waiver for first-time payers of estimated tax, provided the balance due on the return is below a threshold amount (unspecified) and is paid with a timely-filed return.

HRB Comment: We support the Treasury recommendation to provide a waiver for first-time payers of estimated tax. To encourage compliance, the waiver should apply if the tax is paid with a timely-filed return regardless of amount.

8

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
H. Waiver of De Minimis Penalties for Individuals and Corporations	There is no statutory provision allowing the Treasury Secretary to waive estimated tax penalties below a de minimis amount.	See JCT staff recommendations regarding abatements of interest (pages 4-5).	Provide penalty waiver authority for individual estimated tax penalties below a de minimus amount, e.g., $10 to $20.

HRB Comment: A de minimis waiver of penalties provides very little benefit. We agree with the JCT Staff recommendation.

III. PENALTY FOR FAILURE TO PAY TAXES (sec. 6651(a)(2) and (3))

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
A. In General	Penalty is one-half percent of net amount of tax due for each month the return is not filed, up to a maximum of 25 percent a month. Interest also applies to the unpaid tax.	Repeal penalty. Interest would continue to apply.	Retain present law, except increase penalty percentage r[illegible] after six months from one-hal[illegible] percent to one percent a mont[illegible]

HRB Comment: We support the JCT Staff recommendation. The Treasury recommendation is unnecessarily punitive.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
B. Encourage Installment Agreements	Penalty rate is reduced to one quarter percent per month for any month an installment agreement is in effect (provided return is timely filed). IRS imposes $43 user fee on installment agreements.	Impose a 5-percent late payment service charge if no installment agreement is in effect by the fourth month after assessment; waive $43 IRS user fee if taxpayer agrees to automated withdrawal of installment payments from bank account.	Reduce penalty rates by one-half for any month an installment agreement is in effect. Consideration should be given to using a fixed interest rate to avoid possible balloon payment at end of agreement.

HRB Comment: We do not support the JCT Staff recommendation to impose a penalty after the fourth month after assessment. The four-month period seems arbitrary and does not allow for circumstances beyond the taxpayer's control. We strongly support waiving the $43 IRS user fee when a taxpayer agrees to automatic withdrawal.

The Treasury recommendation to reduce the penalty rate while an installment agreement is in effect has merit. Although it may add complexity to the calculation, it is in the taxpayer's favor. Elimination of the penalty during an installment agreement would simplify matter and provide greater incentive to enter into an installment agreement.

IV. PENALTY FOR FAILURE TO FILE TAX RETURNS (sec. 6651(a)(1))

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
A. In General	Penalty is five percent of net amount of tax due for each month return is not filed, up to a maximum of 25 percent. This penalty is coordinated with the failure to pay penalty, by reducing the failure to file penalty by the amount of the failure to pay penalty for that month.	Retain present law.	Lower rates to one-half percent for first five months, then increase to one percent; retain 25 percent maximum; eliminate coordination with failure to pay penalty, which has the effect of potentially doubling combined penalties for taxpayers who delay filing and paying for lengthy periods of time.

HRB Comment: We support the Treasury recommendation to eliminate the coordination with the failure to pay penalty. We recommend that the late-filing penalty be calculated as a flat percentage of the unpaid tax, not based on the number of months the return was late. An additional flat penalty could be added if the return were filed more than two months after the extended due date.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
B. Penalty for Failure to File "No Balance" Returns	No penalty is imposed on the failure to file returns that do not show a balance due the IRS.	No recommendation.	Impose new service charge, possibly only after IRS contact (amount unspecified).

HRB Comment: No penalty should be imposed on an unfiled tax return that ultimately results in a refund. The two-year statute of limitations to claim refunds on tax returns that are not timely-filed is penalty enough.

V. TAX RETURN ACCURACY PENALTIES (secs. 6662 and 6694)

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
A. Standards Applicable to Disclosed Positions 1. Taxpayers	Penalty may apply if there is no reasonable basis for a disclosed position taken on a return. (Generally, at least a 20 percent likelihood of success if challenged.)	Penalty may apply if there is no substantial authority for a disclosed position taken on a return. (Generally, at least a 40 percent likelihood of success if challenged.)	Penalty may apply if there is no realistic possibility of success on the merits. (Generally, at least a 33-1/3 percent likelihood of success if challenged.)
2. Practitioners	Penalty may apply unless a disclosed position is not frivolous. (Generally, at least a 5 to 10 percent likelihood of success if challenged.)	Penalty may apply if there is no substantial authority for a disclosed position taken on a return. (Generally, at least a 40 percent likelihood of success if challenged.)	Penalty may apply if there is no realistic possibility of success on the merits. (Generally, at least a 33-1/3 percent likelihood of success if challenged.)

HRB Comment: We do not see a need to increase the threshold for disclosed positions. Taxpayers and tax preparers should be encouraged to disclose positions on returns and be assured that a penalty will not be imposed unless the position taken is frivolous.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
B. Standards Applicable to Undisclosed Positions 1. Taxpayers	Penalty may apply if there is no substantial authority for the undisclosed position. (Generally, at least a 40 percent likelihood of success if challenged.)	Penalty may apply unless the taxpayer reasonably believes that the tax treatment is more likely than not the correct tax treatment under the Code. (Generally, more than 50 percent likelihood of success if challenged.)	Penalty may apply if there is no substantial authority for the undisclosed position. (Generally, at least a 40 percent likelihood of success if challenged.)
2. Practitioners	Penalty may apply if there is no realistic possibility of being sustained on the merits. (Generally, at least a 33-1/3 percent likelihood of success if challenged.)	Penalty may apply unless the taxpayer reasonably believes that the tax treatment is more likely than not the correct tax treatment under the Code. (Generally, more than 50 percent likelihood of success if challenged.)	Penalty may apply if there is no substantial authority for the undisclosed position (Generally, at least a 40 percent likelihood of success if challenged.)

HRB Comment: The likelihood of success is difficult to quantify, especially in situations in which there is little or no authoritative guidance. The Treasury recommendation of a 40-percent-likelihood-of-success-test is reasonable.

VI. RETURN PREPARER PENALTIES (sec. 6694)

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
A. Unrealistic Position	If an understatement is due to a position for which there was not a realistic possibility of being sustained on its merits and the position was not disclosed or was frivolous, the preparer penalty is $250.	Impose penalty equal to greater of $250 or 50 percent of preparer's fee.	Similar to JCT staff recommendation but exact percentage of penalty is unspecified.
B. Willful or Reckless Conduct	If an understatement is due to willful or reckless conduct, the preparer penalty is $1,000	Impose penalty equal to greater of $1,000 or 100 percent of preparer's fee.	Similar to JCT staff recommendation but exact percentage of penalty is unspecified.

HRB Comment: We strongly support the JCT Staff recommendation. Preparers should be held to high standards, and an increase in the potential penalty sends a clear message of those standards.

VII. PENALTY FOR FILING A FRIVOLOUS TAX RETURN (sec. 6702)

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
	The penalty for filing a frivolous income tax $500.	No recommendation.	Increase the penalty to $1,500; return is permit abatement for first time occurrence if nonfrivolous return is filed within a reasonable period of time after filing the frivolous return.

HRB Comment: We support the Treasury recommendation to increase the penalty to $1.500. Abatement of the penalty should be limited to the first occurrence and should only be allowed if the frivolous return was not willfully filed.

VIII. PENALTY FOR FAILURE TO DEPOSIT TAXES (sec. 6656)

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
	There is a four-tier penalty rate structure for failure to deposit taxes: (1) A depositor is subject to a penalty equal to two percent of the amount of the underpayment if the failure is corrected on or before the date that is five days after the prescribed due date. (2) A depositor is subject to a penalty equal to five percent of the amount of the underpayment if the failure is corrected after the date that is five days after the prescribed due date but on or before the date that is fifteen days after the prescribed due date. (3) A depositor is subject to a penalty equal to ten percent of the amount of the underpayment if the failure is corrected after the date that is fifteen days after the due date but on or before the date that is ten days after the date of the first delinquency notice to the taxpayer. (4) A depositor is subject to a penalty equal to fifteen percent of the amount of the underpayment if the failure is not corrected on or before the date that is ten days after the date of the first delinquency notice to the taxpayer. Many taxpayers are required to make deposits of taxes; the frequency of the deposits depends on the type of tax and the amount required to be deposited.	No new legislation for at least two years to allow scheduled statutory and regulatory changes to be reviewed and implemented. However, consideration should be given to revising regulations to permit penalty abatement for inadvertent failures occurring when taxpayer changes to a different deposit schedule.	Few intermediate changes should be made at this time to the deposit rules or penalties to provide a sufficient period of time for changes to the deposit rules to take effect. The penalty for failure to use the correct deposit method should be reduced from ten percent to two percent. Consideration should be given to reducing penalty if failure to deposit is corrected within one banking day.

HRB Comment: Given the complexity of the deposit rules, the JCT Staff suggestion allowing abatement of the penalty when a taxpayer changes deposit schedule is reasonable. We also support the Treasury recommendation to reduce the penalty to two percent for failure to use the correct deposit method. It is more important that the deposits be made than the method by which they are made.

The Treasury recommendation to reduce the penalty for failure to deposit may discourage timely deposits. If later deposits are acceptable, the deposit schedule should be changed.

We support general simplification of the deposit rules.

IX. PENALTIES FOR FAILURE TO FILE FORM 5500 SERIES ANNUAL RETURN FOR PENSION AND OTHER DEFERRED COMPENSATION PLANS (secs. 6652(d)(2), 6652(e), 6692(e))

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
	The Code and Titles I and IV of ERISA impose 3 separate penalties for failure to file a timely and complete return; the Code imposes separate penalties for failure to file Schedule SSA, Schedule B, and notification of plan status change.	Consolidate the separate Code and ERISA penalties for failure to file timely and complete return into one penalty.	Consolidate the separate Code and ERISA penalties for failure to file timely and complete return into one penalty.
	The IRS, Department of Labor, and Pension Benefit Guaranty Corporation administer the separate penalties.	Designate the IRS as the agency responsible for administration of the consolidated penalty.	Designate the Department of Labor as the agency responsible for administration of the consolidated penalty.

HRB Comment: We agree that the penalties should be consolidated. We support the JCT Staff recommendation to designate the IRS as the agency responsible for collecting the penalty.

X. PENALTY FOR FAILURE TO FILE ANNUAL INFORMATION RETURNS FOR CHARITABLE REMAINDER TRUSTS (sec. 6652(c)(2)(A))

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
	Split-interest trusts (and certain other organizations) are required to file Form 1041-A (Trust Accumulation of Charitable Amounts). The penalty for failure to file Form 1041-A is $10 for each day return is not filed, up to a maximum of $5,000 for any one return. Split-interest trusts are also required to file Form 5227 (Split-Interest Trust Information Return). It is not clear under present law that any penalty applies to the failure to file Form 5227.	Provide that the penalty for failure to file Form 5227 is equivalent to the penalty for failure to file Form 990. Consider increasing penalties applicable to failure to file Form 1041-A.	No recommendation.

HRB Comment: We support the JCT Staff recommendation to provide for a penalty for failure to file Form 5227. The current penalty for failure to file Form1041-A is reasonable, and should not be increased.

H&R BLOCK PENALTY AND INTEREST COMMENTS APPENDIX

PENALTY REFERENCE CHART

IRC §	Type of penalty	Amount	Limitation	Abatement/Waiver Standard	Program Appealed Under
72(q)	Premature distributions from annuity contracts	10% of amount includible in income		Exceptions under § 72(q)(2)	N/A
72(t)	Early distributions from qualified plans	10% of amount includible in income		Exceptions under § 72(t)(2)	N/A
138(c)(2)	Distributions from Medicare+choice MSA not used for medical	15% of taxable amount		Exceptions under §§ 138(c)(2)(B) and 138(c)(3)	N/A
6651(a)	Failure to file	4.5% of net tax due if FTP also applies; 5% if only FTF applies	25%; $100 or 100% minimum may apply	Reasonable cause	Post-assessment
6651(a)(2)	Failure to pay	.5% of net unpaid tax / month; starts after due date	25%	Reasonable cause	Post-assessment
6651(a)(3)	Failure to pay after notice and demand	.5% of net unpaid tax / month; starts 21 days (10 days if under $100,000) after notice and demand	25%	Reasonable cause	Post-assessment
6651(d)	Failure to pay after notice and demand for immediate payments	1% of net unpaid tax/month; starts on day notice is given or 10 days after issuance of notice of intent to levy	25%	Reasonable cause	Post-assessment
6651(f)	Fraudulent failure to file	15% of net tax per month	75%	Reasonable cause	Deficiency
6652(a)	Failure to file information document for dividends and patronage dividends aggregating less than $10.	$1 per document	$1,000	Reasonable cause	Post-assessment
6652(b)	Failure to report tips	50% of tax due on unreported tips		Reasonable cause	Post-assessment
6654	Failure by individual to pay estimated income tax	Underpayment rate under § 6621 times the underpayment for the period		Exception and waivers under § 6654(e)	Post-assessment
6656	Failure to make deposit of taxes	2% to 15%	N/A	Reasonable cause Waivers for first time depositor under §6656(d)	Post-assessment
6657	Bad checks	2% of amount of check	If less than $750, lesser of $15 or amount of check	Reasonable cause	Post-assessment
6662	Accuracy-related penalty	20% of underpayment	N/A	Reasonable cause	Deficiency
6662(d)	Substantial understatement of tax	20% of underpayment		Reasonable cause	Deficiency
6662(e)	Substantial valuation misstatement under Chapter 1	20% of underpayment		Reasonable cause	Deficiency

6662 (f)	Substantial overstatement of pension liabilities	20% of underpayment	N/A	Reasonable cause No penalty if less than $1,000.	Deficiency
6662 (g)	Substantial estate or gift tax valuation understatement	20% of underpayment		Reasonable cause	Deficiency
6662 (h)	Gross valuation misstatements	40% of underpayment		Reasonable cause	Deficiency
6663	Civil fraud penalty	75% of portion attributable to fraud			Deficiency
6672	Failure to collect or pay over tax, or attempt to evade or defeat tax	100%			Deficiency
6673	Tax court delay	Up to $25,000			Tax Court
6674	Fraudulent statement or failure to furnish statement to employee	$50 per statement or failure			Post-assessment
6675	Excessive claims with respect to certain fuels	Greater of 2 x excessive amount or $10		Reasonable cause	
6682	False information with respect to withholding	$500 per statement		Reasonable cause	Post-assessment
6693	Failure to provide reports on certain tax-favored accounts or annuities	$50 per failure		Reasonable cause	Post-assessment
6693 (b)(1)	Overstatement of nondeductible contributions	$100 per overstatement	N/A	Reasonable cause	Deficiency
6693 (b)(2)	Failure to file form for nondeductible contributions	$50 per failure		Reasonable cause	Post-assessment
6693 (c)(1)	Employer penalty relating to Simple Retirement Accounts	$50 per day	N/A	Reasonable cause	Post-assessment
6693 (c)(2)	Trustee and Issuer penalty (Simple accounts)	$50 per day	N/A	Reasonable cause	Post-assessment
6694 (a)	Understatement of taxpayer's liability by return preparer	$250		Reasonable cause	Deficiency
6694 (b)	Preparer negligence	$1,000		Proof that neither willful or reckless	Deficiency
6695	Other preparer penalties	$50 each failure	$25,000/ year	Reasonable cause	Post-assessment
6695 (g)	Preparer due diligence for EIC	$100 each failure			
6700	Penalty for promoting abusive tax shelters	$1,000 or 100 of gross income	N/A	Reasonable cause	Refund Claim (IRC § 6703)
6701	Aiding and abetting understatement of tax liability	$1,000	One penalty per taxpayer per period	Statutory waiver	Refund Claim (IRC § 6703)
6702	Frivolous return	$500		Substantial correctness	Refund Claim (IRC § 6703)
6704	Failure to keep necessary records to meet reporting requirements under § 6047(d)	$50 per individual	$50,000	Reasonable cause and not willful failure	Post-assessment
6712	Failure to disclose treaty-based return position	$1,000		Reasonable cause Acted on good faith	Deficiency
6721	Failure to file correct information returns	$50 per return	up to $250,000/y ear	Reasonable cause	Post-assessment
	-If corrected within 30 days	$15 per return	up to $75,000/ year	Reasonable cause	Post-assessment

	-If corrected before August 1	$30 per return	$150,000/year	Reasonable cause	Post-assessment
	-If intentional disregard	$100 per return	N/A	Reasonable cause	Post-assessment
6722	Failure to furnish correct payee statements	$50 per statement	$100,000/year	Reasonable cause	Post-assessment
	-If intentional disregard	$100 per statement or 10%	N/A	Reasonable cause	Post-assessment
6723	Failure to provide TIN	$50 per failure	$100,000/year	Reasonable cause	Post-assessment
		CRIMINAL PENALTIES			
7201	Attempt to evade or defeat tax	Up to $100,000 and/or up to 5 years imprisonment, plus court costs			
7202	Willful failure to collect or pay over tax	Up to $10,000 and/or up to 5 years imprisonment, plus court costs			
7203	Willful failure to file return, supply information, or pay tax	Up to $25,000 and/or up to 1 year imprisonment, plus court costs			
7204	Fraudulent statement or failure to make statement to employees	Up to $1,000 and/or up to 1 year imprisonment, plus court costs			
7205	Fraudulent withholding exemption certificate or failure to supply information	Up to $1,000 and/or up to 1 year imprisonment, plus court costs			
7206	Fraud and false statements	Up to $100,000 and/or up to 3 years imprisonment, plus court costs			
7207	Fraudulent returns, statements, or other documents	Up to $10,000 and/or 1 year imprisonment, plus court costs			
7210	Failure to obey summons	Up to $1,000 and/or up to 1 year imprisonment, plus court costs			
7211	False statement to purchasers or lessees relating to tax	Up to $1,000 and/or up to 1 year imprisonment			
7212	Attempts to interfere with administration of Internal Revenue laws	Up to $5,000 and/or up to 3 year imprisonment	If only by threat of force, up to $3,000 and/or 1 year imprisonment		
7213	Unauthorized disclosure of information	Up to $5,000 and/or up to 5 years imprisonment, plus court costs			
7215	Offenses with respect to withholding	Up to $5,000 and/or 1 year imprisonment, plus court costs			

7261	Representation that retailer's excise tax is excluded from price of article	Up to $1,000			
7268	Possession to sell in fraud of law or to evade tax	Greater of $500 or twice the taxes attempted to be evaded			
7269	Failure to produce records	Up to $500, plus court costs			
7341	Sales to evade tax	Sum paid on the contract			
7342	Penalty for refusal to permit entry or examination	$500			

CHART OF RETIREMENT PLAN ADDITIONS TO TAX

IRC §	Description of Penalty	Amount	Abatement/Waiver Standard
72(q)	Premature distributions from annuity contracts	10% of amount includible in income	Exceptions under § 72(q)(2)
72(t)	Early distributions from qualified plans	10% of amount includible in income	Exceptions under § 72(t)(2)
4971	Failure to meet minimum funding standard	10% (5% for multiemployer plan) on accumulated funding deficiency. Additional tax — 100% percent of such accumulated funding deficiency to the extent not corrected within the taxable period.	
4972	Nondeductible contributions to qualified employer plans	10% of nondeductible contributions	Exceptions under § 4972(c)(6)
4973	Excess contributions to individual retirement accounts, certain § 403(b) contracts, certain individual retirement annuities, and MSAs	6% of excess contributions	Timely withdrawal under §408(d)(4)
4974	Certain accumulation in qualified retirement plans	50% of minimum required distribution not withdrawn	Waiver under § 4974(d)
4975	Prohibited transactions	15% of amount involved in prohibited transaction	Exemptions under §§ 4975(c)(2), 4975(d)
4976	Funded welfare benefits	100% of disqualified benefit	Exceptions under § 4976(b)(2), (b)(3), (b)(4)
4977	Certain fringe benefits	30% of excess fringe benefits	None
4978	Certain dispositions of employee stock ownership plans and certain cooperatives	10% of amount realized on disposition	None
4979	Certain excess contributions	10% of excess contribution	Exception under § 4979(f)(1)
4979A	Certain prohibited allocations of qualified securities	50% of amount involved	None
4980	Reversion of qualified plan assets to employer	20% of employer reversion; 50% unless (A) the employer establishes or maintains a qualified replacement plan, or (B) the plan provides benefit increases meeting the requirements of IRC § 4980(d)(3)	Exception for employee stock ownership plans under § 4980(c)(3)
4980B	Failure to satisfy continuation coverage requirements of group health plans	$100 per day of noncompliance; lesser of tax or $2,500 if discovered after notice of examination	Waiver under § 4980B(c)(5); exceptions under § 4980B(d)
4980C	Issuers of qualified long-term care insurance contracts	$100 per insured per day requirements aren't met	Waiver under § 4980C(b)(2)
4980D	Failure to meet certain group health plan requirements	$100 per day per individual, lesser of tax or $2,500 ($15,000 if not de minimis) if discovered after notice of examination;	Exceptions under § 4980D(c)
4980E	Failure of employer to make comparable medical savings account contributions	35% of amount contributed	Waiver under § 4980E(c)

PREPARED STATEMENT OF PETER L. FABER

Good morning, Mr. Chairman and members of the Committee. My name is Peter L. Faber. I am a partner in the law firm of McDermott, Will & Emery and I have been engaged in the practice of corporate tax law for 37 years. I have served as Chair of the American Bar Association Section of Taxation and the New York State Bar Association Tax Section and currently chair the Tax Committee of the New York City Partnership and Chamber of Commerce, but I appear before you today in my individual capacity and not on behalf of any organization.

I want to offer you the perspective of a practicing tax lawyer who deals with the tax managers of large corporations every day. Our firm advises over 50 of the Fortune 100 companies in tax matters on a regular basis, and we are often called upon to counsel them with respect to proposed aggressive tax strategies that have been suggested to them by accounting and investment banking firms. Here is a view from the trenches.

I, and I suspect most of my colleagues in the corporate tax bar, believe that there is a corporate tax shelter problem and that it is qualitatively and quantitatively different from any kind of compliance problem that we have seen in recent years. I do not have any easy answers to suggest to you, and I would submit that the problem, and the possible solutions, are more complex than would first appear. In fact, the corporate tax shelter phenomenon raises fundamental issues about the extent to which taxpayers in general, not just corporations, can rely on the literal language of statutes and regulations. I would urge the Committee to proceed cautiously in this area. Solutions should be tailored to meet the problems that they address and should not inhibit the ability of taxpayers to conduct legitimate business operations. What may be a "tax shelter" in the eyes of one person may be a legitimate tax planning strategy in the eyes of another. If we start spraying machine gun fire at a crowd of people because we know that there is a murderer among them, we may kill the murderer but we will inevitably hurt a lot of innocent people in the process. Congress should not do that here.

The problem is real, make no mistake about that. For reasons that I will describe, people at Big-5 accounting firms are under pressure to develop and sell tax planning ideas to corporations and tax managers at corporations are under pressure to buy them. It is no answer to say that corporate tax revenues are up or that they are a high percentage of corporate profits. Were it not for corporate tax shelters, they might be higher.

What we are seeing today is not new. It is an old game, but the players have changed. In the 1970s and early 1980s, tax shelters were marketed all the time. The sellers were so-called "financial planners" (typically insurance salesmen) and the buyers were doctors. Today, the sellers are Big-5 accounting firms and the buyers are large corporations. But there is qualitative difference between the old tax shelters and the new ones. The difference results from the greater tax sophistication of both the sellers and the buyers. The shelters that were sold to individuals in the 1970s were clearly phony. They typically were based on the purchase of depreciable property at inflated prices for nonrecourse notes that did not expose the buyer to economic risk. (I described one of these schemes to my family once at the dinner table and my 12-year-old daughter immediately spotted the flaw, thus showing more perceptive analytical ability than most of my clients.) The corporate shelters of today are much subtler. They literally comply with the statute and the regulations, exploiting glitches or drafting errors to create artificial tax benefits that do not reflect economic reality. One technique, invented by an accounting firm and previously brought to the attention of this Committee, involved using an artificial structure of domestic and foreign limited liability companies so as to create a fictional tax loss through the operation of basis adjustments under IRS regulations despite the fact that the taxpayer suffered no economic loss. The IRS announced that it would shut this technique down, but its ability to do so remains to be seen. A company using it would have literally complied with the Internal Revenue Code and the Treasury's own regulations.

To combat these techniques, the IRS has been using principles that the courts have developed over the years to deal with situations in which the statutory law has led to results that the judges regarded as inappropriate. These include the economic substance, business purpose, and step transaction doctrines. Although the Service has been successful in convincing courts to apply these doctrines to transactions that the Service regarded as abusive, one suspects that many transactions have gone undetected. Although large corporations are audited on a regular basis, aggressive tax strategies engaged in by smaller and mid-sized corporations may not be picked up.

The reason that corporate tax shelters have become more of an issue in recent years has been their mass marketing by the Big-5 accounting firms. The aggressive tax strategies are more sophisticated than those that were marketed 20 years ago, they are packaged more effectively, and they are marketed more extensively and more aggressively. And corporations have been willing to engage in strategies that years ago they might have been reluctant to consider. Why is this? In my experience, there are pressures on both the sellers' side and the buyers' side that have encouraged the proliferation of aggressive tax strategies.

Let's look first at the sellers' side. The large accounting firms are putting pressure on their partners to maximize revenues. The partners are being urged to sell big ticket items and not to rely on counseling clients on the tax consequences of normal business transactions, for which they may only be able to bill at hourly rates. If they can sell a client on a new tax saving idea, they can often bill for it based on a percentage of tax savings, and I have seen some tax strategies for which accounting firms have billed as much as 40% of the anticipated savings.

The internal pressure to generate profits is applied at the office and individual partner level, and it can be seen in the reluctance of offices of accounting firms to use people in other offices even when those people have needed expertise.[1]

The accounting firms have partners and employees whose sole job is to dream up new tax saving ideas and others whose sole job is to sell them. An article in Forbes magazine quotes a Big-5 partner as saying that his firm had an inventory of 1,000 "mass market tax savings ideas" and had recently hired 40 "professional salesmen" to sell them.[2] Last year I was in the office of a Big-5 firm and overheard the person in the next office on the telephone trying to convince a company to use her firm for tax planning services. Her big pitch was that "we have a group of people in Washington who do nothing but dream up tax savings ideas."

What we are seeing now is that tax savings ideas are being marketed like toothpaste. They have become, and are commonly referred to as, "tax products," and the accounting firms are quite blatant about treating them as such. In fact, I remember seeing a recruiting advertisement in a tax magazine a year or so ago in which a job at a Big-5 firm was described as including the development and marketing of "tax products."

When people are under this kind of pressure to produce and sell tax products, they are inevitably going to come up with ideas that literally seem to work if one reads them "once over lightly" but that arguably do not stand up under a rigorous application of the "common law" tests of economic substance, business purpose, and step transaction. People who are under pressure to produce a certain number of tax saving ideas a month may not think them through carefully. Although all of the Big-5 firms will tell you that they have rigorous internal review procedures, the fact of the matter is that a number of schemes have emerged from the accounting firms in recent years that never should have seen the light of day. The internal dynamics are such that there is pressure to bring an idea to market that has a potential for generating big fees, and one suspects that it may be hard for people in the internal review process to say "no."

This raises issues of professionalism that perhaps go beyond the scope of these hearings but that are of concern to me. The accounting firms for years have acted as professional advisors to their clients, and the clients have come to expect that of them. If a firm presents a tax product to a company for which it expects to be paid a fee based on a percentage of expected tax savings, it is functioning as a commission salesman and not as a professional advisor. A firm that presents a client with a 20-page "opinion" that a tax product that it is selling for a percentage of tax savings works is deceiving the client and misrepresenting its role. The "opinion" is not a professional opinion, it is a sales document. I have seen "opinions" of this sort from Big-5 firms that failed to point out significant weaknesses in the proposals. The lack of professionalism continues after the product is sold. I have seen one instance in which a Big-5 firm that sold a tax product to a client that clearly did not work urged the client to vigorously defend the technique when the Internal Revenue Service challenged it on audit despite the fact that defending it would clearly have been fruitless and by doing so the client might have lost the opportunity to trade the issue in exchange for IRS concessions on other issues. It is clear that the ac-

[1] An extreme example of this is one case in which an out-of-state office of a Big-5 firm litigated a New York State tax case in New York without consulting the New York office, one suspects because they did not want to share credit for the fees with the New York office. (A reading of the opinion indicates that they did a bad job of it.)

[2] Janet Novack and Laura Saunders, "The Hustling of X-Rated Shelters," Forbes, December 14, 1998.

counting firm did so because it wanted to defend its own product and not because it was acting in the client's best interests.

There are also pressures on the buyers' side that have made corporate tax managers more willing to consider aggressive tax strategies than they were in the past. Corporate tax managers are often urged to minimize their companies' tax burdens. Taxes may be viewed by financial people as being like other costs of doing business that can be reduced by sound management. The sellers of tax products are beginning to realize that they may be able to sell their wares to corporations not by approaching the tax managers but by approaching the chief financial officer, who will then put pressure on the tax people to go along. If the chief financial officer advises the head of the tax department that the company's taxes are a higher percentage of income than those of its competitors and that a number of its competitors have adopted a particular tax strategy and wants to know why their company cannot be equally creative, it takes a hardy tax manager to stand up to this kind of pressure.

My bottom line, based on giving tax advice to large corporations every day, is that there is a problem. Having said that, I do not have any easy solutions to offer to you, and I would urge caution on both the Congress and the Treasury in how they approach the corporate tax shelter phenomenon.

I begin with two basic propositions: (1) there is nothing wrong with a corporation structuring its operations so as to minimize its tax burden, and (2) taxpayers, including corporations, should be entitled to rely on laws and regulations as written without having to psychoanalyze the drafters to think of what they would have written if they had been perceptive enough to anticipate modern-day transactions. Judge Learned Hand said over 65 years ago that "anyone 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."[3] If this were not so, I and my colleagues would be out of business. There is nothing wrong, for example, with putting a foreign manufacturing operation in a separate foreign subsidiary so as to defer U.S. tax on the income. The fact that the U.S. parent corporation would have been currently taxed by the United States if it had conducted the operation in a foreign branch is immaterial. If the corporation in fact creates a foreign corporation to conduct a foreign manufacturing operation and the foreign corporation is a real entity with assets, employees, and operations, it should be respected as such, even if the decision to create it was tax motivated. Similarly, if a corporation desiring to distribute assets to its shareholders transfers them to a newly-formed subsidiary and distributes the stock of that subsidiary to its shareholders in a manner that meets the requirements of section 355 of the Internal Revenue Code, the transaction should be treated as a tax-free spin-off, even though, had the assets been distributed directly, both the corporation and the shareholders would have been taxed.

There is much to be said for the proposition that a taxpayer should be allowed to rely on the literal language of statutes and regulations. The tax laws are extremely complicated, and they have been so for as long as I can remember.[4] It is hard enough to read and understand the laws and regulations as written. The problem of the tax practitioner and corporate tax manager is compounded if one cannot assume that they mean what they say and that there are circumstances in which literal compliance with their terms will not be enough. We are, after all, a country of laws and not people, and taxpayers, like other citizens, should be entitled to rely on the laws as they appear in the law books.

I do not urge that the economic substance, business purpose, and step transaction doctrines be repealed, but only that they be applied cautiously. None of us are perfect, and the people who draft statutes and regulations will from time to time make mistakes or will fail to anticipate transactions to which those laws and regulations might be applied so as to produce results that, had they thought of them, they would not have permitted. If that happens, arguably the correct remedy is to change the law or regulation and not to penalize a taxpayer who thought that it meant what it said.

I am troubled by the idea that one can draft a generic definition of "tax shelter" that will bring within its scope only the "bad" transactions and that will omit the "good" ones. I have participated in bar association attempts to codify the economic substance doctrine and to develop a definition of "tax shelter" and I am not sure that it can be done. Every definition that I have seen has either failed to catch some abusive tax strategies or has caught nonabusive strategies that should not have

[3] *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935).

[4] I recently sent to Senators Roth and Moynihan copies of testimony that I presented to this Committee on behalf of the New York State Bar Association Tax Section 24 years ago urging that the tax laws be simplified. It was reprinted in *Tax Notes*, February 21, 2000, at page 1163.

been caught. Congress should not, for example, in an attempt to stop abusive transactions enact rules that will impose tax penalties on ordinary everyday equipment leasing transactions.

We should think long and hard about what aspects of the problem can be addressed by legislation, what aspects can be addressed by regulations and rulings, and what aspects should be addressed by the courts. In my view, the issue should be addressed by all three branches of government and it should not be assumed that all aspects of the situation should be addressed by legislation. I think, for example, that it would be a mistake to try to codify the common law principles that the courts have developed over many decades.

It is clear that corporate tax shelters will not be discouraged unless a meaningful "downside" risk is created. If a corporate tax manager believes that the only risk of engaging in an aggressive tax strategy is the later repayment of taxes that the company would have had to pay if it had not engaged in the strategy and interest, which represents the cost of the money of which it had the use, there will be no disincentive to adopting the next "tax savings idea of the month" that is presented by an accounting or investment banking firm. One possibility would be to increase the levels of existing penalties without trying to draft a generic definition of "tax shelter."

Another approach would be to require increased disclosure and to heighten the risk of an Internal Revenue Service audit. Last week, the Treasury Department released comprehensive proposed regulations requiring greater disclosure of aggressive tax strategies. These proposals will be carefully reviewed by responsible organizations in the business community, including the American Bar Association Section of Taxation, the New York State Bar Association Tax Section, the American Institute of Certified Public Accountants, and the Tax Executives Institute, Inc. I can tell you from personal experience that many aggressive strategies that were adopted by corporations would not have been adopted if the disclosure regime contemplated by these proposals had been in place.

Requiring tax shelter promoters to provide the Internal Revenue Service with a list of taxpayers that have adopted particular types of tax strategies is an idea that should be explored seriously. Imposing penalties on the sellers of tax products as well as on the buyers should also be examined. Here again, some caution is recommended. It would not be appropriate to require an accounting or law firm to disclose the name of every client that it advised that owning property might be more tax-efficient than leasing it. Legitimate business transactions should not be brought within the sweep of disclosure rules aimed at tax shelters, and the IRS should not be inundated with useless information. I suspect that the Internal Revenue Service and the Treasury Department already have the authority to require a sufficient degree of disclosure to enable them to enforce the laws effectively, but you should seriously consider any proposals that they may advance or legislation that would increase their ability to detect aggressive tax strategies.

Along the same lines, you should give them the tools, including personnel and other resources, that they need to do their jobs in this area. Ultimately, no legislative or regulatory approach to corporate tax shelters will work unless the Internal Revenue Service is given the resources that it needs to enforce them. It has been politically popular in recent years to criticize the IRS, but the few instances of abuse that have been publicized by this Committee and others should not obscure the fact that the overwhelming majority of IRS employees are competent, dedicated, and honest men and women who do their jobs conscientiously and who do not abuse their public trust. Any failure to provide the Service with the resources that it needs to administer the tax laws can only result in a lower audit rate and that encourages taxpayers, individual as well as corporate, to take aggressive positions.

In conclusion, Mr. Chairman, let me say that in my view, and in the view of most other responsible tax practitioners with whom I have discussed the matter, there is a corporate tax shelter problem, and I am pleased that this Committee is holding hearings on the subject. The problem should be addressed by all three branches of government, and one should not assume that legislation is necessarily the way to address all aspects of it. Congress should move cautiously in defining "bad" transactions and it should encourage the Treasury to require increased disclosure of aggressive tax strategies. The Treasury should also be encouraged to regulate the conduct of the promoters of tax shelters by tightening the standards reflected in Circular 230 and elsewhere. I will be happy to answer any questions that you and the members of the Committee may have.

PREPARED STATEMENT OF KENNETH J. KIES

I'm Ken Kies, Co-Managing Partner of the PricewaterhouseCoopers Washington National Tax Services office. The question I have been asked to address is whether there is any demonstrated problem with "corporate tax shelters" that would require sweeping legislative action.

The Treasury Department and other proponents of so-called "corporate tax shelter" legislation suggest that an alarming and historic erosion of the corporate income tax base is underway. This assertion is totally without support. Referring to my charts, you will note that, other than a slight dip in 1999, corporate income tax receipts have grown rapidly over the past decade. While the economy has grown by 47% since 1992, corporate income taxes have grown by 84%. In fact, over the past five years, corporate income tax revenues have been at their highest level as a percent of GDP than at any time since 1980.

Some have suggested that the slight decline in corporate income tax receipts in 1999 may be attributable to corporate tax shelters. There is no basis for this assertion. This modest drop is largely attributable to greater depreciation deductions flowing from increased capital investment, and was actually projected by OMB at the beginning of last year. Such a decline is hardly a first—in fact, there have been 15 instances since 1950 where corporate tax receipts have dropped from one year to the next.

The sole piece of statistical information Treasury has identified to support its view is data concerning differences between taxable corporate income and book income, or profits that corporations report to their shareholders. Treasury has taken the tax returns of 811 corporations over the 1991–96 period and looked at the differences between book and tax income as reported by these corporations. Specifically, Treasury looked at Schedule M of these corporate returns, where taxpayers provide details as to what accounts for the difference between book and tax income. Treasury's methodology raises a couple of interesting questions. First, what were the differences listed by these taxpayers? Treasury alone has access to this data, but it has to date failed to identify these differences. It simply concludes that "corporate tax shelters" are part of the story. Second, these differences were actually reported and described by taxpayers on their M–1's. All of the companies studied were part of the IRS Coordinated Exam Program. In these examinations, these differences are among the first items examined by IRS auditors. In other words, there is nothing secret about these differences are among the first items examined by IRS auditors. In other words, there is nothing secret about these differences—Treasury and the IRS know what they are.

While PricewaterhouseCoopers does not have access to the specific tax returns studied by Treasury, we have analyzed differences between book and tax income, and we can explain much of the difference in quantifiable terms that have nothing to do with "corporate tax shelters." Over the 1992–96 period, differences between book and tax depreciation explain $19 billion to $28 billion of this difference, while differences in the treatment of foreign earnings account for $43 billion. Stock options also account for part of the difference. While it is difficult to estimate the magnitude of the book-tax difference attributable to stock options, it is likely to be quite large, given the dramatic run-up in the stock market which has taken place in recent years. Thus, our study shows that differences between book and taxable income really are attributable to such mundane activities as investing in new equipment, doing business in a global economy, and incentivizing employees with stock compensation.

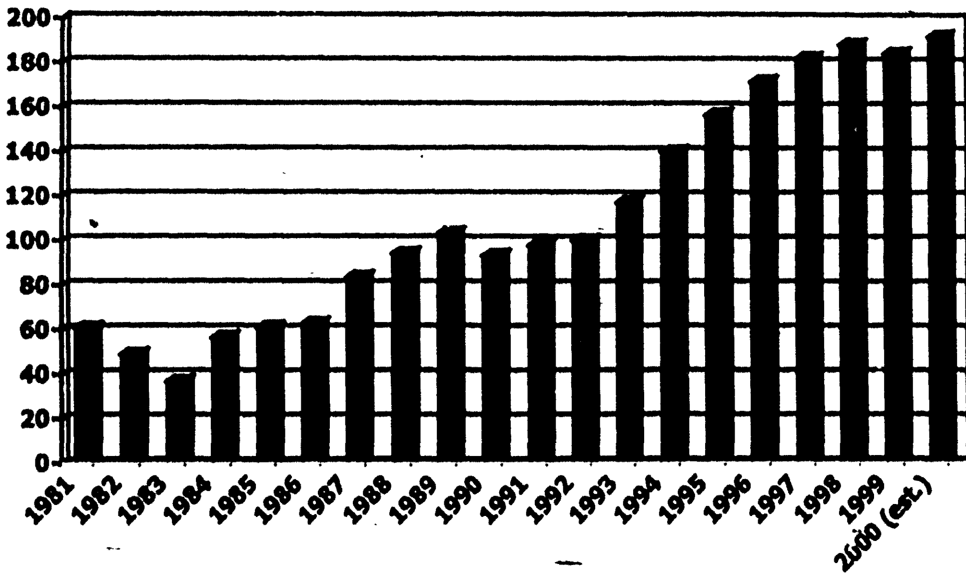
Effective tax rates provide yet another measure that you can look to in considering whether there is any economic evidence of increasing "corporate tax shelter" activity. My firm has undertaken a study that found that effective tax rates have been relatively constant over the past ten years. A Treasury economist presented a similar study last year and found a slight drop in the effective corporate tax rates over the 1990–98 period. However, he found that this decline was largely unrelated to corporate tax shelters. The Treasury economist concluded, "Rather than shelters, it is the decline in corporate losses that accounts for most of the decline in the average tax rate in the 1990s."

In assessing the need for legislative action in this area, it is also important to note that two things have happened since the Treasury's initial proposals from February 1999. First, the Treasury last week finally found time to implement "corporate tax shelter" reporting requirements that Congress enacted in 1997. Congress at that time—three years ago—stated that this reporting would deter inappropriate transactions. Second, the IRS over the past year has won an historic string of victories in the courts in cases involving perceived "corporate tax shelters." In these cases, the government successfully used economic substance and other common-law doc-

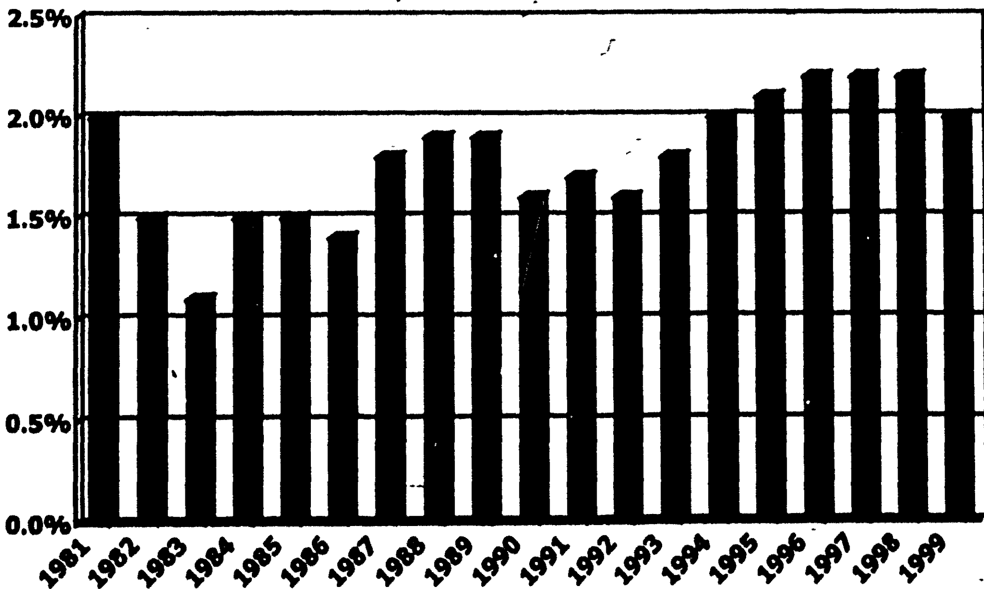
trines to attack shelter-like transactions. These government wins have had a profound effect on corporate taxpayers and their advisers and their willingness to even entertain transactions that could be viewed as questionable.

Let me just close by saying that Treasury Secretary Summers' recent assertion that "corporate tax shelters" may be the most serious compliance issue threatening our tax system today is unsustainable based on the facts. One need look no further than the recently released GAO audit of the IRS to see real and serious compliance problems. That report revealed that the IRS fails to collect many tens of billions of dollars each year where there is no question that taxes are in fact owed. If you look at the charts, you'll see that the IRS had $231 billion in unpaid assessments in fiscal 1999. Of this amount, $127 billion was simply written off. These are real compliance issues deserving of serious attention, as compared to the "corporate tax shelter" one, which makes for good headlines but which fails to withstand careful scrutiny.

Corporate Income Tax Receipts
($billions; OMB)



Corporate Income Tax Receipts as % of GDP
(OMB)



STATEMENT OF KENNETH J. KIES
– PRICEWATERHOUSECOOPERS

BEFORE

THE SENATE FINANCE COMMITTEE

HEARING ON PENALTY AND INTEREST PROVISIONS IN THE INTERNAL REVENUE CODE
MARCH 8, 2000

I. INTRODUCTION

PricewaterhouseCoopers appreciates the opportunity to submit this written testimony to the Finance Committee. This testimony focuses on the issue of "corporate tax shelters," specifically on the question whether there is a problem with "corporate tax shelters" that requires broad legislative action.

PricewaterhouseCoopers, the world's largest professional services organization, provides a full range of business advisory services to corporations and other clients, including audit, accounting, and tax consulting. The firm, which has more than 6,500 tax professionals in the United States and Canada, works closely with thousands of corporate clients worldwide, including most of the companies comprising the Fortune 500. These comments reflect the collective experiences of many of our corporate clients.

We believe there is no demonstrated problem with "corporate tax shelters" that would require sweeping legislation. Economic data does not suggest any systemic erosion of the corporate income tax base attributable to "corporate tax shelters." Moreover, current-law administrative tools, if used properly, are more than adequate to deter, detect and penalize abuses.

II. "MOST SERIOUS COMPLIANCE ISSUE"?

Rhetoric in the "corporate tax shelter" debate has reached a fever pitch. Treasury Secretary Summers on February 28 said "corporate tax shelters" may be the "most serious compliance

issue threatening the American tax system today."[1] This characterization seems overblown, especially in light of a new General Accounting Office (GAO) audit[2] of the IRS's 1999 financial statements that found that the IRS fails to collect tens of billions of dollars each year from taxpayers where there is no question that taxes are in fact owed.

The GAO audit states that this failure by the IRS to pursue such cases could "adversely affect future compliance."[3] Specifically, the audit found that the IRS in fiscal 1999 had $231 billion in unpaid assessments, of which $127 billion was simply written off. Of the amount not written off, $56 billion was categorized as "uncollectible." Until recently, this term typically was reserved for cases where the taxpayer owing the outstanding taxes was experiencing financial difficulties or other hardships that made collection highly unlikely. In fiscal 1999, however, the definition of uncollectible taxes was broadened to include tax that could not be collected because of increasing IRS workloads and judgments that resource constraints would not allow the IRS to pursue actively the case. The GAO report notes that these cases were not pursued even though information in the case files indicated that the taxpayer had financial resources available to pay at least some of the amounts owed. Thus, taxpayers are escaping tens of billions of dollars in taxes owed each year simply because the IRS does not have time to follow up.

Furthermore, the IRS in its last study of the "tax gap" found that individual noncompliance with the income tax cost the government more than $95 billion a year.[4] The tax gap is defined as the difference between income taxes owed and those voluntarily paid. Key components of the tax gap that were identified include unreported income by sole proprietors, overstated deductions, and failures to file.

These facts illustrate that there are far larger tax administration problems facing the IRS than any problems perceived to be posed by "corporate tax shelters."

III. EROSION OF THE CORPORATE INCOME TAX BASE?

A key question in this debate is whether "corporate tax shelters" are eroding the corporate income tax base. We see no credible evidence of such a phenomenon.

Since 1992, corporate federal income tax payments have grown by 84 percent, from $100.3 billion in fiscal 1992 to $184.7 billion in fiscal 1999.[5] By point of comparison, GDP has grew by 47 percent over this period. Over the past six fiscal years, corporate income tax payments have been at their highest levels of GDP since 1980.[6] Moreover, corporate income taxes in

[1] "Tackling the Growth of Corporate Tax Shelters," Remarks of Treasury Secretary Lawrence H. Summers before the Federal Bar Association, February 28, 2000.
[2] *Financial Audit: IRS' Fiscal Year 1999 Financial Statements* (GAI/AIMD-00-76, February 29, 2000).
[3] Id. at 15.
[4] *Federal Tax Compliance Research*, IRS Publication 1415 (4-96).
[5] *Budget of the United States, Fiscal Year 2001: Historical Tables*, Office of Management and Budget, February 2000, at 27-28.
[6] Id. at 31-32.

fiscal 1999 stood at 10.1 percent of total federal receipts – higher than the average (9.7 percent) for the 1981-99 period.[7]

Corporate Income Tax Receipts: 1981-1999
(Source: OMB)

Fiscal Year	Receipts ($ millions)	% of Federal Receipts	% of GDP
1981	61,137	10.2	2.0
1982	49,207	8.0	1.5
1983	37,022	6.2	1.1
1984	56,893	8.5	1.5
1985	61,331	8.4	1.5
1986	63,143	8.2	1.4
1987	83,926	9.8	1.8
1988	94,508	10.4	1.9
1989	103,291	10.4	1.9
1990	93,507	9.1	1.6
1991	98,086	9.3	1.7
1992	100,270	9.2	1.6
1993	117,520	10.2	1.8
1994	140,385	11.2	2.0
1995	157,004	11.6	2.1
1996	171,824	11.8	2.2
1997	182,293	11.5	2.2
1998	188,677	11.0	2.2
1999	184,680	10.1	2.0

Despite this high level of corporate income tax payments, some commentators have pointed to a two-percent drop in corporate income tax receipts in fiscal 1999, as compared to the prior year, as possibly indicating "corporate tax shelter" activity.[8] Possible explanations for this drop include a relative decline in taxable corporate income attributable to depreciation deductions associated with higher levels of investment and increases in employee compensation.[9] The Congressional Budget Office (CBO) in its January 2000 budget outlook noted depreciation as among the factors putting downward pressure on corporate tax receipts.[10] It also should be noted that the slight falloff in corporate profits was not unforeseen – the Office of Management

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[7] Id. at 29-30.

[8] See, Martin A Sullivan, "Despite September Surge, Corporate Tax Receipts Fall Short," 85 *Tax Notes* 565 (Nov. 1, 1999).

[9] See, *New York Times*, September 21, 1999, "When an Expense is Not an Expense." This article points to rising compensation paid in the form of stock options as a possible explanation. An increase in employee compensation increases personal income tax (at the employee level) at the expense of corporate income tax, because employee compensation generally is deductible in computing corporate income tax and includable in computing personal income tax.

[10] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2001-2010*, January 2000, p. 60.

and Budget (OMB) last year projected that corporate income tax payments would fall in FY 1999, before rising again in FY 2000.[11] It also should be noted that the decline in corporate tax receipts between fiscal years 1998 and 1999 was entirely due to an increase in refunds of taxes overpaid in prior years – gross tax payments actually increased from $213 billion to $216 billion over this period. Since the Joint Committee on Taxation reviews all refund claims in excess of $1 million, there is no reason to believe that the growth in tax refunds is due to undetected or inappropriate transactions.

If unusually high levels of corporate tax shelter activity had been occurring over the last few years, we would expect to see a drop in corporate tax liability relative to normative measures of pre-tax corporate income. To test this hypothesis, PricewaterhouseCoopers has measured corporate effective tax rates using data from the National Income and Product Accounts and audited financial statements.[12] We found no suspicious drop in tax liabilities relative to corporate income; to the contrary, we found flat or rising corporate effective tax rates over the last five years.

In a paper presented October 24, 1999, at the National Tax Association's 92nd Annual Conference on Taxation, a Treasury Department economist presented an independent study of corporate average tax rates that specifically commented on the question whether there was any evidence of a problem with "corporate tax shelters." Using a different measure of corporate profits than was used by PricewaterhouseCoopers, the Treasury economist found a slight drop in the average corporate tax rate over the 1990-98 period. However, the economist found that this decline was "largely unrelated to corporate tax shelters." The economist concluded, "Rather than shelters, it is the decline in corporate losses that accounts for most of the decline in the average tax rate in the 1990s."[13]

The Treasury Department has not presented any compelling evidence to support its contention that "corporate tax shelters" are eroding the corporate income tax base. Rather, Treasury has cited statements made Joseph Bankman of Stanford University that "corporate tax shelters" are responsible for $10 billion in lost corporate income tax revenues each year. Bankman essentially admits he has no data supporting his $10 billion figure in his Internet tax policy chatroom,[14] where he answers a question from a reader as to the references for his $10 billion figure as follows: "The $10 billion figure that I am quoted on is obviously just an estimate." This unsubstantiated claim hardly represents the type of serious economic analysis that should be undertaken before adopting sweeping tax policy changes of the scope envisioned by Treasury.

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[11] The Administration's FY 2000 budget projected that corporate income revenues would total $182.2 billion in FY 1999, or $2.5 billion less than the amount actually paid.

[12] *See*, Statement of PricewaterhouseCoopers to the Senate Finance Committee for the Record of Its February 8, 2000 Hearing on the Administration's FY 2001 Budget.

[13] The explanation is that the recession in 1990 artificially boosted the measured average tax rate because companies with losses had no income against which to apply tax credits, losses from prior years, and other tax attributes. With the subsequent recovery, growing profits allowed for use of these tax attributes, which had the effect of reducing the overall average tax rate.

[14] http://www.law.nyu.edu/bankmanj/federalincometax

IV. BOOK INCOME AND TAXABLE INCOME

Treasury officials also have cited as evidence of tax shelter activity the gap between corporate income reported to shareholders (book income) and to the IRS on tax returns (taxable income).[15] This section describes the different concepts used to measure book and taxable income, reviews Treasury's analysis, and presents some new data on book-tax differences.

A. Background

Corporations with assets of $25,000 or more are required to reconcile book income to taxable income on Schedule M-1 of the corporate tax return (Form 1120). The starting point for Schedule M-1 is the taxpayer's book income. As reported on financial statements, however, book income may reflect a different group of legal entities than are included in the taxpayer's return. This occurs as a result of difference in book and tax consolidation rules (the percentage ownership threshold for tax consolidation generally is higher than for book consolidation). Because it is not meaningful to compare income across different legal entity groups, companies typically adjust the book income figure they report on Schedule M-1 to a tax consolidation concept.

Book income is reported net of federal and state income taxes, while taxable income is reported before federal and after state income taxes. Consequently, to reconcile book and taxable income, federal income tax expense must be added back to book income.

Differences in pre-tax book income and taxable income can be classified as permanent or temporary. Permanent differences are items of income or expense that are recognized under one of these accounting systems and not the other, and do not reverse over time. Examples of permanent differences include tax-exempt interest and nonqualified stock option expense (which are included in book income but not taxable income) and non-deductible travel and entertainment expenses (which are included in taxable income but not book income).

Temporary differences are items of income or expense that are recognized in different fiscal years for tax and book purposes. The periods and methods of *capital cost recovery* (i.e., depreciation, amortization and depletion) generally differ between financial and tax accounting, with typically faster cost recovery for tax purposes. Another important temporary difference is *foreign source income*. Book income includes foreign source income net of foreign tax; by contrast, the taxable income concept used by Treasury excludes income earned by foreign affiliates from sources outside the United States unless this income is distributed to the U.S. parent. The excess of book over taxable income arising from net foreign earnings is a temporary difference because it reverses when foreign earnings are distributed (causing an increase in taxable but not book income).

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[15] Statement of Jonathan Talisman, Acting Assistant Secretary for Tax Policy, U.S. Department of the Treasury, Testimony Before the House Committee on Ways and Means Hearing on Corporate Tax Shelters, November 10, 1999.

B. Treasury Analysis

Treasury analyzed Schedule M-1 data for 811 corporations, with mean asset size in excess of $1 billion (in 1992 dollars), over the 1991-1996 period. Treasury compared adjusted pre-tax book income (book income plus federal income taxes less tax-exempt interest as reported on Schedule M-1) with taxable income (taxable income before net operating loss deduction and special deductions) reported on corporate tax returns as filed. Treasury found that in real terms, taxable income for the 811 corporations roughly doubled between 1991 and 1996, but that book income increased even faster. While acknowledging that "it is unclear how much of the divergence between tax and book income reflects tax shelter activity," Treasury nevertheless views the more rapid growth of book than taxable income as evidence of a growing shelter problem.[16]

Treasury recognizes that book and taxable income can diverge for reasons that are unrelated to tax shelters, including depreciation, foreign source income, and nonqualified stock options.[17] However, Treasury only considers one of these factors – depreciation – and makes no attempt to adjust for the other potential causes of book-tax differences. Treasury finds that book-tax depreciation differences cannot explain the growth in the book-tax income gap over the 1991-96 period, and suggests that growing tax shelter activity is a likely explanation.

In summary, Treasury finds that adjusted pre-tax book income has grown more rapidly than taxable income for a sample of corporations over the 1991-1996 period, and that this difference cannot be attributed to book-tax depreciation differences. Although Treasury recognizes that book and taxable income can diverge for many differences unrelated to tax shelter activity, its testimony nevertheless concludes that "the data are clearly consistent with other evidence that the problem [tax shelter activity] is significant."

C. PricewaterhouseCoopers Analysis

This section extends Treasury's analysis in several ways: (1) data is collected for all public companies (not just the 811 corporations analyzed by Treasury); (2) book-tax depreciation differences are calculated from several sources back to 1985; (3) the foreign component of book income is calculated back to 1984; and (4) the available data on stock option awards is reviewed.

1. Depreciation

Figure 1a shows the excess of tax depreciation over book depreciation. Tax depreciation is based on published IRS data on corporate income tax returns, while book depreciation is calculated based on the Standard and Poors Compustat database, which excludes privately held companies. The excess of tax over book depreciation is likely overstated because the book

[16] See, fn. 15 at 5.
[17] Ibid.

depreciation measure excludes privately held companies.[18] As shown in Figure 2a, the tax-book depreciation gap increased after 1992, mirroring the rise in the book-tax income difference over this period. Thus, these data suggest that the growing tax-book depreciation gap is part of the explanation for the book-tax income difference.[19]

This analysis can, of course, be criticized because the measure of book depreciation excludes privately held companies. One solution to this data limitation is to use the Capital Consumption Allowance (CCA) adjustment estimated by the Bureau of Economic Analysis (BEA). The CCA adjustment represents the excess of tax depreciation over BEA's definition of economic depreciation for all U.S. corporations.[20] The CCA adjustment likely *understates* the actual tax-book depreciation difference because economic depreciation is based on replacement cost accounting, while historic cost accounting is required for financial reporting. **Figure 1b** shows the CCA adjustment. These data suggest that the growing tax-book depreciation gap is part of the explanation for the book-tax income difference after 1992.

In summary, we find that both measures of the corporate tax-book depreciation gap – one based on Compustat data and the other based on the CCA adjustment – indicate that the tax-book depreciation gap increased over the 1992-96 period (by between $19 billion and $28 billion). This difference thus helps explain the faster growth of book income than taxable income over this period.[21]

2. Foreign source income

Figure 2 isolates the foreign component of book income over the 1984-1996 period based on Compustat data. To the extent this foreign income is not distributed to U.S. shareholders, it results in a book-tax difference. Foreign source income in 1992 was $47 billion according to financial statement data, which compares closely with Treasury data indicating after-tax foreign earnings and profits were $51 billion in 1992, of which $41 billion was distributed.[22] Thus, undistributed foreign earnings contributed about $10 billion ($51 billion minus $41 billion) to the book-tax income difference in 1992.

By 1996, foreign source book income had increased to $106 billion, from $47 billion in 1992. Treasury has not published data on the distribution rate of foreign earnings and profits in 1996. However, it is likely that the distribution rate is closer to the 41 percent level recorded in 1984 and 1986, than the 81 percent rate in 1992 – a year with heavy foreign losses.[23] If the

[18] The domestic share of book depreciation was estimated by multiplying total depreciation by the ratio of U.S. to worldwide assets.
[19] This conclusion is sensitive to the portion of corporate book depreciation that is not covered by the Compustat data. Depending on how large a gross-up is necessary to account for privately held companies, the tax-book depreciation gap could have a different pattern over the 1992-1996 period.
[20] CCA measured on a GDP basis is used in this analysis – domestic plant and equipment are included and foreign plant and equipment are excluded.
[21] The excess of tax over book depreciation increased by $27.6 billion (from $134 billion to $161 billion) over the 1992-1996 period, and the CCA adjustment increased by $19 billion (from $3 billion to $22 billion).
[22] Hines, James R., Jr., "The Case Against Deferral: A Deferential Reconsideration," May 1999, Table 1.
[23] Ibid. (cited as source for data).

distribution rate of foreign income is estimated at 50 percent in 1996, this would imply undistributed foreign earnings contributed $53 billion (50 percent of $106 billion) of the book-tax income difference in 1996. Thus, the growth in foreign income between 1992 and 1996 reasonably can explain $43 billion ($53 billion of undistributed foreign income in 1996 less $10 billion in 1992) of the growth in the excess of book over taxable income during this period.[24]

3. Stock options

Figure 3 shows that the value of all unexercised in-the-money stock options owned by top executives at Forbes 800 companies increased from $2.4 billion in 1994 to $10.6 billion in 1998. The growth in the value of stock option grants is in part due to a rise in the overall level of the stock market and in part due to an increase in share awards. **Figure 4** shows that shares authorized for stock option plans increased from 6.9 percent of all shares outstanding in 1989 to 13.2 percent in 1997.

The overwhelming majority of stock option awards are nonqualified stock options (NSOs). Because NSOs generally are not treated as an expense for financial reporting purposes, the exercise of NSOs by employees gives rise to a permanent book-tax difference. The rapid growth in NSOs clearly has contributed to the growing book-tax income gap, although it is difficult to estimate the magnitude of the effect. Any reduction in the corporate tax base due to NSOs, however, is offset by an increase in the individual income tax base (because the gain on exercise is deducted by the employer and included by the employee).

D. Conclusion

While corporations' taxable and book income have both increased at an extraordinarily rapid rate since 1991, Treasury has expressed concern that book income has grown more rapidly than taxable income over this period. As Treasury itself acknowledges, book-tax income differences can arise for many reasons unrelated to tax shelter activities, including foreign source income, depreciation. and stock options. While it is difficult to allocate book-taxable income differences among each of these factors, we find evidence that they account for much of the difference. This new data cast doubt on Treasury's conclusion that recent trends in book-tax income differences are evidence of increasing "corporate tax shelter" activity.

V. ARE CURRENT-LAW IRS TOOLS SUFFICIENT?

Another key question in this debate is whether tools currently available to the IRS are sufficient to enforce compliance with the corporate income tax. Proponents of sweeping new legislation to address "corporate tax shelters" are quick to dismiss the formidable array of tools the government now has to deter, detect, and attack transactions considered as abusive. In our view, these tools are more than sufficient.

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[24] A more precise estimate would require grossing up book income, depreciation, and foreign source book income to take into account privately held companies.

A. Reporting and disclosure requirements

The Treasury Department recently has taken steps to expand reporting and disclosure of shelter-like transactions. On February 28, Treasury issued regulations activating the rules that had been enacted by Congress in 1997 requiring promoters to register certain "corporate tax shelters" with the IRS.[25] Treasury also issued regulations requiring corporations to disclose shelter-like transactions,[26] and expanding rules requiring organizers of "potentially abusive tax shelters" to maintain lists of investors in such arrangements.[27]

These recent actions taken by Treasury further reinforce the point that the government can address perceived problems with respect to "corporate tax shelters" without additional legislation. In enacting the "corporate tax shelter" registration requirements three years ago, Congress stated that this reporting would "improve compliance by discouraging taxpayers from entering into questionable transactions."[28] Now that these reporting requirements finally have been implemented by Treasury, Congress will have an opportunity to assess their impact and determine whether they have been effective. Further action should not be taken, particularly action that would create vague standards and broad new powers, until the efficacy of the existing legislative rules can be evaluated.

B. Use of "common-law" doctrines

Pursuant to several "common-law" tax doctrines, Treasury and the IRS can challenge a taxpayer's treatment of a transaction if they believe the treatment is inconsistent with statutory rules and the underlying Congressional intent. For example, these doctrines may be invoked where the IRS believes that (1) the taxpayer has sought to circumvent statutory requirements by casting the transaction in a form designed to disguise its substance, (2) the taxpayer has divided the transaction into separate steps that have little or no independent life or rationale, (3) the taxpayer has engaged in "trafficking" in tax attributes, or (4) the taxpayer improperly has accelerated deductions or deferred income recognition.

The common-law doctrines – known as the business purpose doctrine, the substance over form doctrine, the step transaction doctrine, and the sham transaction and economic substance doctrine – give the IRS considerable leeway to recast transactions based on economic substance, to treat apparently separate steps as one transaction, and to disregard transactions that lack business purpose. Recent applications of those doctrines have demonstrated their effectiveness and cast doubt on Treasury's asserted need for additional tools.

The recent decisions in ACM v. Commissioner[29] and ASA Investerings v. Commissioner[30] illustrate the continuing force of these long-standing judicial doctrines. In ACM, the Third

[25] TD 8876.
[26] TD 8877.
[27] TD 8875.
[28] General Explanation of Tax Legislation Enacted in 1997, Staff of the Joint Committee on Taxation, December 17, 1997 (JCS 23-97).
[29] 157 F.3d 231 (3d Cir. 1998). See also Saba Partnership, T.C.M. 1999-359 (10/27/99).

Circuit, affirming the Tax Court, relied on the sham transaction and economic substance doctrines to disallow losses generated by a partnership's purchase and resale of notes. The Tax Court similarly invoked those doctrines in ASA Investerings to disallow losses on the purchase and resale of private placement notes. Both cases involved complex, highly sophisticated transactions, yet the IRS successfully used common-law principles to prevent the taxpayers from realizing tax benefits from the transactions.

More recent examples of use of common-law doctrines by the IRS are the Tax Court's decisions in United Parcel Service v. Commissioner[31] (8/9/99), Compaq Computer Corp. v. Commissioner[32] (9/21/99), and Winn-Dixie v. Commissioner[33] (10/19/99). In United Parcel Service, the court agreed with the IRS's position that the arrangement at issue – involving the taxpayer, a third-party U.S. insurance company acting as an intermediary, and an offshore company acting as a reinsurer – lacked business purpose and economic substance. In Compaq, the court agreed with the IRS's contention that the taxpayer's purchase and resale of certain financial instruments lacked economic substance and imposed accuracy-related penalties under section 6662(a). In Winn-Dixie, the court held that an employer's leveraged corporate-owned life insurance program lacked business purpose and economic substance.

This recent line of cases and the IRS's increasingly successful use of common-law doctrines in these cases argue against any need for expanding the IRS's tools at this time or (as the Treasury Department has suggested) for codifying the doctrines.

C. Threat of penalties

As an initial matter, the Tax Code includes significant disincentives to engage in potentially abusive behavior. Present law imposes 20-percent accuracy-related penalties under section 6662 in the case of negligence, substantial understatements of tax liability, and certain other cases. In considering a proposed transaction that may turn on a debatable reading of the tax law, a corporate tax executive must weigh the potential for imposition of these penalties, which could have a negative impact on shareholder value and on the corporation.

Furthermore, it should be noted that Congress, in the 1997 Taxpayer Relief Act, strengthened the substantial understatement penalty as it applies to "tax shelters." Under this change, which was supported and encouraged by the Treasury Department, an entity, plan, or arrangement is treated as a tax shelter if it has tax avoidance or evasion as just one of its significant purposes.[34] These changes have made it even more important for chief tax executives to weigh carefully the risks of penalties and even more difficult to determine which transactions might trigger penalties. At this time, there is no demonstrated justification for making these penalties even harsher.

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[30] T.C.M. 1998-305.
[31] T.C.M. 1999-268.
[32] 113. T.C. No. 17.
[33] 113. T.C. No. 21.
[34] Section 6662(d)(2)(C)(iii). Prior law defined tax shelter activity as an entity, plan, or arrangement only if it had tax avoidance or evasion as the principal purpose.

D. Anti-abuse rules

The Code includes numerous provisions that arm Treasury and the IRS with broad authority to prevent tax avoidance, to reallocate income and deductions, to deny tax benefits, and to ensure taxpayers clearly report income.

These rules long have provided powerful ammunition for challenging tax avoidance transactions. For example, section 482 authorizes the IRS to reallocate income, deductions, credits, or allowances between controlled taxpayers to prevent evasion of taxes or to clearly reflect income. While much attention has been focused in recent years on the application of section 482 in the international context, section 482 also applies broadly in purely domestic situations. Further, the IRS also has the authority to disregard a taxpayer's method of accounting if it does not clearly reflect income under section 446(b).

In the partnership context, the IRS has issued regulations under subchapter K aimed at arrangements the IRS considers as abusive.[35] The IRS states that these rules authorize it to disregard the existence of a partnership, to adjust a partnership's methods of accounting, to reallocate items of income, gain, loss, deduction, or credit, or otherwise to adjust a partnership's or partner's tax treatment in situations where a transaction meets the literal requirements of a statutory or regulatory provision, but where the IRS believes the results are inconsistent with the intent of the Code's partnership tax rules.

The IRS also has issued a series of far-reaching anti-abuse rules under its legislative grant of regulatory authority in the consolidated return area. For example, under Treas. Reg. Sec. 1.1502-20, a parent corporation is severely limited in its ability to deduct any loss on the sale of a consolidated subsidiary's stock. The consolidated return investment basis adjustment rules also contain an anti-avoidance rule.[36] The rule provides that the IRS may make adjustments "as necessary" if a person acts with "a principal purpose" of avoiding the requirements of the consolidated return rules. The consolidated return rules feature several other anti-abuse rules as well.[37]

E. Treasury action

Treasury on numerous occasions has issued IRS Notices stating an intention to publish regulations that would preclude favorable tax treatment for certain transactions. Thus, a Notice allows the government (assuming that the particular action is within Treasury's rulemaking authority) to move quickly, without having to await development of the regulations themselves – often a time-consuming process – that provide more detailed rules concerning a particular transaction.

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[35] Treas. Reg. § 1.701-2.

[36] Treas. Reg. § 1.1502-32(e).

[37] *See, e.g.*, Treas. Reg. § 1.1502-13(h) (anti-avoidance rules with respect to the intercompany transaction provisions) and Treas. Reg. § 1.1502-17(c) (anti-avoidance rules with respect to the consolidated return accounting methods).

Examples of the use of this authority include Notice 97-21, in which the IRS addressed multiple-party financing transactions that used a special type of preferred stock; Notice 95-53, in which the IRS addressed the tax consequences of "lease strip" or "stripping transactions" separating income from deductions; and Notices 94-46 and 94-93, addressing so-called "corporate inversion" transactions viewed as avoiding the 1986 Act's repeal of the General Utilities doctrine.[38]

Moreover, section 7805(b) of the Code expressly gives the IRS authority to issue regulations that have retroactive effect "to prevent abuse." Although many Notices have set the date of Notice issuance as the effective date for forthcoming regulations,[39] Treasury has used its authority to announce regulations that would be effective for periods prior to the date the Notice was issued.[40] Alternatively, Treasury in Notices has announced that it will rely on existing law to challenge abusive transactions that already have occurred.[41]

F. Targeted legislation

To the extent that Treasury and the IRS may lack rulemaking or administrative authority to challenge a particular type of transaction, one other highly effective avenue remains open – that is, enactment of legislation. In this regard, over the past 30 years dozens upon dozens of changes to the tax code have been enacted to address perceived abuses. For example, Congress last year enacted legislation (H.R. 435) addressing "basis-shifting" transactions involving transfers of assets subject to liabilities under section 357(c).

These targeted legislative changes often have immediate, or even retroactive, application. The section 357(c) provision, for example, was made effective for transfers on or after October 19, 1998 – the date House Ways and Means Committee Chairman Bill Archer introduced the proposal in the form of legislation. Chairman Archer took this action, in part, to stop these transactions earlier than would have been accomplished under the effective date originally proposed by Treasury (the date of enactment).

G. IRS National Office Activities Regarding "Corporate Tax Shelters"

The question whether broad legislative action regarding "corporate tax shelters" is warranted at this time should be considered in view of current administrative initiatives now being undertaken at the IRS. Larry Langdon, Commissioner of the IRS's new Large and Mid-Size Business Division, has announced that the IRS is establishing a special office to coordinate IRS efforts to address corporate tax shelter issues.[42] The new office will allow for quick

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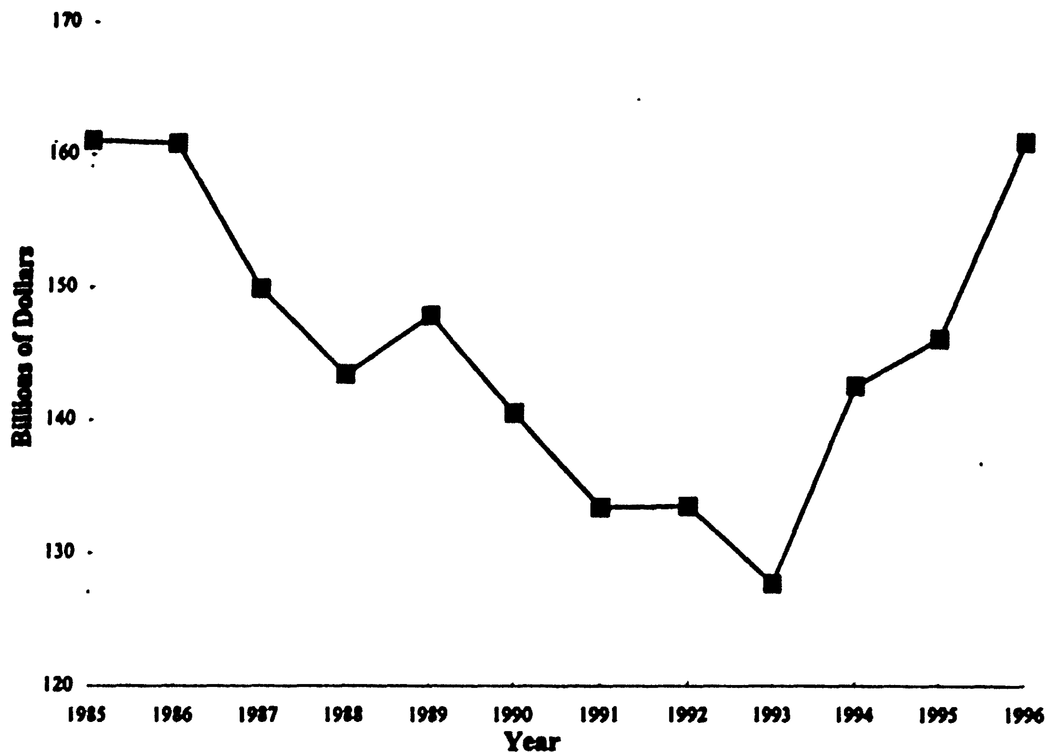
[38] The General Utilities doctrine generally provided for nonrecognition of gain or loss on a corporation's distribution of property to its shareholders with respect to their stock. *See*, General Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935). The General Utilities doctrine was repealed in 1986 out of concern that the doctrine tended to undermine the application of the corporate-level income tax. H.R. Rep. No. 426, 99th Cong., 1st Sess. 282 (1985).
[39] *See, e.g.*, Notice 95-53, 1995-2 CB 334, and Notice 89-37, 1989-1 CB 679.
[40] *See, e.g.*, Notice 97-21, 1997-1 CB 407.
[41] Notice 96-39, I.R.B. 1996-32.
[42] BNA *Daily Tax Report*, January 18, 2000, G-4.

communication between IRS examiners. the IRS Chief Counsel, and the Treasury Department in identifying and addressing abuses. These IRS efforts will serve as a strong deterrent to abusive transactions and further call into question the need for legislative action at this time.

VI. CONCLUSION

Congress should reject the broad legislative proposals regarding "corporate tax shelters" that have been advanced by the Treasury Department and others. The economic data indicate no need for these radical changes. Further, the proposals that have been advanced to date are completely unnecessary in light of the array of legislative, regulatory, administrative, and judicial tools available to curtail perceived abuses. Finally, these proposals would create an unacceptably high level of uncertainty and burdens for corporate tax officials while potentially imposing penalties on legitimate transactions undertaken in the ordinary course of business.

Figure 1a: Excess of Tax over Book Depreciation, 1985-1996



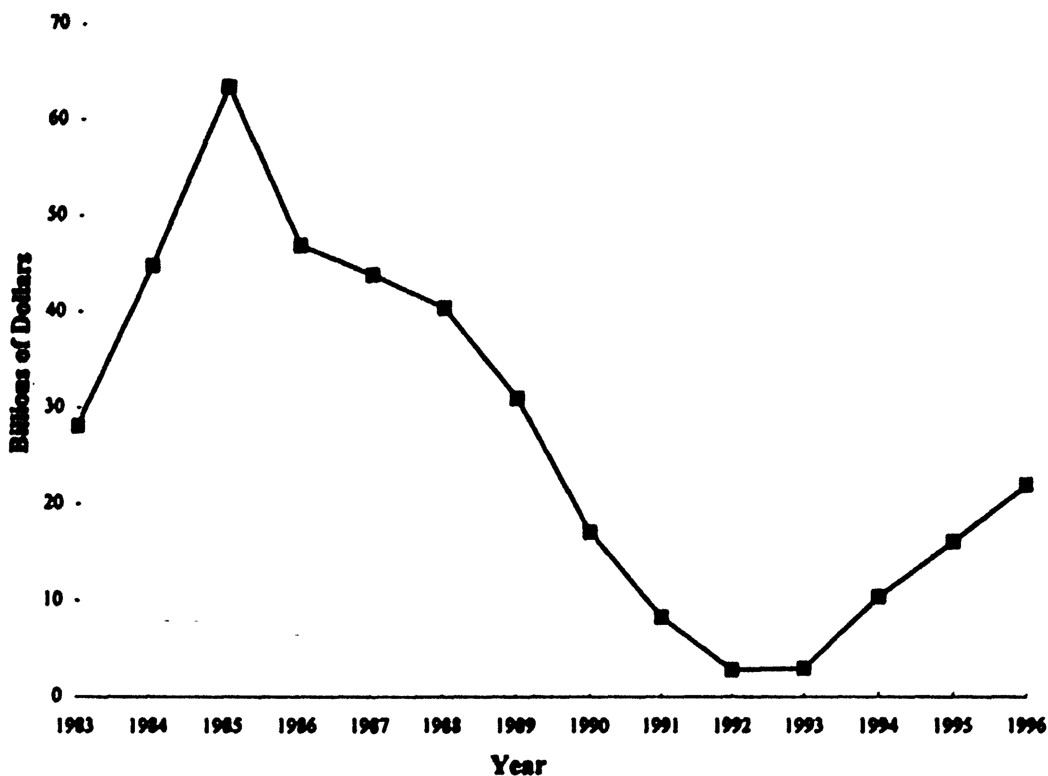
Excess of Tax over Book Depreciation = Tax Depreciation & Amortization (Tax Returns)
- Book Depreciation & Amortization (Income Statement)

Corporations excluding S Corporations, RICs, REITs, and Foreign Corporations

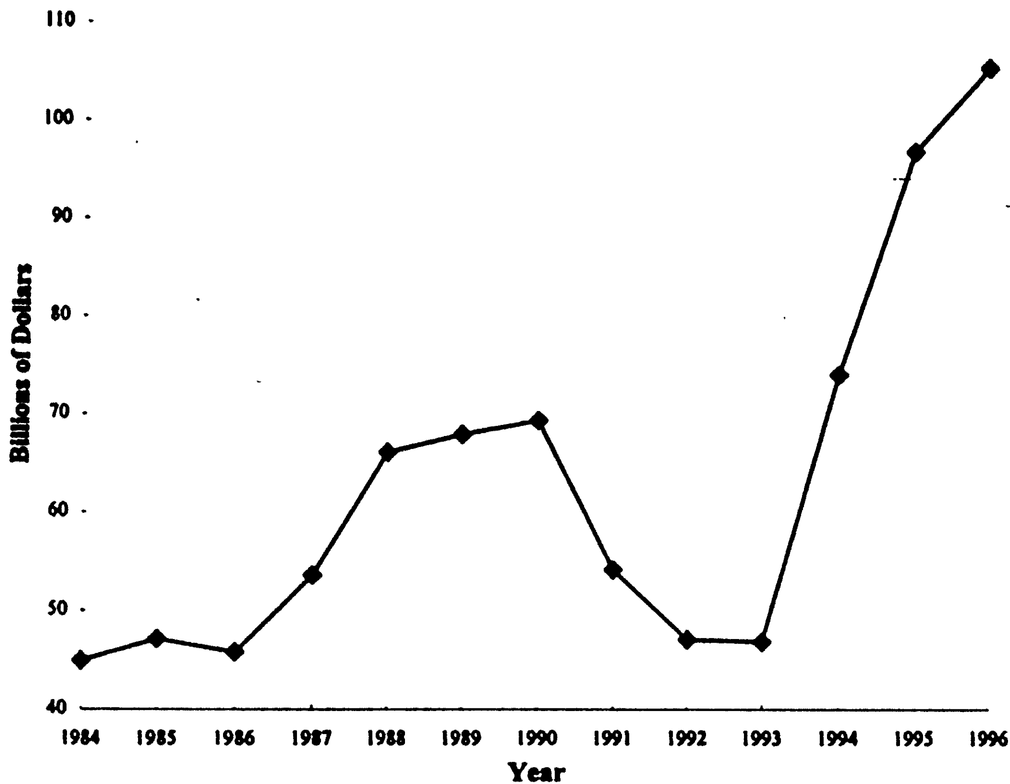
Sources:

1. Internal Revenue Services, Statistics of Income;
2. Standard and Poors, Compustat, January 2000 and earlier years release.

Figure 1b: Excess of Tax over Economic Depreciation, 1983-1996

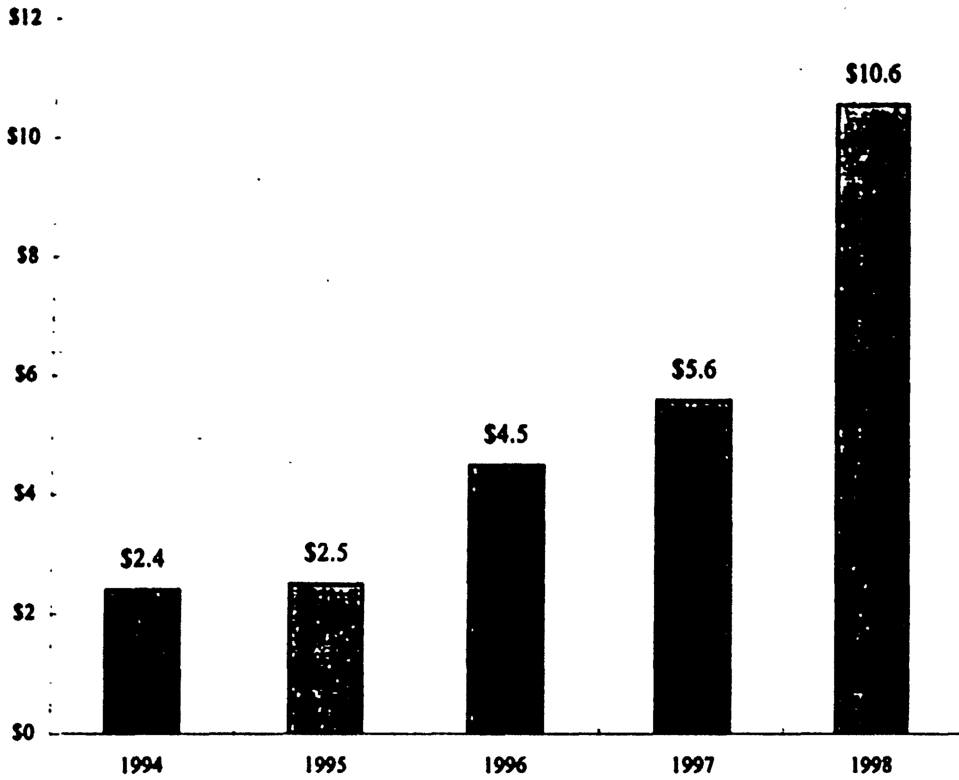


Excess of Tax over Book Depreciation = Capital Consumption Adjustment for Coprorate Profits (NIPA)
Corporations excluding S Corporations
Source: U.S. Commerce Dept., Bureau of Economic Analysis, Survey of Current Business, February 2000.



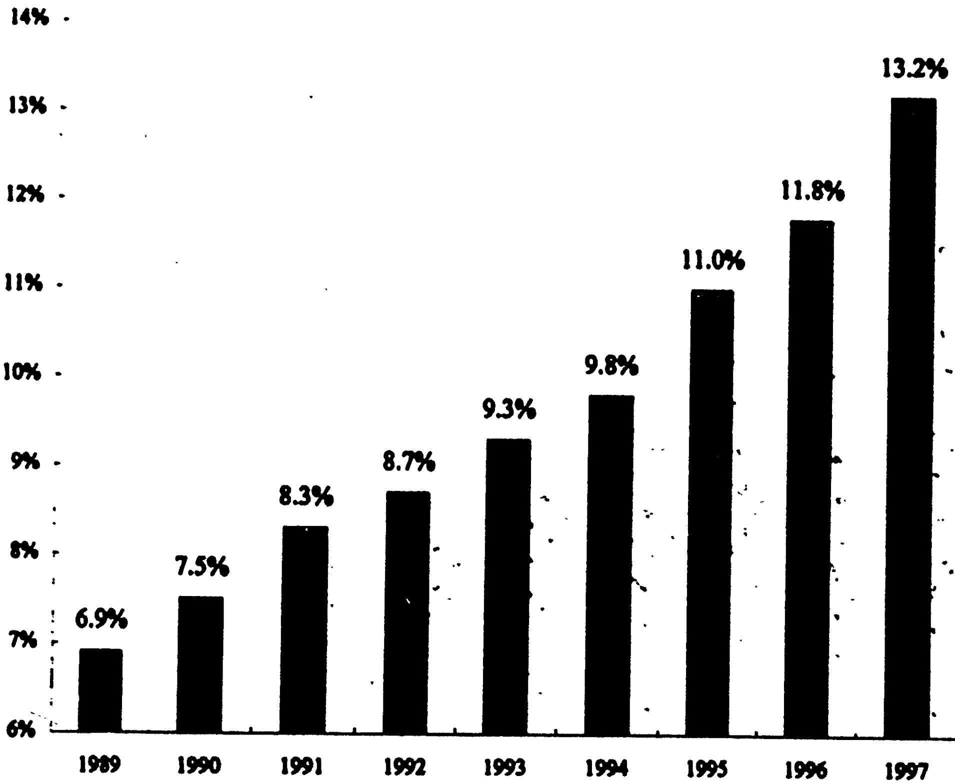
Corporations excluding S Corporations, RICs, REITs, and Foreign Corporations
Source: Standard and Poors, Compustat, January 2000 and earlier years release.

Figure 3
Values of Forbes 800 Executives' Unexercised, but in-the-Money Stock Options ($Billions)



Source: Forbes

Figure 4
Shares Authorized for Management and Employee Stock Option Plans as Percent of Shares Outstanding*



*Calculations are based on weighted average shares outstanding on fully diluted basis.
Source: Pearl Meyer & Partners, Inc.; Forbes

PREPARED STATEMENT OF DAVID A. LIFSON

My name is David Lifson, and I chair the Tax Executive Committee of the American Institute of Certified Public Accountants (AICPA). The AICPA is the national professional association for CPAs, and our more than 330,000 members are from firms of all sizes, from businesses, education, and government. Our members work regularly with the tax laws you write, and we have a strong interest in making the tax law fair, simple, and administrable.

I am pleased to submit our comments on the broad topic of penalties and interest within the Internal Revenue Code, including provisions relating to corporate tax shelters which seem to have captured the attention of many over the past year. We share the objective of Congress, the Administration, and others of maintaining and improving compliance with our tax system, and strongly support measures to curtail abuses. In the corporate tax shelter area, we hope you will agree, however, that any new legislation must be carefully focused so as not to burden normal transactions and more average taxpayers. Requirements on everyday, ordinary taxpayers to, in effect, audit themselves, disclose issues, and be subject to severe penalties and interest could potentially undermine respect for our self-assessment system of taxation just as much as unpunished abusive behavior by a few corporate taxpayers. These are areas of delicate balancing.

CORPORATE TAX SHELTERS

The AICPA, along with Congress, the Treasury, and many others in this room have been working for over a year to develop an approach to corporate tax shelters that will curtail abusive transactions while not unduly burdening normal business activities of more average taxpayers. Our recommendations as approved recently by the Tax Executive Committee are attached as Appendix 1. We are all concerned about the misuse of our tax system, but we at the AICPA are also concerned that legislation not be so overly broad, vague, and punitive as to have a chilling effect on legitimate tax planning. Taxpayers should be entitled to structure their transactions in a way that results in the minimum tax burden, consistent with the spirit (as well as the letter) of the tax law. Taxpayers should be able to plan with confidence and to feel that they are being treated fairly under our highly complex tax system. We think our recommendations meet these objectives.

In addressing corporate tax shelters legislatively, we encourage you to keep in mind that the system must work efficiently, so that taxpayers and practitioners can understand and the Internal Revenue Service can enforce the rules. The tax system works through compliance and enforcement, based on broad powers that Congress has already given the IRS to curb abuses. Not every perceived abuse requires new legislation with its concomitant new regulations, rulings, and litigation. Indeed, the government has prevailed in several very recent cases based on present law (Compaq Computer Corp., 113 TC No. 17 (September 21, 1999); *IES Industries, Inc. v. U.S.*, No. C97–206 (N.D. Iowa Sept. 22, 1999); Winn-Dixie Stores, Inc., 113 TC No. 21 (October 19, 1999); and Saba Partnership, Brunswick Corporation, Tax Matters Partner, TC Memo 1999–359 (October 27, 1999)), following the recent decisions in *ACM Partnership v. Commissioner* (157 F2d 231 (3d Cir. 1998, affg. in part T.C. Memo. 1997–115)) and ASA Investerings Partnership (1998–305 TCM, aff'd 201 F.3d 505 (2/1/00)).

We are also pleased with the recent announcement that the IRS has formed a new Office of Tax Shelter Analysis to develop ways to identify and address corporate tax shelter issues. The Treasury Department and IRS have also recently issued temporary and proposed corporate tax shelter registration and disclosure regulations that we hope will help in this effort. Much of the problem in the corporate tax shelter area has been the failure to enforce existing rules rather than the need for new rules. As the government becomes more successful in identifying and prosecuting tax shelter cases, taxpayers and shelter promoters will tend to lose their appetites for abusive transactions.

This statement supplements and refines comments on corporate tax shelters that we presented to the House Ways and Means Committee last fall, a copy of which is attached as Appendix 2, and testimony on the corporate tax shelter provisions in President's budget proposals that we presented to the Senate Finance Committee last spring.

Disclosure of Corporate Transactions

We have strongly supported an effective disclosure mechanism to advise the government of corporate transactions that warrant review, and have encouraged the IRS to use its existing authority to curtail abuses. Less than two weeks ago, the Treasury Department issued extensive temporary and proposed regulations con-

taining corporate tax shelter disclosure requirements for taxpayers and advisers. We commend the Treasury for this initiative and for the generally positive approach taken by the new regulations. After we have had an opportunity to review and study the regulations in detail, we will submit comments to the IRS. Because the new regulations reflect a comprehensive effort by Treasury to deal with this critical aspect of potentially abusive transactions, we would suggest that the need for additional disclosure legislation has been removed, perhaps permanently, but at least until everyone has a better understanding of the effect of these regulations.

We do believe that disclosure should be considered in relation to penalties and discuss this issue in the "Corporate Tax Shelter Penalties" below.

Identifying Potentially Abusive Transactions

In focusing on the target of abusive corporate tax shelters and trying to avoid burdening other transactions, we believe there is substantial merit in the approach of developing fairly objective "indicators" of transaction criteria which call for special attention from the Service. For example, we support indicators based on tax indemnity or contingency fee arrangements, confidentiality requirements, and the involvement of a "tax indifferent party." We suggested the use of a neutral term, "reportable transactions," to characterize those transactions that would be required to meet additional reporting and disclosure requirements (and are pleased to note that Treasury has used this term in its new regulations.) We have recommended that taxpayers disclose with the return and that early disclosure be limited to third party promoters, organizers and advisors. We are pleased that Treasury seems to be heading in this direction which we think will reduce IRS and taxpayer burdens from multiple filings on the same transactions. We have also recommended the use of a dollar de minimis rule to focus on larger transactions and are pleased to see Treasury moving in this direction in the regulations.

However, we believe that some suggested indicators would sweep in many ordinary business transactions or impose a broad "pre-tax profits" test on transactions which are not easily analyzed on this basis. Congress must guard against overreaching in this area if the disclosure regime is to be effective in identifying troublesome transactions and avoid massive "over-reporting." Further, careful consideration must be given to the proper relationship between the disclosure requirements and the penalty provisions. In our view, neither the Joint Committee recommendations nor Treasury's FY 2001 budget proposals have found that balance.

Disclosure requirements: The indicators recommended by the JCT include transactions causing permanent book/tax differences and those failing a pre-tax profits test. We are concerned that the book/tax indicator would include many normal commercial transactions such as key-man insurance, purchased intangibles, and the use of stock options as employee compensation. To narrow this indicator to those differences most likely to be relevant, we recommend that it be revised to include only those transactions the Treasury Department identifies in regulations as requiring special disclosure. This approach would permit the government, with public comment and input, to target the troublesome transactions while excluding more benign differences such as acquisition of intangibles (goodwill), tax credits (such as the research credit and section 29 credits), incentive stock options, and capital gains and losses—all of which create book-tax differences, but do not, per se, lead to the view that an abusive transaction has occurred.

Similarly, the broad application of a "pre-tax profits" test will cause many ordinary transactions to be classified as "tax shelters." For example, many incentives Congress enacted to encourage taxpayers to undertake transactions that are not susceptible to this bottom-line analysis, like the research credit or even charitable contributions, would have to be reported or specifically excluded from this test in legislation. It would be impossible to compare the pre-tax profits with expected tax benefits in many ordinary transactions because the economic return is unknown, such as stock purchased on margin or real estate purchased with non-recourse debt. Other normal business transactions, such as leasing, financing or advertising, are not susceptible to an analysis which requires a determination of the expected pre-tax return from the transaction. These examples cause us to conclude that if this approach is followed, exceptions must be legislatively provided for transactions in these categories.

In considering the relationship between the penalty standard and the disclosure provisions, we are particularly concerned that the five tax shelter indicators in the Joint Committee staff recommendations would automatically deem a transaction to constitute a tax shelter (defined under current law as having "a significant purpose" of avoiding or evading Federal income tax) for penalty purposes. Defining a corporate tax shelter by reference to having "a significant purpose" of tax avoidance or evasion has not proved helpful in determining the proper target under current

law. Worse, the Joint Committee staff recommendation puts corporate taxpayers in a double jeopardy, by proposing the indicators be in addition to the "significant purpose" test rather than a substitute for it. Thus, if a transaction does not fall within one of these indicators, the IRS could still argue that a significant purpose of the transaction is the prohibited avoidance or evasion, and subject the taxpayer to additional disclosure requirements and higher penalties. In short, from the government's perspective, it's "Heads, I win; tails, you (may well) lose." This poorly defined, subjective IRS discretion is inconsistent with effective tax planning and is not good tax policy.

We recommend consideration be given to an alternative standard to replace the "significant purpose" test of present law, and that is to focus on transactions that "would not have been entered into but for the tax benefits" for both disclosure and penalty purposes. This tests for business purpose and economic substance at the same time and is more in keeping with other precedents in the Code.

If Congress determines to retain the "significant purpose" test of current law, then the potential overreaching of that definition should be addressed by expressly excluding those transactions that are not tax shelters. Under this approach, exceptions from disclosure and penalty provisions would be provided for a transaction which was undertaken for reasons germane to the conduct of the corporation's business, expected to produce a pre-tax return that is reasonable in relation to the costs incurred, or reasonably consistent with the legislative purpose for which the tax provision was enacted.

Finally, there should also be a de minimis level below which transactions do not need to meet additional disclosure requirements or be subject to extraordinary penalties. The level should be set high enough to avoid high volumes of unnecessary filings. We support a reporting level based on $10 million in tax savings or $1 million in fees or commissions (per reportable transaction, regardless of time frame). This will also avoid application of this regime to smaller taxpayers and less-sophisticated practitioners.

Economic Substance Tests: The Treasury budget proposals and the Joint Committee on Taxation recommendations both incorporate, albeit differently, an economic substance test: that is, the transaction's pre-tax profits must be significant relative to the expected tax benefits. The JCT uses the test as an indicator for disclosure and penalty purposes; Treasury would use this test to directly subject transactions to penalty under the substantial understatement penalty, as well as codifying the test to deny tax benefits from transactions that fail it (a so-called "super 269 approach). As noted earlier, we are concerned that the broad application of a pre-tax profits test is overly inclusive of normal business transactions for both disclosure and penalty purposes. Hence we suggested alternative approaches discussed above (that is, use of a "but for the tax benefit" test or providing exceptions for normal business and Congressionally intended transactions).

In addition, we strongly and specifically reject enactment of a new "super 269" as has been included in Treasury's budget proposals as well as some Congressional bills (including, most recently, Senator Bob Graham's (D–Fl) proposed amendment to the education savings bill). These proposals would impose a new Section 269 regime, over and above current law requirements, would deny deductions, losses, or credits unless a complex analysis demonstrates an appropriate level of pre-tax profit. This approach, combined with a presumption of non-economic purpose, is overly broad in targeting abuses, and would adversely affect many normal business transactions at a minimum by injecting a high level of uncertainty and requiring documentation of an analysis for tax purposes that has no other meaning or business purpose. Treasury's statement that their proposal would not affect legitimate business transactions is simply not supportable.

Corporate Tax Shelter Penalties

Our earlier testimony tied the disclosure requirements to tax shelter penalty provisions, recommending that taxpayers be able to reduce or eliminate understatement penalties if they disclose transactions that have indications of possibly abusive sheltering. We believe that the "reportable transactions" regime for disclosure could be carried over into the substantive penalty area under Section 6662(d) [1]. Under our proposal, if a reportable transaction is disclosed, the penalty rate would be less, and possibly eliminated, depending on the level of support for the position taken. For reportable transactions that are disclosed but that lack substantial authority and

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[1] In short, our recommendation is not intended to layer another regime for "reportable transactions" on top of those in current law, but to stimulate consideration of a means to restructure and simplify the substantial understatement penalty for certain transactions, and to better coordinate those with the disclosure requirements.

lack a sound opinion concluding "more likely than not" on the merits, the 20% penalty of current law should apply. A somewhat higher penalty would be appropriate for reportable transactions that are not disclosed. However, where the requisite standard is met and disclosure has been made, there should be no penalty.

We note that some proposals offered would apply to individual taxpayers. We suggest that any higher penalties and disclosure requirements should apply to corporate taxpayers initially, and expanded to other taxpayers, if necessary, only after the reportable transaction regime is well established.

Regarding the level of support required for a taxpayer to avoid penalty, we do not support the Joint Committee staff's proposed 75% likelihood standard for abatement of their proposed enhanced penalty on transactions falling within an indicator. The current more-likely-than-not standard is comprehensible in application where the practitioner and taxpayer have to determine that they have the preponderance of authority. Even this is not easy in situations where little guidance or case law exists. Determining the degree of certainty to a specific percentage is virtually impossible, and will be difficult for the IRS and courts to apply. A 75% standard would also set a higher standard than would be required to prevail on the merits of a case. At the same time, the more likely than not standard should be a meaningful one and we support efforts to make it so.

We do not believe there should be a penalty on the taxpayer for failure to disclose on a tax return where there is no understatement of tax. Although we understand the intent of a disclosure penalty, a flat-dollar amount would not act as a deterrent, and other formulations of the penalty are too complex for the potential benefit that might be provided. Similarly, we do not support any strict liability penalties, believing that the IRS should have the ability to waive penalties when justified.

We note that the Treasury Department intends to revise Circular 230 within the next six months, and encourage you to coordinate with them to provide similar standards for those who are not regulated in their practice before the IRS. (See comments below under Circular 230.) Penalties for aiding and abetting under section 6701 should be considered for third parties where the taxpayer is subject to the substantial understatement penalty for insufficient authority. We support an increase in the level of the penalty, currently $1,000, and suggest consideration be given to a penalty structure of the higher of a dollar amount or a percent of fees received. As to the penalty itself, broad application is not appropriate because it is the civil equivalent of a criminal penalty.

Similarly, when the substantial understatement penalty is imposed on a "reportable transaction" for failure to disclose or for insufficient authority, a penalty should be considered on the tax return preparer for that transaction, subject to the normal due process safeguards. Again, this penalty might be the higher of $1,000 or a percent of fees.

Circular 230

We support efforts to raise the standards required of "more likely than not opinions" through changes to Circular 230. The current rules should be expanded to cover "tax shelter" opinions outside the third party context and should be better coordinated with the existing penalty rules. Circular 230 should be revised to require all tax shelter opinion letters to meet the standards and requirements of the current regulations under Section 6664.

Most individuals who practice before the IRS are responsible professionals who have nothing to do with abusive tax shelters. Unfortunately, many individuals involved in developing, advising, and selling of tax shelters are not practitioners who are subject to Circular 230 (that is, not an attorney, CPA, or enrolled agent). The penalties for aiding and abetting the understatement of tax liability could be expanded to include these third parties. Also, promoter and advisor penalties should be imposed for failure to disclose when transactions are developed and sold, and these could be fashioned along the lines of Section 6707, as a percentage of fees, and could be expanded to apply to investment bankers, opinion writers, insurance companies, and others who are involved in such transactions. For practitioners governed by Circular 230, sanctions already in existence include suspension from practice before the IRS or disbarment, and we would encourage tough penalties for others who engage in abusive conduct. (See discussion under Corporate Tax Shelter Penalties above).

Other aspects of Circular 230 can also be brought to bear on abusive tax shelters, and we will work with the Treasury, the bar, and enrolled agents to improve Circular 230. Within the AICPA, we are reviewing the ethical conduct of practitioners involved in corporate tax shelter cases, and are determined to maintain the highest level of responsibility of our members. We are pleased to note that Treasury intends to revise Circular 230 in the next six months.

Due Diligence by Corporations

We have been told that a common problem with abusive tax shelters is that tax opinions on certain transactions often do not match the actual facts. This has led to proposals that corporate officers be required to be more diligent in their examination of positions taken in tax returns. We support the requirement of a "corporate officer attestation" on the return, disclosing reportable transactions. Our suggestion is that a responsible corporate official having knowledge of the facts, rather than one having a position with a particular title within the corporation, should be required to sign the attestation. The legislative report should make clear that the official could reasonably rely on expert opinions as to the tax law, valuations, etc., and on other responsible corporate personnel as to factual matters. We do not believe that attestation should carry personal liability, as this extreme sanction may not be appropriate for the conduct of the corporate official. Also, large companies frequently insure their officials against liability so that personal liability would often be deflected by large, sophisticated businesses.

IRS Administration

Focused tax administrative efforts will be required to successfully address the problem of corporate tax shelters. Centralized administration and review of the penalties proposed should be incorporated into the new IRS Office of Tax Shelter Analysis. We note that the new regulations will help in this regard. Effective means of using the required disclosures will be needed, along with utilizing an active "notice to taxpayers" process (such as was done in IRS Notice 99–59), as the IRS identifies questionable transactions.

Corporate Tax Shelters Conclusion

We strongly oppose the undermining of our tax system by stretching and contorting the tax law beyond the recognition of most practitioners and those who enacted it. Clearly, there are abuses, and they must be dealt with effectively to preserve respect for the system. However, in crafting legislation to curtail abuses, you must take care not to unduly burden average taxpayers with normal business transactions. Taxpayers should be able to plan transactions to minimize their taxes where they have a good faith belief and appropriate level of support for the position being taken. With our complex tax law they should feel that they are being treated fairly, and you risk taxpayer ire as you require taxpayers to, in effect, audit themselves, disclose issues, and be subject to severe penalties. Drawing this delicate balance is at the heart of the issue we are addressing today.

PENALTIES AND INTEREST

Introduction

The AICPA worked with Members of Congress, the Internal Revenue Service, and other tax practitioners and business groups in 1989 in connection with the last major reform of the federal tax penalty provisions. The result of those efforts was the Improved Penalty Administration and Compliance Tax Act of 1989 ("IMPACT"). Since then, questions have been raised regarding the appropriate administration of the interest and penalty provisions, such as the use of penalties as a bargaining tool by the IRS. Also since that time, a number of revisions to the interest and penalty provisions have been made or proposed. We believe there once again is a need to take a comprehensive look at the interest and penalty provisions and make needed reforms to ensure the provisions are appropriately and fairly applied and are designed to accomplish their purpose. We encourage you to do so.

We offer you our assistance with such an undertaking, and, as an initial step, provide you with our comments on: the Joint Committee on Taxation's 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) (JCS–3–99), July 22, 1999; the Department of the Treasury's study, entitled Penalty and Interest Provisions of the Internal Revenue Code, released October 25, 1999; and the penalty and interest reform provisions in the National Taxpayer Advocate's 1999 Annual Report to Congress, released January 4, 2000.

Our comments regarding penalties are based on our continued belief in the philosophy embraced by IMPACT, that the purpose of penalties is to encourage compliance, not to raise revenue. We urge Congress not to alter that philosophy. We also urge Congress to adhere to the philosophy that interest is not to be imposed as a penalty, but rather is solely compensation for the use of money.

Our comments are based on considering the penalty and interest regime in its entirety. Individual comments and suggestions should not be accepted or rejected in

a piecemeal fashion since the appropriateness of one provision often depends on the status of another.

Penalty Provisions

1. Accuracy-Related and Preparer Penalties

Note: The following discussion relates only to non-tax shelter items.

Standards for Taxpayers and Preparers

Both the JCT staff and Treasury propose modifications to the standards that must be satisfied with respect to a tax return position in order to avoid the accuracy-related penalty applicable to taxpayers under section 6662 for the substantial understatement of tax and the preparer penalty under section 6694(a) for understatement of a taxpayer's liability due to an unrealistic position. Under present law, to avoid the substantial understatement penalty, a taxpayer must have "substantial authority" for an undisclosed position and a "reasonable basis" for a disclosed position; for a tax return preparer to avoid the preparer penalty, an undisclosed position must have a "realistic possibility of being sustained on the merits" and a disclosed position must not be "frivolous." Both the JCT staff and Treasury recommend that the same standards apply to taxpayers and tax return preparers. We do not object to that recommendation, but request that in making such a change, Congress clarify in the statutory language that the imposition of a penalty against a taxpayer and the imposition of a penalty against the taxpayer's return preparer must be based on separate determinations. The imposition of a penalty against one is not evidence that the imposition of a penalty against the other is appropriate. For example, a taxpayer may pay a penalty for personal reasons, such as to avoid expending additional time and money to contest the issue even though the taxpayer might have been successful if the matter had been pursued; an automatic imposition of a penalty against the return preparer in such a case clearly would be inappropriate. An independent review of the applicable authorities and of the facts, including who had knowledge of specific facts, must be considered in determining whether the imposition of a penalty against a particular party is appropriate.

Standards for Disclosed Positions

Under current law, to avoid a substantial understatement penalty with respect to a disclosed position, a taxpayer must have a "reasonable basis" for a return position; for a tax return preparer to avoid a preparer penalty with respect to a disclosed position, the position must not have been "frivolous." The JCT staff recommends raising the minimum standard for taxpayers and tax return preparers regarding disclosed positions such that, to avoid a penalty for a disclosed position, there must be at least "substantial authority." Treasury recommends raising the minimum standards for taxpayers and tax return preparers regarding disclosed positions such that, to avoid a penalty for a disclosed position, there must be at least a "realistic possibility of being sustained on the merits."

We have serious concerns about raising the standard for taxpayers and tax return preparers above the "reasonable basis" standard currently applicable to taxpayers. We are particularly troubled by the JCT staff's proposal to establish "substantial authority" as the minimum standard for disclosed positions. Such a high standard may be unworkable. While taxpayers and tax return preparers may be able to ascertain whether "substantial authority" exists with regard to some issues, that is not true in all cases. The Federal tax law is forever changing, and, as a result, there may be virtually no guidance issued at the time a return is filed, and, therefore, virtually no authority with respect to the proper tax treatment of an item. Further, even if there is some authority, given the exceedingly complex nature of the tax law, it may nevertheless be extremely difficult for taxpayers and preparers to know the probable correctness of many return positions. It is not only unrealistic, in many cases it is impossible, to ensure such a high degree of accuracy as is required by a "substantial authority" standard or even the "realistic possibility of being sustained on the merits" standard without forcing taxpayers to avoid otherwise meritorious positions on the return.

While taxpayers may be able to ascertain whether "substantial authority" or "realistic possibility of being sustained on the merits" exists with regard to some issues, that certainly is not true in all cases. This problem is compounded by the fact that the IRS has failed to adhere to a provision added to the Internal Revenue Code in 1989 to assist taxpayers and preparers in determining whether "substantial authority" is present for a position. IMPACT created section 6662(d)(2)(D) of the Code, requiring the IRS to publish, not less frequently than annually, a list of positions for which the IRS believes there is no "substantial authority" and which affect a significant number of taxpayers. To date, the IRS has never issued any such list for any

year. If the IRS is unable itself to determine which positions lack "substantial authority," it is unreasonable to adopt this threshold as the minimum reporting standard for return positions by taxpayers and tax return preparers.

In its 1989 civil tax penalty study, the IRS acknowledged the practical limits on the probable correctness of returns. In the Commissioner's Study of Civil Penalties, 1989, at VIII-11, the IRS noted:

> While not in and of themselves determinative of the correct standard of behavior, a variety of factors limit the ability of taxpayers to report positions disclosing a liability that is probably correct. Perhaps the most significant limitation is the ambiguity inherent in applying a complex and changing set of tax rules to an infinite variety of factual situations, which may themselves be of ambiguous import. These complexities may result in failure to recognize issues, incorrect conclusions as to the probability that a particular position will prevail, and differences of opinion regarding probability that are not resolvable short of the courthouse. The complexity of modern financial affairs, when coupled with the legal requirement to file a return by a statutory deadline and the costs of making the best possible assessment of each individual issue may also provide practical limits on the pursuit of a theoretically perfect return.

For these reasons, we believe the standard for disclosed positions should be the "reasonable basis" standard currently applicable to taxpayers.

Standards for Undisclosed Positions

Under current law, to avoid the substantial understatement penalty with respect to an undisclosed position, a taxpayer must have "substantial authority;" for a tax return preparer to avoid a preparer penalty with respect to an undisclosed position, the position must have a "realistic possibility of being sustained on the merits." The JCT staff recommends that, for an undisclosed position, the taxpayer and the tax return preparer must reasonably believe that the tax treatment is "more likely than not" the correct tax treatment under the Code. In contrast, Treasury does not propose raising the standard for undisclosed positions above the "substantial authority" standard that currently applies to taxpayers; it would apply that standard to both taxpayers and tax return preparers.

We agree with Treasury that the "substantial authority" standard is the more appropriate threshold standard for undisclosed positions, rather than the higher "more likely than not" standard recommended by the JCT staff. Currently, the only authorities that can be relied upon to constitute "substantial authority" are those issued by the government itself or the judiciary. Acceptable authorities include: the Internal Revenue Code and other statutory provisions, regulations, court decisions, and administrative pronouncements (e.g. revenue rulings, revenue procedures, proposed regulations, private letter rulings, technical advice memoranda, actions on decisions, information releases, notices, and other similar documents published by Treasury or the IRS). In addition, the list of authorities includes General Explanations of tax legislation prepared by the Joint Committee on Taxation (the "Blue Book"). Conclusions in treatises, legal periodicals, legal opinions or opinions of other tax professionals do not qualify under present IRS rules.

Taxpayers and preparers who take positions relying on the government's own rules and pronouncements should be able to feel comfortable that their positions are sufficiently accurate so as to free them from the possibility of penalties. A "more likely than not" standard for undisclosed positions would mean disclosure would be required even though the "substantial authority" threshold is satisfied with respect to a position. Having taxpayers disclose items on their returns which comport with the government's own list of authorities would unnecessarily increase compliance costs for taxpayers and burden for the IRS. Further, such an approach would literally inundate the IRS with countless inconsequential disclosures, weakening the overall effectiveness of the disclosure regime. Thus, we believe the standard for undisclosed positions should be "substantial authority."

Reasonable Cause Exception

The JCT staff recommends repeal of the reasonable cause exception to the substantial understatement penalty. We disagree, believing that the exception is necessary to provide flexibility needed to waive the penalty in appropriate situations.

Amount of Preparer Penalty

The JCT staff recommends increasing the amount of tax return preparer penalties. For first-tier violations, i.e., preparation of a return with a position that does not meet the minimum preparer standards, the JCT staff recommends changing the preparer penalty from a flat $250 per occurrence to the greater of $250 or 50% of the tax preparer's fee. For second-tier violations, i.e., understatements that result from willful or reckless disregard of the rules or regulations, the JCT staff rec-

ommends increasing the amount from a flat $1,000 per occurrence to the greater of $1,000 or 100% of the preparer's fee.

Treasury also recommends increasing the tax return preparer penalties. Treasury recommends that consideration be given to a fee-based or other approach that more closely correlates the preparer penalty to the amount of the underlying understatement of tax rather than the flat dollar penalty amount under current law.

We support retaining the two-tier flat dollar penalty under current law. We base our recommendation on the lack of empirical evidence indicating that the flat dollar amount is not effective. In our opinion, deterrence for preparers results not from a dollar penalty, but rather from the possible adverse impact on the preparer's ability to practice and on his/her reputation for integrity and ethical behavior.

2. Failure to File Penalty

Rate

The current law contains a failure to file penalty of 5% of the net tax due, for each month (or portion thereof) the return remains unfiled, up to a maximum of 25%. The JCT staff proposes no change to the current provision. Treasury recommends that the penalty be restructured to eliminate front-loading; it proposes doing this by lowering the penalty rate in the initial months and providing for the increase in the rate, up to the 25% maximum, over a longer period of time. The example Treasury presented was charging a rate of 0.5% per month for the first 6 months and 1% per month thereafter, up to the 25% maximum. Treasury recommends retaining the current rule for fraudulent failure to file.

We agree with Treasury's reasoning that the front-loading of the failure to file penalty in the first five months of a filing delinquency does not provide a continuing incentive to correct filing failures and imposes additional financial burdens on taxpayers whose filing lapse may be coupled with payment difficulties, thus, possibly impeding prompt compliance. We also agree with Treasury that the current structure seems especially harsh given the fact, by merely requesting one, a taxpayer is entitled to an automatic extension for most or all of those five months. (An individual taxpayer is entitled to an automatic four-month extension; a corporate taxpayer is entitled to an automatic six-month extension.)

Given the significance to the tax system of taxpayers fulfilling their filing obligations, the failure to file penalty should be structured to provide a strong incentive for timely compliance, and a continuing incentive to promptly correct any failure to file.

Service Charge

Under current law, since the late filing penalty is a percentage of the net tax due, no penalty applies with respect to a late-filed return if the return reflects a refund due or no tax due. Treasury recommends imposing a new de minimis service charge for late returns that have a refund or no tax due, at least in situations where the IRS has already contacted the taxpayer regarding the failure to file the return.

We do not support this recommendation. We view such an approach as unjustified. Such an approach is particularly inequitable in situations where the taxpayer has a refund due, since the IRS has had interest-free use of the taxpayer's money.

Safe Harbor

Treasury recommends adoption of a provision that would permit the IRS to take into account a taxpayer's compliance history in determining if there is reasonable cause for abatement of the failure to file penalty. Treasury does not support providing automatic relief from the failure to file penalty based on safe harbor rules, however.

Although we agree with Treasury that a taxpayer's compliance history should be considered in determining the appropriateness of a penalty, we recommend a more expansive simplification of the penalty abatement provisions. To reduce the burden on both taxpayers and the Service resulting from the imposition of many inappropriate penalties, we recommend that safe harbor provisions be established for a variety of penalties (particularly those that are mechanical in nature, such as the failure to file, failure to pay and failure to deposit penalties) that would be deemed to represent reasonable cause. The object of these safe harbors would be to minimize the assessment and subsequent abatement of many penalties. Safe harbor provisions could take the form of:

- No penalty assessment for an initial occurrence; however, the taxpayer should receive a notice that a subsequent error would result in a penalty;
- Automatic non-assertion of a penalty based upon a record of a certain number of periods of compliance; and/or

- Voluntary attendance at an educational seminar on the issue in question, as the basis for non-assertion or abatement.

Such safe harbors would encourage and create vested interests in compliance, since a history of compliance would result in relief. Additionally, the likelihood of future abatements would diminish if the taxpayer has a history of non-compliance. Furthermore, a system of automatic abatement would reduce the time spent by both the Service and taxpayers on proposing an assessment, initiating and responding to correspondence, and on the subsequent abatement. The ability to abate a penalty for a reasonable cause other than those used for automatic abatements would continue; however, reasonable cause abatements requiring independent evaluation should be reduced.

3. Failure to Pay Penalty

Retention or Repeal

Current law contains a failure to pay penalty equal to 0.5% per month (or fraction thereof), up to a maximum of 25%. This penalty was created in 1969 to respond to the belief that the then-applicable interest rate (a flat 6%) on underpayments was not sufficient to encourage timely payment of tax and to discourage the use of the government as a low-cost lender.

The JCT staff recommends repealing the penalty for failure to pay taxes, noting the repeal would be consistent with a policy initiative begun by RRA'98, in which the rate of the penalty for failure to pay was reduced. The National Taxpayer Advocate also recommends a repeal of the penalty. Treasury acknowledges that the initial intent of the penalty was to address the fact that the interest rate on underpayments did not take into account the then market rate; nevertheless, it recommends retaining the failure to pay penalty, but with a restructured rate, as noted below.

We believe that, since the rate of interest on underpayments is now tied to the market rate of interest, this penalty, as a substitute for interest, should be repealed. If the penalty is not repealed, we recommend adoption of the mitigation and waiver provisions noted below.

Expansion of Mitigation of Penalty for Months During Period of Installment Agreement

Under current law, the failure to pay penalty for individuals with respect to a timely filed return is reduced from .5% to .25% for any month in which an installment agreement is in effect. This mitigation provision does not apply to halve the penalty in any case in which a final notice has been issued (at which time the penalty increases to 1% per month).

The National Taxpayer Advocate recommends that this mitigation provision be expanded to include reducing the penalty rate from 1% to .5% in situations (1) when a final notice is issued in error or as the result of an administrative practice and (2) when a final notice has been issued, for any month in which an installment agreement is in effect. We agree with the recommendation.

Waiver of Penalty When an Installment Agreement is in Effect

The National Taxpayer Advocate also recommends that the failure to pay penalty be waived for any month in which an approved installment agreement is in effect, even if the 1% per month penalty rate otherwise applies. Under the recommendation, however, the failure to pay penalty would be reinstated for the entire period if the taxpayer defaulted prior to completing the agreement. We agree with that recommendation.

Rate

Treasury recommends restructuring the calculation of the failure to pay penalty. The penalty would equal 0.5% per month for the first 6 months and 1% per month thereafter, up to the maximum of 25%. The penalty would be reduced to 0.25% per month during the first 6 months and 0.5% per month thereafter if the taxpayer makes and adheres to a payment agreement. As under current law, a higher rate would apply once the IRS takes action to enforce collection.

As noted above, we recommend repealing the failure to pay penalty rather than revising the rate.

Service Charge

The JCT staff recommends imposing an annual 5% late payment service charge on taxpayers that do not enter into an installment agreement within 4 months after assessment. The service charge would be imposed on the balance remaining unpaid at the end of the 4-month period.

We do not support establishment of a service charge for failure to enter into an installment agreement. We believe that such a service charge will penalize taxpayers who already are struggling to pay their tax obligations.

Related Installment Agreement Issues

Waiver of Fee. The JCT staff recommends waiving the installment agreement fee for taxpayers that agree to the automated withdrawal of each installment payment.

We support the JCT staff's recommendation. We believe that waiving the fee for taxpayers that enter into agreements to pay tax via an automated system of withdrawal will provide an incentive to enter into these agreements and better ensure payment of taxes. We have heard that some states that offer automated withdrawal payment plans have shown high rates of adherence to installment agreements. We believe that adoption of this provision will similarly facilitate a higher rate of adherence to installment agreements for the Federal government.

Installment Agreement Interest Rate. Treasury recommends providing the IRS with the authority to use a fixed rather that a floating interest rate on installment agreements in order to facilitate adherence to such agreements and to avoid possible balloon payments.

We support Treasury's recommendation to simplify the installment interest rate calculation.

4. Estimated Tax Penalty

Status as Penalty or Interest

The JCT staff recommends repealing the individual and corporate estimated tax penalties and replacing them with interest charges. The National Taxpayer Advocate also recommends eliminating the penalty and allowing interest to be automatically asserted, or as an alternative, he calls for simplification of the estimated tax penalty computations. Treasury recommends retaining the individual and corporate estimated tax penalties as penalties.

We support the recommendation of the JCT staff and the National Taxpayer Advocate for converting the estimated tax penalties for individuals and corporations into interest provisions. The conversion of the estimated tax penalties into interest charges would result in a more accurate characterization since the penalties are essentially fees for the use of money.

Deductibility of Interest

The JCT staff recommends that interest on underpayments of estimated tax by individual taxpayers be nondeductible personal interest, whereas interest paid on underpayments of estimated tax by corporate taxpayers be deductible. We recommend that deficiency interest be deductible by individual taxpayers to the extent the deficiency to which the interest relates is attributable to the taxpayer's trade or business or investment activities.

$1,000 Threshold for Individuals

The JCT staff recommends increasing to $2,000 the threshold below which individuals are not subject to the estimated tax penalty. Currently the threshold amount is $1,000 after reduction for withheld taxes. The JCT staff also recommends that the calculation of the threshold be modified to take into account certain estimated tax payments, i.e., estimated taxes paid in four equal installments on or before their due date. Accordingly, for qualifying individual taxpayers, no interest on under deposits of estimated tax would be imposed if the tax shown on the tax return, reduced by withholding and certain estimated tax payments, is less than $2,000.

Treasury recommends retaining the current $1,000 threshold, but allowing estimated tax payments to be considered under a proposed simplified averaging method in determining whether the threshold is satisfied.

We support increasing to $2,000 the threshold below which individuals are not subject to the estimated tax penalty. We also support allowing estimated tax payments to be considered under a simplified averaging method in determining if the threshold is satisfied. Both recommendations should simplify the computations required to calculate estimated tax payments and the interest (JCT) or penalty (Treasury) on underpayments.

Safe Harbors

The JCT staff recommends repealing the modified safe harbor that is applicable to individual taxpayers whose adjusted gross income for the preceding taxable year exceeded $150,000. Under the JCT staff's proposal, all taxpayers making estimated payments based on the prior year's tax would do so based on 100% of the prior year's tax.

We support this JCT staff recommendation for simplification of the safe harbor provisions.

Rate

The JCT staff recommends applying only one interest rate per underpayment period—the rate applicable on the first day of the quarter in which the payment is due. Currently, if interest rates change while an underpayment is outstanding, separate calculations are required for the periods before and after the interest rate change. Having only one interest rate apply per underpayment period would end the potential for multiple interest calculations occurring within one estimated tax underpayment period.

We support this JCT staff recommendation for simplification of the computations.

Underpayment Balances

The JCT staff recommends changing the definition of "underpayment" to allow existing underpayment balances to be used in underpayment calculations for succeeding estimated payment periods, i.e., making underpayment balances cumulative. Under the proposal, taxpayers would no longer be required to track each outstanding underpayment balance until the earlier of the date paid or the following April 15th.

We support this JCT staff recommendation for simplification of the computations.

Leap Year Issue

The JCT staff recommends establishment of a 365-day year for estimated tax penalty calculation purposes. Current IRS procedures require separate calculations when outstanding underpayment balances extend from a leap year through a non-leap year.

We support this JCT staff recommendation for simplification of the computations.

First-Time Offender

Treasury recommends providing a reasonable cause waiver of the estimated tax penalty for individuals that are first-time payers of estimated tax. The proposed waiver would be available only if the balance due is below a certain amount and is paid with a timely-filed return. Current law does not provide a general reasonable cause waiver for failure to pay estimated tax for individuals.

Although we do not support Treasury's position on retaining the estimated tax penalty, if the penalty is continued, we do support the recommendation for a reasonable cause waiver of the penalty for individuals that are first-time offenders.

Penalty Waiver

Treasury recommends waiving the estimated tax penalty if the penalty is below a certain de minimis amount—e.g., $10 to $20. There is no current statutory authority permitting the IRS to waive estimated tax penalties below a de minimis amount.

Although we do not support Treasury's position on retaining the estimated tax penalty, if the penalty is continued, we support the recommendation for establishing a de minimis waiver, but recommend a higher de minimis amount.

Safe Harbor for Corporations

We recommend increasing the taxable income cut off point from $1 million to $10 million for defining a "large corporation" for purposes of the Section 6655(d)(1)(B)(ii) safe harbor.

5. Failure to Deposit Penalty

Recently Enacted Provisions

Both the JCT staff and Treasury recommend that no major changes be made to the failure to deposit penalty provisions, to allow time for recent changes in these rules to be implemented and evaluated.

We support the recommendations that no major changes be made to the new rules until the provisions have been in effect long enough to be evaluated, but we encourage the introduction of any minor changes that add to the simplification of the failure to deposit penalty.

Deposit Schedule

The JCT staff recommends that Treasury consider revisions to the deposit regulations, particularly the change in deposit schedule, to change in a later calendar quarter.

We support the JCT staff's recommendation as a simplification of the failure to deposit provisions.

Penalty for Wrong Method of Deposit

Treasury recommends that it be provided with the authority to reduce the penalty for use of the wrong deposit method from 10% to 2%. Currently, taxpayers who use the wrong deposit method may be subject to the penalty rate of 10% and, thus, may be treated as harshly as if they did not make the deposit at all.

We support Treasury's recommendation; the lower rate would not be unduly harsh and would accomplish the same objective of encouraging payment by the proper method.

Systemic Problems of Payroll Services

The JCT staff and Treasury recommend that the IRS work with payroll services to resolve systemic errors, rather that deal with individual employers on a case by case basis.

We support the JCT staff and Treasury's recommendations. Such an approach could greatly simplify the resolution of such problems.

6. Pension Benefit Penalties

The JCT staff recommends consolidating the IRS and ERISA penalties for failure to file timely and complete Form 5500, and reducing from three to one the number of governmental agencies authorized to assess, waive, and reduce penalties for failure to file Form 5500. The JCT staff recommends designating the IRS as the agency responsible for enforcement of reporting. The JCT staff also recommends repealing the separate penalties for failure to file Schedules SSA and B and for failure to provide notification of changes in plan status. The JCT staff recommends treating these situations as a failure to file a complete Form 5500.

Treasury recommends consolidating the penalty for failure to file Form 5500 into a single penalty that will not exceed a specified dollar amount per day or a monetary cap per return. Treasury proposes that the single penalty would be waived upon a showing of reasonable cause. Welfare and fringe benefit plans would be subject to a similar single penalty under Treasury's proposal. Treasury recommends designating the Department of Labor as the agency responsible for enforcement of reporting. The Department of Labor's DFVC voluntary compliance program would continue to provide relief from late filing or failure to file penalties for Form 5500 under the proposed single penalty.

Although we do not have comments on the specific recommendations, we do encourage proposals such as these that promote simplification.

7. Uniformity of Administration

Statistical Information

The JCT staff and Treasury recommend that the IRS improve its method of providing statistical information on abatements and the reasons and criteria for abatements. We support this recommendation.

Supervisory Review

The JCT staff and Treasury recommend improving the supervisory review of the imposition and abatement of penalties. We support this recommendation on the theory that such improved review would promote equitable treatment of taxpayers.

Abatement

The JCT staff recommends consideration by the IRS of establishing a penalty oversight committee similar to the Transfer Pricing Penalty Oversight Committee.

We support the JCT staff's recommendation as a means to promote equitable treatment of taxpayers. Previously, the AICPA has recommended the creation of a database regarding the imposition and abatement of penalties and the establishment of a coordinator of penalty administration to promote consistent application.

Interest Provisions

Determining the amount of interest owed to or by taxpayers in connection with their Federal tax liabilities is governed by a rather complicated set of interest and procedural provisions in the Internal Revenue Code. We believe simplification of the interest regime is in order and commend the JCT staff for proposing the establishment of a single interest rate applicable to both underpayments and overpayments of all taxpayers and the abatement of interest in various instances. We agree that these proposals will greatly simplify interest computations and are disappointed that Treasury essentially recommends maintaining the current interest regime, including interest rate differentials for corporate taxpayers. We think the recommendations made by the JCT staff, coupled with our proposed modifications, will result in a fairer, simpler, more administrable interest regime. We also believe that the JCT staff's interest simplification recommendations, with our modifications,

should be adopted in their entirety because the benefits of each component necessarily depends upon the enactment of the others.

Like both the JCT staff and Treasury, we believe the Internal Revenue Code's interest provisions should provide for compensation to the government for the time that the taxpayer has use of the government's tax dollars and to the taxpayer for the time the government has use of the taxpayer's money. Interest is fundamentally a charge or compensation for the use or forbearance of another's money—it is not a penalty. The interest provisions should not be used to financially punish taxpayers.

1. Interest Rate

The JCT staff recommends providing one interest rate for overpayments and underpayments for both individuals and corporations, equal to the short-term applicable federal rate ("AFR") plus 5 percentage points. Treasury recommends a uniform interest rate in the range of AFR plus 2 to 5 percentage points except in the case of large corporate overpayments or underpayments, for which Treasury recommends retaining the current rate differential, including "hot interest."

We strongly believe that adopting a single rate for underpayments and overpayments of all taxpayers will substantially reduce the administrative difficulties and financial inequities associated with the numerous differentials contained in the current regime. We, therefore, support the JCT staff's single rate recommendation.

Establishing one rate for every taxpayer necessarily entails blending the various market rates applicable to all taxpayers; however, we are concerned that the JCT staff's proposal may establish an excessively high interest rate. At current market rates, raising the overpayment and underpayment rates to AFR+5 percentage points would result in a 10 percent rate; that would be the highest rate of interest for ordinary underpayments in more than a decade. Individual taxpayers would see their underpayment rate jump from 8% to 10% and the minimum rate that would apply to corporate taxpayers would be equal to the current "hot interest" rate. We concur with Treasury that the appropriate rate should be in the range of the AFR plus 2 to 5 percentage points and should reflect typical market rates.

2. Interest Abatement

Additional Causes for Abatement

The JCT staff recommends that the IRS be granted the authority to abate interest: (1) where necessary to avoid gross injustice; (2) for periods attributable to any unreasonable IRS error or delay, whether or not related to managerial or ministerial acts; (3) in situations where the taxpayer is repaying an excessive refund based on IRS calculations, without regard to the size of the refund; and, (4) to the extent the interest is attributable to taxpayer reliance on a written statement of the IRS. Treasury agrees to abatement of interest when the taxpayer has reasonably relied on erroneous written advice from the IRS, but does not recommend further legislative expansion of abatement of interest, arguing that current law provides sufficient relief. The National Taxpayer Advocate recommends abatement when the taxpayer is experiencing significant hardship.

We support the recommendations of the JCT staff and the National Taxpayer Advocate and strongly encourage their adoption. Further, because the IRS has been reluctant in the past to grant relief in this area, we request that the terms "gross injustice," "unreasonable" and "significant hardship" be adequately defined to provide the IRS with clear standards for implementation.

Application of Abatement Attributable to Errors and Delays to Nondeficiency Federal Taxes

The current law provision allowing abatement based on errors or delays by the IRS is limited to interest on income, estate, gift, generation skipping, and certain excise taxes. The National Taxpayer Advocate recommends that the abatement provision be expanded to apply to interest on employment taxes, the remainder of excise taxes, and certain other taxes. We agree with that recommendation.

3. Suspension of Interest Where IRS Fails to Contact Taxpayer

Neither Treasury nor the JCT staff make any recommendations with regard to the interest suspension provision, enacted as part of the Internal Revenue Service Restructuring and Reform Act of 1998, that suspends the accrual of deficiency interest for individual taxpayers in all cases where the IRS fails to notify the taxpayer within 18 months (1 year beginning in 2004), specifically stating the taxpayer's liability and the basis for that liability. Under use of money principles, interest is charged solely as compensation for the use of another's money. While there may be some situations in which use of money principles should give way to more compel-

ling objectives, such as in the abatement context, we believe such an automatic suspension provision is an unnecessary feature for a single-rate interest regime with broad interest abatement authorities. An expanded interest abatement provision should provide adequate relief for those taxpayers subjected to excessive interest charges. We, therefore, recommend that this provision be repealed and that any resulting savings to the government be applied to lowering the proposed single-rate amount.

4. Interest Netting

Treasury argues that, given the recent enactment of global interest netting, it is premature to adjust interest rates to eliminate all interest differentials. On the other hand, the JCT staff notes that establishing a single rate of interest will simplify tax administration and "limit" the need for interest netting on a going-forward basis. We believe that restoring interest rate harmony will mitigate (but not eliminate) the need for interest netting in most cases, because the rate at which interest is paid by a taxpayer to the IRS with respect to any underpayment of tax will be the same rate paid by the IRS to a taxpayer who overpays a tax liability. Unfortunately, the Internal Revenue Code contains several special rules providing for interest-free periods whereby taxpayers and the government are given grace periods to take certain actions without accruing additional interest charges. For example, the government is given 45 days to process refund claims and taxpayers are afforded 21 calendar days to pay demand notices (10 business days if the amount exceeds $100,000). Thus, even with the single-rate interest regime advocated by JCT staff, there would continue to be some situations where taxpayers could be charged interest on periods of underpayment that run concurrently with a non-interest bearing overpayment period for the taxpayer.

We support JCT's proposed single rate regime but believe that interest netting still would be appropriate in some circumstances, to ensure that taxpayers are not charged interest on amounts where no true liability actually exists. Extending interest netting to interest-free periods would be consistent with use of money principles and would not harm the government since during these periods of time, neither the taxpayer nor the government are actually indebted to one another. In our judgment, taxpayers do not object to interest-free periods; they recognize the importance of administrative convenience, to allow the government sufficient time to process claims for refund. Taxpayers, however, do resent the imposition of interest on equivalent outstanding amounts under the pretext that a true liability exists where none does. Absent netting, the problem will become more acute if the interest rates are equalized at a higher level, as the JCT staff is proposing.

The JCT report states that limiting the availability of netting to situations in which the taxpayer both owes and is owed interest for the same period preserves the integrity of the rule requiring the suspension of interest where the IRS fails to contact an individual taxpayer. The JCT staff seems to be saying that taxpayers should be required to pay interest during some periods of mutual indebtedness when they clearly are not indebted to their government in order to preserve the concept of suspending interest for taxpayers who have admittedly underpaid their taxes. Logic dictates that taxpayers who owe tax should pay interest and those who owe no tax should not pay interest.

In summary, we believe that a new single-rate interest regime should contain an interest netting component whereby taxpayers can identify periods of mutual indebtedness involving interest-free periods and request the IRS to have their interest charges recalculated in accordance with procedures similar to those set forth in Rev. Proc. 99-19.

5. Interest and Look-Back Rules

The JCT staff recommends that the single interest rate also apply to the Code sections that reference the underpayment or overpayment rate under present law. The Treasury report does not address this issue. There are several provisions that allow taxpayers to re-determine their tax liability based on facts determined after the filing date of the return without requiring an amended return to be filed—the so-called "look-back" provisions. As we indicated above, we believe that a single interest rate should be applicable to the underpayments and overpayments of all taxpayers, but question the amount of the rate increase proposed by JCT. We are concerned that, in the context of these sections, under JCT staff's proposed rate structure, most taxpayers would face a significant increase in the amount of interest.

6. Exclusion of Individual Overpayment Interest from Income/Denial of Deduction

In an attempt to equalize rates on an after-tax basis for individual taxpayers and corporations, the JCT staff recommends that overpayment interest paid by the IRS

to individuals be excludable from income. While acknowledging that the same rate and same tax treatment with regard to deficiency interest would provide equivalent effective interest rates for individual and corporate taxpayers, Treasury does not propose an exclusion for interest and believes a deduction for deficiency interest for individuals is not warranted.

While JCT's recommendation is one way to provide equivalent effective interest rates on underpayments and overpayments for individuals, the proposal is incomplete because it fails to clarify the deductibility of deficiency interest attributable to trade or business or investment activities of a non-corporate taxpayer. Section 163(h)(2) provides that, in the case of a taxpayer other than a corporation, no deduction shall be allowed for personal interest paid or accrued during the taxable year. The term "personal interest" does not include interest paid or accrued on indebtedness properly allocable to a trade or business. Temporary regulations section 1.163-9T(b)(2)(i)(A) provides, however, that interest relating to taxes is personal interest regardless of the source of the income generating the tax liability. This interpretation of the statute has generated considerable litigation and two different standards for the deductibility of interest on deficiencies incurred in a trade or business—a corporation filing a Form 1120 is clearly entitled to deduct deficiency interest while an individual operating an unincorporated trade or business reporting income on a Form 1040 return is denied the interest deduction. We believe section 163(h) should be modified to allow every taxpayer a deduction for interest attributable to a deficiency attributable to trade or business activities, regardless of the form in which the businesses is operated, or to investment activities.

7. Dispute Reserve Accounts

The JCT staff recommends that taxpayers be allowed to deposit amounts in a "dispute reserve account," a special interest-bearing account within the U.S. Treasury. These accounts are intended to help taxpayers better manage their exposure to underpayment interest without requiring them to surrender access to their funds or requiring them to make a potentially indefinite-term investment in a non-interest bearing account. The Treasury report does not contain similar relief.

We have some concerns about how the dispute reserve account system will operate. For example, will the IRS be permitted to use the offset provisions against amounts deposited into these accounts? Nevertheless, we believe the JCT staff's recommendation blends the good features of several current-law approaches to avoid deficiency interest charges and merits serious consideration.

8. Interest-Free Periods

Treasury recommends that, when administratively feasible, the 45-day rule restricting overpayment interest on refunds should be applied, in the case of early-filed returns, to the date the return was received, rather than the last day prescribed for filing the return. The JCT report does not recommend any changes with regard to these so-called rules of convenience.

Under the Code, taxpayers are given a 21-day interest-free grace period to pay tax liabilities (10 business days if the underpayment is in excess of $100,000) while the government is given 45-days to make tax refunds. In addition, overpayment interest accrues on an overpayment from the later of the due date of the return or the date the payment is made, until a date not more than 30 days before the date of the refund check.

Nuances associated with these special rules contribute to the complexity of interest computations. We believe that in the context of comprehensive interest reform, consideration should be given to reviewing and adjusting the application of these rules. The lengths of the grace periods were established years ago and may no longer reflect the actual length of time it takes to complete the assigned task (e.g., transmit data, issue refund checks, remit payment). On the surface, it seems patently unfair to give the IRS 45 days from the due date of a return to process a refund check while allowing some taxpayers only 10 business days to respond to an IRS bill. We believe that these rules should be updated, with a view toward simplification.

9. Application of Compound Interest Only to the Underlying Tax

The National Taxpayer Advocate recommends that compound interest apply only to the tax liability and that simple interest apply to penalties and/or additions to tax.

We disagree with that recommendation. Interest computations already are extremely complex; this proposal would add to that complexity. Further, such an approach would be inconsistent with the use of money principles on which interest is based.

10. Limitation on the Total Amount of Interest that Can Accumulate

The National Taxpayer Advocate recommends that the total amount of interest that can accumulate on a liability should be limited to 200% of the underlying tax liability.

We disagree with that recommendation as being inconsistent with the use of money principles on which interest is based.

Standards Applicable To IRS

1. Standards

The JCT staff recommends that standards similar to those that apply to tax practitioners should be imposed on IRS employees.

We support the JCT staff's recommendation, but urge that sanctions be specified to encourage enforcement. As a matter of fairness and consistency, we recommend that, under current law, the IRS require revenue agents to have concluded that there is at least a "realistic possibility of success" before proposing an adjustment against a taxpayer. (If, as is proposed, the standards for tax return preparers are raised, the standard for IRS revenue agents should be raised similarly.) One method of ensuring that a position contained in a Revenue Agent Report has satisfied the standard could be to require that each Report be signed, evidencing supervisory approval, by an individual at the group manager or higher level, attesting to the fact that the proposed adjustments set forth therein meet the applicable standard. Implementing a policy such as this would be consistent with tax administration principles for the IRS set forth in Rev. Proc. 64–22, 1964–1 C.B. 689. Rev. Proc. 64–22 requires that the Service apply and administer the law in a reasonable and practical manner, and that issues only be raised by examining officers when they have merit, and never arbitrarily or for trading purposes.

2. Awards of Costs and Fees

Section 7430 of the Code currently requires the IRS to pay the reasonable administrative and litigation expenses of a taxpayer in certain circumstances if the IRS does not show that its position was "substantially justified." Such awards are not available, however, to taxpayers having a net worth above a certain dollar amount.

We recommend that recovery of such expenses under section 7430 be available to all taxpayers, regardless of their net worth. The IRS should be held accountable to all taxpayers and responsible for reimbursing a taxpayer for expenses it unduly causes the taxpayer to incur.

3. Monitoring and Reporting

The JCT staff recommends that the IRS be required to publish annually, information regarding payments made under section 7430 for taxpayers' administrative and litigation expenses and the administrative issues that resulted in the making of those payments.

Treasury recommends that, on an ongoing basis, the IRS undertake review of cases involving awards of attorney's fees and cases where penalties have not been judicially sustained, in order to enhance quality review of the administrative process.

We support the JCT staff's recommendation.

Communications Between IRS And Taxpayers

1. Communications with Individuals

The JCT staff recommends that the IRS place a higher priority on improving the processes by which the names and addresses of individual taxpayers are updated in the IRS's records.

Treasury recommends that on an ongoing basis the IRS improve the quality of its notices and communications to taxpayers regarding the basis for penalty and interest assessments and the abatement procedures. Treasury also recommends that the IRS institute procedures to reduce the burdensome nature of the current abatement process.

We support these recommendations.

2. Method of Communicating

The JCT staff recommends consideration by the IRS of the use of e-mail and fax instead of regular mail for communicating with taxpayers. The JCT staff also recommends that the IRS consider proposing legislation to provide for use of an alternative delivery system where current law requires use of regular mail.

We support the JCT staff's recommendations.

Penalties and Interest Conclusion

As stated earlier, we believe there is a need for a comprehensive review of the penalty and interest provisions in the Code and reforms to those provisions to ensure they are appropriately and fairly applied and are designed to accomplish their purpose. We welcome the opportunity to work with you now and in the future on such an undertaking.

Appendix 1

AICPA TAX DIVISION—RECOMMENDATIONS FOR CORPORATE TAX SHELTER LEGISLATION

Developed by the Corporate Tax Shelters Task Force, Approved by the Tax Executive Committee on January 20, 2000

I. Require additional disclosure on tax returns of "reportable transactions" by corporations.

A. "Reportable Transactions" would be those that meet specified criteria (discussed below).

B. A de minimis rule should be included to exclude normal commercial transactions for most taxpayers.

1. The level should be set high enough to avoid high volumes of unnecessary filings. We support a reporting level based on $10 million in tax savings or $1 million in fees or commissions (per reportable transaction, regardless of time frame). If a lower threshold is established, it must remain high enough to truly target the troublesome transactions or excessive disclosures will swamp the IRS.

C. Return disclosure should be made in summary form with IRS permitted to specify in regulations the additional materials to be submitted to support the disclosure.

D. Criteria for disclosure should include the presence of specified indicators.

- We support indicators based on tax indemnity or contingency fee arrangements, confidentiality requirements, and the involvement of a "tax indifferent party."
- We recommend that the proposed indicators based on expected profits compared to tax benefits and on levels of risk in transactions be replaced with one that requires disclosure for any transaction that "would not have been entered into but for the tax benefit."

Comment: This approach tests for business purpose and economic substance at the same time and is more in keeping with other precedents in the tax code. However, this test, as those it replaces, could affect investments or other transactions undertaken because of tax incentives intended by Congress. To address such overreaching, we continue to recommend that certain exceptions be provided (described below), including one for those transactions that are consistent with the legislative purpose for which the tax provision was enacted. In addition, Congress could eliminate some uncertainty in this area by including in the legislative history an illustration of the sorts of legislatively provided tax benefits that should not per se require a special disclosure, such as the low income housing credit, other incentive credits, and so forth. (This legislative-purpose exception should also be incorporated into the preparer penalty standards as described in II.B., below.)

- Another proposed indicator is a transaction that causes a permanent book/tax difference. To narrow this indicator to those differences most likely to be relevant, we recommend it be revised to include only those transactions the Treasury Department identifies in regulations as requiring special disclosure.

Comment: This approach would permit the government, with public comment and input, to target the troublesome transactions while excluding the sorts of book/tax differences that do not warrant special treatment. These include differences caused by the acquisition of intangibles (goodwill), tax credits (such as the research credit and section 29 credits), incentive stock options, capital gains and losses, etc.

E. We continue to recommend that exceptions from the disclosure and special penalty regime be provided for transactions germane to the conduct of the business, are expected to produce pre-tax returns that are reasonable in relation to the costs and risks incurred, or are consistent with the legislative purpose of the provision.

Comment: If the current law definition of corporate tax shelters is retained for penalty purposes, that is, transactions having "a significant purpose of tax avoidance," we believe these exceptions are needed. Otherwise, even when a transaction is NOT "reportable," it could be subject to penalty as a corporate tax shelter. On the other hand, if the disclosure and penalty provisions were recast to address "re-

portable transactions" and the current tax shelter definition were eliminated, these exceptions would not be as necessary. A simplified disclosure process for transactions under the de minimis limits could be established to fill any gaps, using a "check the box" form.

II. Penalty Provisions

A. The substantial understatement penalty should be increased on transactions that were not disclosed on the return as a "reportable transaction" and reasonably should have been. Conversely, there should be no penalty when the taxpayer has disclosed and has adequate weight of authority for the position on the return. Adequate weight of authority is met when substantial authority exists for the position and the taxpayer reasonably believes the position is more likely than not the correct one.

B. Any penalty standard adopted should be consistent with the recommendations for the proposed indicators (in I.D., above) based on the required disclosure of any transaction that "would not have been entered into but for the tax benefit." The current law standard of "a significant purpose" should be abandoned.

C. The "more likely than not" standard should be a meaningful one. Tax shelter opinion letters addressing the tax elements of such transactions should meet the standards in the regulations, revised requirements in Circular 230, and a showing that substantial authority supporting the position taken by the taxpayer exists. Taxpayers unable to meet these requirements should be subject to the 20% penalty even when the transaction was disclosed as required. Congress might reiterate its view that meeting this standard requires the taxpayer to have the weight of authority in support of the return position (that is, greater than 50%).

D. Penalties on advisors/promoters should be devised so as to more effectively deter those not subject to Circular 230. If pre-return disclosure or registration is retained, a failure to disclose or register a corporate "reportable transaction" at or near the point of sale should be penalized, perhaps under a revised section 6707 regime.

Penalties should also be considered for application to these parties in those instances where the taxpayer is subject to the substantial understatement penalty for insufficient authority. Revisions to the aiding and abetting penalty in section 6701 could be considered for this purpose. We support an increase in the level of the penalty, currently $1,000, and suggest consideration be given to a penalty structure of the higher of a dollar amount or a percent of fees received. [As to the penalty standard, broad application of this penalty is not appropriate since it is equivalent to a criminal one, but the current requirement "to know" might be changed to "know or reasonably should have known" [it] is a material matter under the internal revenue laws and would result in an understatement of tax.]

E. Similarly, when the substantial understatement penalty is imposed on a "reportable transaction" for failure to disclose or for insufficient authority, a penalty should be considered on the tax return preparer for that transaction, subject to the normal due process safeguards. Again, this penalty might be the higher of $1,000 or a percent of fees.

III. Other Issues

A. Registration or disclosure at the time of the transaction (before return filing), if retained, should be refined into a more workable system and be required of participants other than the taxpayer. We suggest the same terminology of "reportable transaction" be adopted here and that section 6111 be revised to target the transactions described above and to eliminate duplicate filing by the taxpayer. Registration/early disclosure could be required of any transaction where the cumulative fees (for all participants) are expected to exceed $1 million. Failures to disclose by promoters, advisors, and other parties involved in the transaction could be penalized under a revised section 6707 regime.

B. Due diligence by corporate officials could be enhanced by requiring an attestation, by the responsible official having knowledge of the facts, with the return disclosure.

C. We are prepared to work with the IRS and Treasury on a revision to Circular 230 to bring consistency and clarity to these requirements and those in the regulations. The requirements in the current regulations are substantially similar to those the ABA proposes for a specific class of opinion letters.

D. Focused tax administrative efforts will be required to successfully address the problem of corporate tax shelters. Centralized administration and review of the penalties proposed should be incorporated into the efforts that IRS has recently announced to establish a group to review identified shelter transactions. Effective

means of using the required disclosures will be needed along with utilizing an active "notice to taxpayers" process as IRS identifies questionable transactions.

Appendix 2

TAX DIVISION OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS STATEMENT OF DAVID A. LIFSON TO THE HOUSE COMMITTEE ON WAYS AND MEANS FOR HEARINGS ON CORPORATE TAX SHELTERS

NOVEMBER 10, 1999

My name is David Lifson, and I chair the Tax Executive Committee of the American Institute of Certified Public Accountants (AICPA). The AICPA is the national professional association for CPAs, and our more than 330,000 members are from firms of all sizes, and from business, education, and government. Our members work regularly with the tax laws that you write, and we have a strong interest in making the tax law fair, simple, and administrable.

I am pleased to present our testimony on "corporate tax shelters." For the last year, we have had a task force working hard on the issues that the Treasury and Joint Tax Committee staff studies have attempted to address. We have discussed the issues with our leadership and membership; we have met with representatives of the American Bar Association Tax Section and Tax Executives Institute to identify areas of consensus; and we have met with Treasury Department and Congressional staff. While we have made progress, there are still significant areas of difference and a lack of consensus on key issues. We are all concerned about the misuse of our tax system, but we are also concerned that legislation to curtail this activity not be so overly broad, vague, and punitive as to have a chilling effect on normal transactions of average business taxpayers. We urge restraint in legislating solutions until discussions can build a greater consensus on the best approach to the difficult and complex problem of narrowly but effectively targeting abusive corporate transactions, while leaving intact a taxpayer's ability to plan regular commercial transactions without fear of draconian sanctions.

In addressing corporate tax shelters legislatively, we encourage you to keep in mind that the system must work efficiently, so that taxpayers and practitioners can understand and the IRS can enforce the rules. The tax system works through compliance and enforcement, based on the broad powers that Congress has already given the IRS to curb abuses. Not every perceived abuse requires new legislation with its concomitant new regulations and rulings. Indeed, the government has prevailed in several very recent tax cases based on present law (Compaq Computer Corp., 113 TC No. 17 (September 21, 1999); *IES Industries, Inc. v. U.S.*, No. C97–206 (N.D. Iowa Sept. 22, 1999); Winn-Dixie Stores, Inc., 113 TC No. 21 (October 19, 1999); and Saba Partnership, Brunswick Corporation, Tax Matters Partner, TC Memo 1999–359 (October 27, 1999)), following last year's decisions in *ACM Partnership v. Commissioner* (157 F2d 231 (3d Cir. 1998, affg. in part T.C. Memo. 1997–115)) and ASA Investerings Partnership (1998–305 TCM).

We are also pleased with the recent announcement by the IRS that it is forming an operational group to target corporate tax shelter transactions. As we have stated in prior testimony on this subject, some of the problem is lack of enforcement of existing rules rather than the need for new rules. As the government becomes more successful in identifying and prosecuting tax shelter cases, taxpayers and shelter promoters will be curtailed from abusive transactions. Nevertheless, we do support efforts to raise the standards required of "more likely than not opinions" through changes to Circular 230, and believe the practices of those not currently subject to Circular 230 must be subject to meaningful penalties as well.

We specifically reject the imposition of a new "super 269" approach that is included in some proposals. Such a new regime would be imposed over and above current law requirements and would deny deductions, losses, or credits unless a complex analysis demonstrates an appropriate level of pre-tax profit. This approach, combined with a presumption of non-economic purpose, is overly broad in targeting abuses, and would adversely affect many normal business transactions at a minimum by injecting a high level of uncertainty and requiring documentation of an analysis for tax purposes that has no other meaning or business purpose.

My comments today supplement and refine those we provided last Spring to the House Ways and Means Committee and Senate Finance Committee when we were addressing the President's budget proposals related to corporate tax shelters. I have attached our statement from the Senate Finance Committee hearing on April 27, 1999.

Disclosure of Corporate Transactions

We continue to strongly support an effective disclosure mechanism to advise the government of corporate transactions that warrant review. Structuring an effective disclosure regime requires balancing the amount of detail, the timing of disclosure, and the burden of disclosure on taxpayers and advisers.

Disclosure should provide enough information to the IRS to be helpful, but should not include excessive detail that will make their review difficult. For tax return disclosure, we would encourage the use of Form 8275, which contains a concise statement of the legal issues or nature of the controversy. This form could be adapted for corporate tax shelter issues, possibly with check boxes for indicators of transactions that the government might wish to review, such as the involvement of a tax indifferent party, indemnities for the benefit of the corporate participant in a transaction, or other characteristics that the Committee determines are appropriate.

While advance disclosure (that is, before the return is filed) would help the government in some cases, it could be burdensome and should be limited to those situations where it would be most useful to the government. For both advance and return disclosure, we suggest care be used to identify what the IRS can actually make use of at each point in time. Disclosure requirements for advance and return filing should be specific as to what is required, when, and by whom.

We recommend placing the burden of advance disclosure on the promoter, advisor, opinion-writer, or salesman, rather than the taxpayer. Requiring both the taxpayer and these third parties to disclose a transaction is burdensome and provides redundant information to the IRS. Advance disclosure by the third parties will be more helpful to the IRS in the timely identification of problem areas and will be more effective in curtailing abuses by these third parties at an early point in time. We suggest that each of the "responsible" third parties involved be responsible for the reporting, unless there is agreement that one of them will take responsibility. This will create the necessary tension between the parties to insure disclosure.

For disclosures in advance of filing, we encourage you to modify Section 6111 (registration of tax shelters). We suggest a "reportable transactions" regime as a substitute for the "tax shelter" transactions convention currently in place under Section 6111 to identify targets for pre-return disclosures. This approach would be more focused, less subjective, less laden with emotion, and would encourage disclosure.

In defining transactions to be disclosed on the return or in advance, we believe there is merit in the approach of developing fairly objective "indicators" of the sorts of transactions to which the government wants to give special attention. However, both Treasury and the Joint Committee staffs have suggested some indicators that we believe would sweep in many ordinary business transactions. For example, the proposed indicator of a permanent book/tax accounting difference, would include key-man insurance, purchased intangibles, and the use of stock options as employee compensation. Another proposed indicator would look at the economic substance of a transaction, using a pre-tax profits analysis that would result in a number of ordinary transactions being classified as "tax shelters." For example, many incentives that Congress enacted to encourage taxpayers to undertake transactions that are not susceptible to this bottom-line analysis, like the research credit or even charitable contributions, would have to be reported or be specifically excluded from this test in legislation. It would be impossible to compare the pre-tax profits with expected tax benefits in many ordinary transactions because the economic return is unknown, such as stock purchased on margin or real estate purchased with nonrecourse debt. Other normal business transactions, such as leasing, financing or advertising, are not susceptible to an analysis which requires a determination of the expected pre-tax return from the transaction. Indeed, the Treasury Department's study pointed out that the courts have been reluctant to employ this kind of analysis in testing the vitality of transactions for tax purposes.

We are particularly concerned that the five tax shelter indicators in the Joint Committee staff recommendations would automatically deem a transaction to constitute a tax shelter defined under current law as having "a significant purpose" of avoiding or evading Federal income tax. Defining a corporate tax shelter by reference to having a "significant purpose" of tax avoidance or evasion has not proved helpful in determining the proper target, and even Treasury has not yet been able to produce regulations after two years. We believe the Joint Committee staff approach of using more objective indicators is better, but they should be used as a substitute for the current law standards of "tax shelters." These factors should be objective and could be adjusted as more information becomes available and new trends are identified. Also, the Joint Committee staff recommendation contains a double jeopardy—if a transaction does not fall within one of these indicators, the IRS could still argue that a significant purpose of the transaction is the prohibited avoidance or evasion, and thus subject to additional disclosure requirements and higher pen-

alties. In short, from the government's perspective, it's "heads, I win; tails, you (may well) lose."

We urge consideration be given to developing a more neutral approach, such as our suggested "reportable transactions" regime. The results may well be the same: the need for disclosure and a potentially higher penalty structure, but the judgmental tone is removed and the issue becomes one of mechanical reporting, not of emotion. If a transaction satisfies an indicator, it is subject to a disclosure and enhanced penalty structure; if it does not, it should be subject to the normal penalty regime (including disclosure as an abating criterion).

Some of the proposals before you try to avoid affecting normal business transactions resulting from overly-broad indicators by exempting specific types of transactions. We recommend a different approach. If a broad economic purpose test is retained, we believe the best way to reach the Chairman's stated objective of not adversely impacting normal business and financial transactions is to provide exceptions for defined categories of transactions. Our categories would include transactions that meet a business purpose test, are consistent with the legislative intent of the applicable provision, or are expected to produce returns that are reasonable in relation to the cost and risk of the transaction.

Finally, there should also be a de minimis level below which transactions do not need to meet additional disclosure requirements or be subject to extraordinary penalties, and we agree with the American Bar Association's proposals for a minimum of $1 million in professional fees or $10 million in tax benefits. This will avoid application of this regime to smaller taxpayers and less-sophisticated practitioners. We note that some proposals offered would apply to individual taxpayers. We suggest that any higher penalties and disclosure requirements should apply to corporate taxpayers initially, and expanded to other taxpayers, if necessary, only after the reportable transaction regime is well established.

Penalties

We believe that the "reportable transactions" regime for disclosure could be carried over into the substantive penalty area under Section 6662(d)[2]. A reportable transaction would have to be disclosed on the tax return or the taxpayer would face heavier penalties. Disclosure will help the IRS identify problem issues, and, coupled with penalties where a position taken does not have sufficient merit, will provide a strong deterrent against abusive transactions. For reportable transactions that are disclosed but that lack substantial authority and lack a sound opinion concluding "more likely than not" on the merits, the 20% penalty of current law should apply. A somewhat higher penalty on reportable transactions that are not disclosed would provide an economic incentive for disclosure as would our suggestion in earlier testimony that where the requisite standard is met and disclosure has been made, there should be no penalty.

We do not support the Joint Committee staff's proposed 75% likelihood standard. The current more-likely-than-not standard is comprehensible in application where the practitioner and taxpayer have to determine that they have the preponderance of authority. Even this is not easy in situations where little guidance or case law exists. Determining the degree of certainty to a specific percentage is virtually impossible, and will be difficult for the IRS and courts to apply. It would also set a higher standard than would be required to prevail on the merits of a case.

We do not believe there should be a penalty on the taxpayer for failure to disclose on a tax return where there is no understatement of tax. Although we understand the intent of this proposal, a flat-dollar amount would not act as a deterrent, and other formulations of the penalty are too complex for the potential benefit that might be provided. Similarly, we do not support any strict liability penalties, believing that the IRS should have the ability to waive penalties when justified.

We believe that a standard must be established under Circular 230 for all tax shelter opinion letters. The current rules should be expanded to cover "tax shelter" opinions outside the third party context and should be better coordinated with the existing penalty rules. There are other aspects of Circular 230 that can also be brought to bear on abusive tax shelters, and we will work with the bar, enrolled agents, and the Treasury to improve Circular 230. Within the AICPA, we are reviewing the ethical conduct of practitioners involved in corporate tax shelter cases, and are determined to maintain the highest level of responsibility of our members.

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[2] In short, our recommendation is not intended to layer another regime for "reportable transactions" on top of those in current law, but to stimulate consideration of a means to restructure and simplify the substantial understatement penalty for certain transactions, and to better coordinate those with the disclosure requirements.

Most individuals who practice before the IRS are responsible professionals who have nothing to do with abusive tax shelters. Unfortunately, many individuals involved in developing, advising, and selling of tax shelters are not professionals who are subject to Circular 230 (that is, not an attorney, CPA, or enrolled agent). The penalties for aiding and abetting the understatement of tax liability could be expanded to include these third parties. Also, promoter and advisor penalties should be imposed for failure to disclose when transactions are developed and sold, and these could be fashioned along the lines of Section 6707, as a percentage of fees, and could be expanded to apply to investment bankers, opinion writers, insurance companies, and others who are involved in such transactions. For practitioners governed by Circular 230, sanctions can include suspension from practice before the IRS or disbarment, and we would encourage tough penalties for others who engage in abusive conduct.

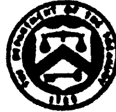
Due Diligence by Corporations

We have been told that a common problem with abusive tax shelters is that tax opinions on certain transactions often do not match the actual facts. This has led to proposals that corporate officers be required to be more diligent in their examination of positions taken in tax returns. We support the requirement of a "corporate officer attestation" on the return, disclosing reportable transactions. Our suggestion is that a corporate official having knowledge of the facts, rather than one having a position with a particular title within the corporation, would be required to sign the attestation. The legislative report should make clear that the official could reasonably rely on expert opinions as to the tax law, valuations, etc., and on other responsible corporate personnel as to factual matters. We do not believe that attestation should carry personal liability, as this extreme sanction may not be appropriate for the conduct of the corporate official. Also, large companies frequently insure their officials against liability so that personal liability would often be deflected.

Conclusion

We strongly oppose the undermining of our tax system by convoluted and confusing tax sophistry. Clearly, there are abuses and they must be dealt with effectively. However, we have a complex tax system and believe that taxpayers should be entitled to structure transactions to take advantage of intended incentives and to pay no more tax than is required by the law. Drawing this delicate balance is at the heart of the issue we are addressing today. We urge you to continue the difficult discussions that develop from today's hearings until a greater consensus can be reached as to the best possible legislative approach. We offer our ideas and assistance in developing an effective and efficient approach to curtailing abusive tax shelters.

[SUBMITTED BY SENATOR MOYNIHAN]



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

March 8, 2000

The Honorable Daniel Patrick Moynihan
U.S. Senate
Washington, DC 20510

Dear Senator Moynihan:

As you begin discussing the very important topics of corporate tax shelters and the penalty and interest regime in the Internal Revenue Code today, I wanted to share some brief thoughts with you regarding corporate tax shelters. I have recently stated our belief that corporate tax shelters represent the most significant compliance problem currently confronting our system of self-assessment. Corporate tax shelters not only reduce the corporate tax base, they breed disrespect for the system by participants and observers, and waste valuable public and private sector resources.

The tax-writing committees of the Congress, working with the Treasury Department, have built an impressive record of addressing specific, abusive transactions as they come to light. Also, Treasury and the IRS have shut down specific transactions by administrative action, when appropriate. It is suggestive of the scale of the problem that action over the last few years to address specific shelters will save the American taxpayer close to $80 billion over the next decade. More recently, to obtain more information about potentially abusive transactions and to help deter them, the Department of the Treasury and the IRS issued proposed and temporary regulations requiring disclosure of certain transactions to the IRS, and requiring developers and promoters of tax-engineered transactions to maintain customer lists. Also, over the course of the last several years, the IRS has prevailed in several court cases against the use of transactions lacking in economic substance.

The point I would like to make is simple: specific statutory patches, regulations, administrative actions, and court victories, while enormously helpful, are not enough. Corporate tax shelter activity continues to proliferate. As you know, the Administration has put forward in the FY 2001 Budget legislative proposals aimed at curtailing corporate tax shelters. The details and rationale for these Budget proposals are contained in the testimony being presented today by Acting Assistant Secretary Talisman. We look forward to working with Congress to pass laws that will address this problem, which I believe to be of great importance. Failure to address this issue in a meaningful way would put the fairness and efficacy of our tax system at risk.

Sincerely,

Lawrence H. Summers

Lawrence H. Summers

[SUBMITTED BY SENATOR MOYNIHAN]

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April 12, 1994

Hon. Daniel Patrick Moynihan
Senate Office Building
Washington, D.C. 20510

Dear Pat,

I have just filed my tax returns for 1993, by mail. As I have mentioned in writing to you previously, it seems to me that our government makes unreasonable demands on its citizens -- not in terms of the aggregate amount of money which they are called upon to pay, but rather because of the enormous amount of paperwork which is required in the process.

My filings included nine separate returns, sent to six different addresses. These include Social Security returns and Unemployment Insurance returns (all on a quarterly basis) as well as the Federal and D.C. Income Tax Return, and the Federal and D.C. Estimated Tax Return for 1994. Since the Social Security and Unemployment taxes are all the result of my wife's disability, it seems to me that a case could be made that we should rather receive an appropriate credit for providing employment to others who need it.

Near my desk here, I have a federal tax file which is three inches thick, and (I estimate) contains more than six hundred pieces of paper. I will have to keep this for several years, in order to be able to respond to any questions which may arise. In addition to the federal tax itself, the booklet supplied to taxpayers contains not only Form 1040 with many schedules, and references to other schedules, which must be applied for, but there are forty-nine pages of "Instructions," which must be carefully examined. These forty-nine pages are mostly three columns each of small print. I estimate that there are at least 1,225 worlds per page. This brings the total of "Instructions" to a total of 50,000 words. But, in addition to the Instructions, there are over thirty-six pages relating to various schedules. The grand total of material accompanying the return is at least 94,000 words, the equivalent of a moderate-sized book.

These Instructions include a great number of "worksheets." I am enclosing Xerox copies of two of these, both of which must

be virtually incomprehensible to the ordinary citizen. In particular, I call to your attention the Itemized Deductions Worksheets on page A-5, where you multiply a line by 80%, and then four lines farther along you multiple a line by 3%, all to get a figure which must be quite beyond the understanding of those taxpayers who have to use it, and of the many others who have to find their way through it to see if it is something they have to use in order to complete their returns.

The net result is an enormous task, at which I spent just short of a hundred hours. Among other things, if you find, on checking, that a mistake has been made somewhere in the process of filling out the return, then the whole thing has to be done over again, including all of the complicated computations.

I do not blame the Internal Revenue Service for this extreme complexity. They have no choice. They have to take the law as it is written by Congress. I do think that Congress has failed to meet its basic responsibility to enact legislation that is reasonably comprehensible, and then not to change the statute too often. This was a role which Wilbur Mills handled very carefully and skillfully, but it has been almost completely neglected in recent years. The key man on this is the Chairman of the Ways and Means Committee of the House of Representatives, but the Chairman of the Senate Finance Committee can also have a very considerable impact on it.

Much of the problem goes back to the "reorganization" of Congress which was carried out close to fifty years ago under the leadership of the younger Senator LaFollette from Wisconsin. He was trying to get away from the "Solid South," and the domination of the two Houses of Congress by a few Southern members, who, in effect, had life terms. The net result of the change then made, though, was to weaken the leadership so that there are now 535 different and essentially independent parties in Congress. Each member has his own responsibility for fund-raising, and the result is that there is very little party leadership in Congress. This of course makes it very difficult for Committee Chairmen.

For example, the problem with respect to the Itemized Deductions Worksheet arises because some members (or the Treasury) wanted to save some part of the tax involved by the deductions allowed by Schedule A without "raising rates." So we have this frightfully complex computation, which is quite unfathomable to most taxpayers. I mention Schedule A only as an illustration. There are many other places where the computations are incomprehensible to ordinary citizens. This Form, and the many other Forms that are required, create a bitter feeling among our citizenry.

Hon. Daniel Patrick Moynihan
April 12, 1994
Page 3

For better or for worse, I am one of those who keep his own records and makes out his own tax return. Practically everyone else, whether of substantial or modest income, feels that he must use a "tax advisor" or consultant, at considerable aggregate cost -- which cost is deductible in determining the tax. The reason that I make out my own return is that I have been doing so for more than sixty years. I started when the tax could be comprehended, and have not been willing to stop. It is only in the past eight or ten years that the task has become very burdensome. I could have my returns prepared by an accountant, but I figure that it would be nearly as much work for me to gather together the necessary factual material as it is for me to make out the returns. Moreover, I resent the fact that my government forces me to use an accountant for such a matter, particularly when my career in law has been largely in the tax field, and I taught federal taxation in law school for a third of a century, between 1934 and 1967 and published the first casebook devoted solely to Federal Taxation. Paying an accountant to do the work seems to me to be a little like the Civil War practice of hiring a substitute in order to avoid the draft. That does not look very good today, and so it is with a system which forces many taxpayers to have their returns made out by people with the most sophisticated computers.

And now the Treasury, with reason, is about to require more paper in order to meet the new rule that there must be a signed receipt for a high proportion of charitable contributions, including a statement that no benefit is received. These receipts must then of course be retained for a number of years.

I venture to suggest that, somehow or other, a better solution to these problems must be found. A tax law can never be as precise as the drafters have been trying to make it over the past several years. It is my earnest hope that the Ways and Means Committee, and the Finance Committee, through the energetic enterprise of their respective chairmen, will take steps to simplify this whole operation, making it possible for the ordinary citizen to comply with his responsibilities, and understand what he is doing in the process.

Keep up the good work.

With best wishes,

Very truly yours,

Erwin Griswold

PREPARED STATEMENT OF NINA E. OLSON

Mr. Chairman and Members of the Committee:

My name is Nina E. Olson. I appear before you today in my capacity as Executive Director of The Community Tax Law Project. The Community Tax Law Project (CTLP) is a 501(c)(3) corporation founded in 1992 to fulfill a three-fold purpose: (1) to provide pro bono representation to low income Virginia taxpayers in federal, state, or local tax disputes; (2) to educate low income individuals about their rights and responsibilities as U.S. taxpayers; and (3) to increase public awareness of and encourage informed debate about tax policy and practice issues impacting low income taxpayers.

The Project accomplishes its mission through a panel of volunteer attorneys and accountants and an in-house staff including two tax attorneys, one of whom is bilingual in Spanish. We conduct substantial outreach efforts to taxpayers who speak English as a Second Language, to participants in welfare-to-work programs, and to victims of domestic violence. CTLP also provides continuing education and training programs for its volunteer attorneys and publishes a national quarterly newsletter about low income taxpayer practice and policy matters, The Community Tax Law Report. In fiscal year 1999, The Community Tax Law Project was awarded $100,000 under the Low Income Taxpayer Clinic Grant Program, authorized by IRC §7526.

The Community Tax Law Project accepts approximately 200 cases per year. All of our clients have income at or below 250% of the federal poverty level. We also provide brief advice to individuals who contact us and whose income is above our guidelines for income eligibility. Since 1992, we have conducted in-depth interviews with over 1,600 taxpayers. Prior to obtaining my law degree and founding the Project, I practiced as an unenrolled preparer and tax adviser for sixteen years.

I appreciate the opportunity to appear before the Committee today to discuss the tax penalty and interest provisions of the Internal Revenue Code. The substance of my remarks today is drawn upon my observations and experiences over my last 25 years of tax practice. I will begin by making some general observations about low and moderate income taxpayers. Next, I will comment upon certain, but not all, proposals advanced by the Joint Committee on Taxation and the Department of the Treasury's Office of Tax Policy. Within this discussion, I will describe The Community Tax Law Project's recommendations for improvements to the current tax penalty and interest provisions.

GENERAL COMMENTS

Low Income Taxpayers, including Taxpayers who speak English as a Second Language.

Low income taxpayers tend to be financially unsophisticated and have limited means with which they can obtain qualified advice regarding tax matters. Welfare reform continues to introduce new taxpayers to the federal tax system, all of whom are low income. Low income taxpayers, including those who speak English as a Second Language (ESL), are often in very tenuous and unstable financial situations. ESL taxpayers in particular may not have authorization to work in the United States and thus are fearful of government because of their immigration status. This fear renders them vulnerable to less reputable advisors.

We have noted that among this population, self-employment is on the rise. These taxpayers do not necessarily adopt self-employment status voluntarily. In many instances our clients do not understand that they are being treated as independent contractors and certainly do not know about their obligations to pay self-employment tax or make estimated tax payments. We find that many participants in the welfare-to-work programs are encouraged to establish home-based day care businesses, with little education about their tax filing and recordkeeping responsibilities. Household workers, farmworkers and day laborers are also subject to misclassification as to their worker status.

Low income taxpayers rely on tax professionals for tax advice as well as tax preparation. Given their limited financial means, they turn to check-cashing establishments for advice and preparation. They are easily lured to commercial establishments that offer to prepare taxes and extend a refund anticipation loan which can be applied toward a purchase at that establishment. Alternatively, they turn to "kitchen table preparers," individuals who have perhaps taken a tax preparation course and now prepare returns for the neighborhood. Low income taxpayers with the simplest returns can seek assistance from VITA sites; however, most VITA sites do not prepare returns requiring a Schedule C for sole proprietorship income. Low income taxpayers are particularly vulnerable to illicit preparers, who make promises of big refunds and who frequently do not sign the returns which they are paid to prepare. We find that ESL taxpayers are easy prey for this type of preparer, given

language barriers or immigration status issues. It should be noted that ESL taxpayers also have difficulty obtaining the requisite Social Security Number (SSN) or Individual Taxpayer Identification Number (ITIN).

Moderate Income Taxpayers

We have noted an increase in self-employment status in the moderate-income taxpayer population. Many of these taxpayers run their own home-based businesses, either as their primary or secondary employment. As a result of the last several years' expanding economy, many of these taxpayers have stock market investments and resulting taxable transactions. They also may have significant investments in 401(k) plans and other retirement accounts, education IRAs, prepaid tuition plan investments, deductions or credits relating to education tax incentives, and exposure to the alternative minimum tax.

These taxpayers seek tax advice and preparation assistance from a number of sources, including unenrolled preparers, enrolled agents, and small CPA firms. They are also very enterprising and often prepare their own tax returns with commercially available tax preparation software packages.

Effect of Complexity on Low and Moderate Income Taxpayer Compliance

The current Internal Revenue Code presents many traps for the unwary or unadvised low or moderate income taxpayer. Family status issues alone constitute a major source of errors on returns. The determination of worker status, ordinary and necessary business expenses, education tax incentives, and taxation of distributions from retirement accounts are all issues faced by these taxpayers.

Taxpayers are no longer able to rely on their common sense and intuition as to which facts are relevant for tax preparation. They are not sure what type of and how much information they should gather. They do not know what information they should report to their preparer to enable him or her to accurately complete the return.

Effect of Complexity on the Taxpayer—Preparer Relationship.

Tax professionals, including unenrolled preparers, have a duty to the tax system as well as their clients. This dual duty is reinforced by the increasing complexity of the Internal Revenue Code. Taxpayers are relying on their preparers and tax advisors to help them comply with the tax law and to inform them of any risks or errors. The federal tax system expects tax professionals to act as the first line of defense for both innocent errors and aggressive, unsupported return positions.

Fact investigation is an increasingly important function of the tax professional as the tax law grows more complex. In many instances, it is no longer appropriate to accept the taxpayer's factual information at face value. The duty to the system means that return preparers and other tax professionals have a professional obligation to inquire further and guide the taxpayer through fact-gathering.

Role of Penalties in a Self-Assessment Tax System

Our self-assessment tax system sets the taxpayer's desire to comply with the tax laws against his or her reluctance to give up hard-earned dollars to the federal government. Penalties, fairly administered, tilt the balance in favor of compliance by increasing the cost of noncompliance and imposing a sense that the taxpayer has violated a societal norm. Most taxpayers are risk-adverse. Even long-term nonfilers emerge and file because they cannot stand the guilt and the feeling of having to "hide." A fair and effective penalty system will not be so punitive that it overcomes the positive influence of guilt, increases anger at the tax system, and becomes a barrier to compliance.

Role of Interest in a Self-Assessment Tax System

Nonpayment of taxes results in a loan from the government (and other taxpayers) to the delinquent taxpayer. Interest serves as compensation to the government/lender for the time-value of money and for the risk undertaken (involuntarily) by the government. While the government wants to encourage taxpayers to timely pay their tax obligations and, conversely, to deter and punish taxpayers who do not timely pay, interest is not the vehicle for satisfying these goals.

The interest charge should be high enough to discourage taxpayers from using the government as a lender of first resort or for cash management purposes. However, the rate of interest should reflect the government's recognition that collection of tax may depend on the government acting as a lender. This is particularly true with the low income population and self-employed individuals, whose cash-flow is often volatile and who do not have access to other lending sources.

Taxpayer Behavior and Tax Collections

Our experience confirms what the Joint Committee Report observes: the older the tax year, the less likely it is that the taxpayer will pay the tax. Taxpayers are frustrated by having to pay two or three times the underlying tax in penalties and interest. They perceive themselves as trying to comply with the tax laws and make good on their tax debts. Spiraling interest and high, continuing late payment penalties make taxpayers feel like they are criminals rather than people having a hard time making ends meet. The high cost of penalties and interest is the greatest impediment we face in convincing nonfiler taxpayers to reenter the system.

SPECIFIC PROPOSALS

Underpayment and Overpayment Interest

As stated above, the rate of underpayment interest must be high enough to encourage taxpayers to pay timely but not so high as to undermine a taxpayer's intent to be in compliance with the tax laws. Interest is not a punitive device. Therefore, we support the Joint Committee's proposal to set the interest rate at AFR plus 5, on the assumption that that rate approximates a mean market rate for a broad class of taxpayers. We suggest that interest be compounded monthly rather than daily. Monthly compounding will also bring tax interest in line with market practices and does not appear punitive to the taxpayer, thereby increasing the rate of compliance.

We support the Joint Committee's proposal to equalize the underpayment and overpayment rate for all taxpayers. The Joint Committee's proposal to exclude overpayment interest from individual taxable income will certainly simplify the administration of interest netting. We are extremely sympathetic to the concern that low and moderate income taxpayers may not be knowledgeable enough to request or complete the complex calculations currently required for interest netting. However, we do have some concern that compliant taxpayers will view this provision as a windfall to noncompliant taxpayers. We suggest an alternative approach, that of permitting the deduction of underpayment interest allocable to sole proprietorships and most activities reportable on Form 1040, Schedule E (i.e., rents, royalties, and income from partnerships and S Corporations).

Interest Abatement

We recommend the following five proposals. First, retain the discretionary nature of abatement. We believe taxpayers should be required to make their case for interest abatement to the IRS and the IRS should be able to exercise its discretion in abating interest, after weighing all of the arguments, facts and circumstances. Second, extend the availability of abatement to interest accrued as a result of all acts by the Internal Revenue Service that cause unreasonable delays or errors in processing.

Third, we support the proposal that Congress grant the Secretary of the Treasury the power to abate interest where it would be inequitable to charge it. Fourth, we propose that the United States Tax Court be granted jurisdiction to review the Secretary's decision in cases where equitable abatement is denied as well as equitable jurisdiction to abate penalties and interest in cases properly before the Court under IRC §§ 6213 and 6214. (This proposal will be discussed in further detail under the section heading "Administrative Provisions.")

We note that under current law, overpayment interest is allowable only after a return is filed, while underpayment interest accrues from the original due date of the return. It is our experience that nonfilers often have a mix of overpayment and underpayment returns outstanding. In fact, they often do not file because they believe, erroneously, that the overpayments will net out the underpayments and it will all even out in the end. In most cases, however, the overpayments will not be allowable because of the expired statute of limitations period under IRC § 6511 for claiming a refund. This situation gives the nonfiler little incentive to reenter the system. In fact, it increases the nonfiler's anger at the tax system, since the government is retaining his or her refunds while collecting the underpayments.

Therefore, we further suggest that, in the context of nonfilers reentering the system, underpayment interest be abated to the extent that a taxpayer has refunds barred under IRC § 6511. This proposal will remove a deterrent for nonfiler re-entry but will not reduce the amount of tax still owing, nor will it reduce the failure-to-file penalty. It should not be objectionable to compliant taxpayers, since the government is retaining the barred refunds and in that way is compensated for the abated interest.

Failure to File Penalty

We believe that the Failure to File Penalty under IRC § 6651(a)(1) acts as an important deterrent to taxpayers contemplating noncompliance and reassures compliant taxpayers that the government is punishing those taxpayers who choose not to comply. We support Treasury's proposal of a gradually increasing penalty rate while retaining the 25% maximum penalty. However, the effectiveness of this rate schedule as an incentive for filing will depend on the Service's adequately publicizing the rate schedule and informing taxpayers through notices and one-on-one contacts. We recommend that the Service hold Special Filing Days, similar to the Nonfiler Program held several years ago. These Special Filing Days could be held in conjunction with the Problem Solving Days so that nonfilers would not be singled out.

We oppose Treasury's proposal that a "service charge" be imposed on no-balance returns that are not timely filed. We believe this service charge will alienate marginal taxpayers who have not filed for innocuous reasons and who already resent that the government has the use of their funds during the nonfiling period without paying them interest. This proposal, if enacted, will also undermine efforts directed at nonfilers, who frequently have both underpayment and overpayment returns outstanding.

Failure to Pay Penalty

We concur with the Joint Committee on Taxation's proposal to repeal the Failure to Pay Penalty under IRC § 6651(a)(2) and (3). A market rate of interest serves to compensate the government for the time value of money and its lending risks. Honest taxpayers who are sincerely attempting to pay taxes, albeit late, feel that they are being charged interest twice, with interest and the Failure to Pay penalty accruing.

Tax administration should focus on incentives to collect outstanding taxes quickly, thereby increasing the likelihood of collection. Collections will increase if taxpayers understand that they can avoid the imposition of an annual service charge, akin to a credit card late payment charge, if they quickly enter into an installment agreement.

Knowing too well how difficult it is to get taxpayers' attention, we suggest that the Service follow the marketing strategies of credit card companies advertising lower rates. The Service should send out a separate notice to the taxpayer two months after notice and demand, which describes the availability of installment agreements and highlights the service charge waiver. This notice should include an easily readable chart with examples of how much money the taxpayer will save by entering into the installment agreement. At the 3-month mark, the Service should make telephone contact with the taxpayer. If the taxpayer submits an installment agreement request by the fourth month after notice and demand, and the agreement is accepted by the sixth month, the service charge would be waived. If a timely submitted installment agreement's processing is delayed, the Service should err on the side of the taxpayer in waiving the service charge.

We support the waiver of the $43 installment agreement fee when the taxpayer agrees to an automatic account debit arrangement. We also propose that in the event the taxpayer defaults on his or her installment agreement, the taxpayer should be notified and given a 30 day period to explain the default and seek reinstatement. We believe that the $23 reinstatement fee should be waived if the taxpayer demonstrates that the default was due to financial hardship as defined in Treas. Reg. §301.6343–1(b)(4).

We also propose that when a taxpayer is classified as "Currently Not Collectible," the Service should inform the taxpayer that the Failure to Pay annual service charge will continue to be imposed. The Service should further advise the taxpayer that if he or she later enters into an installment agreement to pay the tax and makes all payments of tax and interest under the agreement, the service charge will be removed at the end of the installment agreement term. This provision will serve as an incentive for some taxpayers, who temporarily fell on hard times but are now improving their financial situation, to attempt to make payments on taxes attributable to older tax years, whereas now there is no incentive whatsoever.

Return Positions in General

For low and moderate income taxpayers, return position errors fall into two categories:

- Those attributable to the complexity of the tax law and the taxpayer's lack of knowledge of the tax law; and
- Those attributable to inadequate fact development and information exchange between the taxpayer and the return preparer.

As noted earlier, this population of taxpayers are very dependent on tax professionals, usually unenrolled preparers, to navigate the tax system on their behalf. Thus, tax professionals, including unenrolled preparers, must be held to an equal, if not higher, standard of accuracy than the taxpayers themselves.

It is our experience that many commercial preparers working with low income taxpayers are unfamiliar with the accuracy-related or preparer penalties or the advisability of disclosure of return positions. This observation is also true to a lesser extent about certain preparers who assist moderate income taxpayers. Thus, these taxpayers are never informed that they may be subject to accuracy-related penalties and that disclosure of certain positions may avoid the imposition of such penalties.

Accuracy-related penalties are often automatically imposed on this class of taxpayers. Low and moderate income taxpayer returns often give rise to service center or district correspondence audits. In this context, there is little opportunity to develop facts much less discuss the imposition of penalties. All too often the service center issues a notice of deficiency for a return prepared by a tax return preparer, imposing the accuracy-related penalty for negligence, without ever raising the possibility of penalty abatement for reasonable cause. Since only 5% of all notices of deficiency result in a Tax Court petition, it is highly likely that many of these taxpayers will be unnecessarily paying IRC § 6662(a) penalties. Alternatively, they will be challenging the imposition of penalties in the tax collections context.

Accuracy-Related and Preparer Penalties: Individual Nonshelter Positions with Disclosure

Given the Internal Revenue Code's complexity, we believe the "realistic possibility of success" standard is appropriate for disclosed nonshelter positions on individual returns. This belief is based in part on our experience that, with respect to any moderately complex issue, 2 out of 3 taxpayers and preparers will come up with the wrong answer. Therefore, if the taxpayer and/or his preparer discloses the questionable position and puts the Service on notice about their uncertainty, neither the taxpayer nor his preparer should be penalized. This standard has the added benefit of being familiar to many licensed tax professionals, as it is incorporated into their own standards of tax practice.

However, I must reinforce the need for education of the unenrolled preparer community about the need for disclosure of positions. A penalty waiver is meaningless if preparers working with the low and moderate income population are unaware of its availability.

Accuracy-related and Preparer Penalties: Individual Undisclosed Positions

We believe it is reasonable for the Service and the taxpaying public to expect that a higher standard will apply to undisclosed positions than to disclosed ones. Thus, we support applying the "substantial authority" standard for avoidance of penalties on undisclosed individual return positions. We believe it is reasonable for the Service to expect that taxpayers and their preparers research their positions prior to adopting them on returns. Substantial authority is a clearer standard than "more likely than not." It involves weighing authority rather than weighing the myriad intangible factors that enter into an analysis of settlement or hazards of litigation risks.

Accuracy-related Penalties: Reasonable Cause Exception

We strongly recommend the retention of the reasonable cause exception to the accuracy-related penalty. Particularly with respect to undisclosed positions, the low or moderate income taxpayer is often at the mercy of his or her preparer's understanding of the tax law. These taxpayers are singularly ill equipped to second-guess their preparer's advice. Thus, we believe the reasonable cause exception should be expanded to include certain significant mitigating factors and events beyond the taxpayer's control, along the line of the Regulations under IRC § 6724. For example, if a taxpayer has a history of compliance with the tax code prior to the year in which an accuracy-related penalty is imposed, this fact would weigh in favor of waiving the penalty.

Finally, we are concerned about the possibility that taxpayers will incur penalties because their preparers did not adequately investigate the facts (as opposed to authority). While we recognize that the taxpayer is uniquely in possession of the facts regarding his or her financial affairs, the tax preparer, for this population, possesses the knowledge the taxpayer needs in order to comply with the tax laws. All too often our clients tell us they were never asked for information that was vital to accurate return preparation. In interviewing our clients, we asked for it; why did not their preparers? While the standards for fact investigation may differ between controversy practice and return preparation, there is a minimum level of inquiry. In

many of our clients' cases, we find that the tax preparer has not satisfied even the minimum level of inquiry.

Thus, we recommend that Circular 230 be revised to include standards for all tax professionals as to factual as well as analytic investigation. We further recommend that Treasury study and propose a method of registration and regulation of unenrolled commercial preparers which will result in these preparers being better educated about their professional responsibility to the tax system and their clients. We also support continuing education requirements for these preparers. The requirement should establish a minimum number of hours of annual training in ethics and professional responsibility, including IRC § 6103.

I understand that such regulation may increase the costs of tax preparation for taxpayers who can barely afford preparation now. There are solutions to that problem, including the expansion of VITA sites through IRS administered grants for program administration expenses; the expansion of free tax preparation at IRS customer service offices; and the expectation of pro bono service on the part of all tax professionals, such expectation being incorporated into the Circular 230 standards and into any standards governing unenrolled preparers.

Administrative Provisions

We suggest that the Service create a separate form on which the taxpayer can apply for penalty and interest abatement, with clear, easy-to-understand instructions, similar to Form 8857 for IRC §6015 relief. This new form should contain an option for requesting penalty and interest abatement on the grounds of innocent spouse relief. (Alternatively, Form 8857 could include an option to request only penalty and interest abatement on Section 6015 grounds.)

We also suggest that IRC §§ 6320 and 6330 be amended to include a specific provision authorizing penalty and interest relief to be considered in a Collections Due Process Hearing and that the United States Tax Court have jurisdiction to review such claims. This new jurisdiction would have to be coordinated with existing Section 7481.

Both within and without the Collections Due Process procedures, full payment of tax with penalty and interest abatement should be considered a viable collection alternative in appropriate cases. In these situations, the abatement of penalty and interest could be conditioned upon the taxpayer's ongoing tax compliance for the next five years, as is currently the practice in the offer-in-compromise context. Failure to comply would result in reinstatement of the penalties and interest.

We believe that low income taxpayers need a local IRS presence to resolve their tax problems. Therefore, although we support the concept of establishing a separate penalty review unit in each operating division, we believe this unit must have representatives in the field handling penalty and interest protests.

Finally, we encourage the Committee to consider granting the United States Tax Court equity jurisdiction over the Treasury Secretary's proposed equitable abatement of penalties and interest. We also believe that the Tax Court should clearly be granted jurisdiction over IRC § 6015(f) equitable relief from joint and several liability for tax debts, since the denial of equitable relief in this context often functions as a tax penalty. I believe this judicial review will reinforce Congress' intent that penalty and interest be imposed where they truly serve some purpose and do not undermine the collection of tax. We need not be fearful of granting avenues of relief and equity jurisdiction. Court opinions provide taxpayers with a firm measure of what is acceptable behavior and what is not. Judicial review can only enhance compliance and taxpayers' confidence in the tax system.

CONCLUSION

Mr. Chairman, thank you for the opportunity to appear before the Committee today. I will be pleased to respond to any questions you might have about my testimony or related matters.

Joint Committee on Taxation
March 7, 2000
JCX-23-00

TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION CONCERNING INTEREST AND PENALTIES AND CORPORATE TAX SHELTERS BEFORE THE SENATE COMMITTEE ON FINANCE

March 8, 2000

My name is Lindy Paull. As Chief of Staff of the Joint Committee on Taxation, it is my pleasure to present the written testimony of the staff of the Joint Committee on Taxation (the "Joint Committee staff") at this hearing concerning interest and penalties and corporate tax shelters before the Senate Committee on Finance.[1]

Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (the "IRS Reform Act") directed the Joint Committee on Taxation and the Secretary of the Treasury to conduct separate studies of the present-law interest and penalty provisions of the Internal Revenue Code (the "Code") and to make any legislative or administrative recommendations they deem appropriate to simplify interest and penalty administration or reduce taxpayer burden. The studies were required to be submitted to the House Committee on Ways and Means and the Senate Committee on Finance by July 22, 1999.

In responding to this legislative mandate, the Joint Committee staff undertook an extensive study of the present-law system of interest and penalties. The Joint Committee staff reviewed each of the interest and penalty provisions in the Code. The Joint Committee staff economists analyzed the economic considerations that affect taxpayers' decisions with respect to compliance and the Federal government's decisions in setting enforcement parameters, including penalties. The Joint Committee staff met with representatives of the Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "IRS"), requested the General Accounting Office to investigate IRS practices regarding interest and penalties and, with the assistance of the Library of Congress, reviewed interest and penalty regimes in other countries. The Joint Committee staff solicited comments from taxpayers, tax practitioners, tax clinics serving low-

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[1] This testimony may be cited as follows: Joint Committee on Taxation, *Testimony of the Staff of the Joint Committee on Taxation Concerning Interest and Penalties and Corporate Tax Shelters Before the Senate Committee on Finance, March 8, 2000* (JCX-23-00), March 7, 2000.

income individuals, and other interested parties, and met with representatives of major taxpayer groups and professional organizations to discuss their comments.

The Joint Committee staff study[2] includes a variety of recommendations to modify the present-law system of interest and penalties. These recommendations are designed to improve the overall administration of interest and penalties and to provide consistency in application with respect to similarly situated taxpayers. This is the focus of Part I of our testimony.

Part II of our testimony focuses on recommendations made by the Joint Committee staff with respect to corporate tax shelters, which are contained in Part VIII of the Joint Committee staff study. Our testimony includes an attachment containing data regarding Federal income tax receipts and corporate income.[3] Our previous testimony before the House Committee on Ways and Means on corporate tax shelters also included an analysis of the issues presented by various corporate tax shelter proposals.[4] We are currently updating the analysis and will supply it to the Committee once it is completed.

PART I -- INTEREST AND PENALTIES

A. Recommendations Relating to Interest

Equal treatment for all taxpayers

A single interest rate should be applied to all tax underpayments and overpayments for all taxpayers. The single interest rate should be set at the short-term applicable Federal rate plus five percentage points ("AFR+5").

The Joint Committee staff recommendation is based on the concept that the Federal government and taxpayers, to the greatest extent possible, should be treated equally in the payment of interest. Equal treatment of interest would enhance perceptions of fairness and would simplify interest computations in situations involving overpayments and underpayments during overlapping periods of time. To achieve equal treatment, the same rate of interest should

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[2] 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)* (JCS-3-99), July 22, 1999 (the "Joint Committee staff study").

[3] Joint Committee on Taxation, *NIPA and Federal Income Tax Receipts Data* (JCX-24-00), March 7, 2000. This attachment, which is similar to that presented to the House Committee on Ways and Means on November 10, 1999 (JCX-83-99), reflects recent baseline modifications.

[4] Joint Committee on Taxation, *Description and Analysis of Present-Law Tax Rules and Recent Proposals Relating to Corporate Tax Shelters* (JCX-84-99), November 10, 1999.

apply to payments by a taxpayer to the Federal government and to payments by the Federal government to a taxpayer, irrespective of whether the taxpayer is an individual or corporation, and without regard to the amount of the underpayment or overpayment of tax.

Present law does not embody this concept of equality. Corporations are required to pay higher interest rates on underpayments than the interest rates received on overpayments. Under certain circumstances, the rate of interest paid by a corporation on a large underpayment is four and one-half percentage points higher than the interest rate that would be paid by the Federal government on a large overpayment.[5]

The IRS Reform Act moved toward equal treatment by requiring that the same rate of interest apply to underpayments and overpayments of individual taxpayers. The IRS Reform Act also provided a net interest rate of zero for interest payable by and allowable to a taxpayer on equivalent amounts of underpayments and overpayments for the same period. However, the implementation of the zero net interest rate is expected to be complicated. The legislative history to the IRS Reform Act recognizes that implementation of the zero net interest rate may be dependent on taxpayer initiative while the IRS develops procedures for the automatic application of the zero net interest rate. The Joint Committee staff recommendation to apply a single interest rate to underpayments and overpayments of all taxpayers would eliminate most of the implementation issues for taxpayers and the IRS.

Interest paid to an individual taxpayer on an overpayment of tax should be excluded from gross income.

Interest paid by the Federal government to a taxpayer should be treated for Federal income tax purposes in the same manner as interest paid by a taxpayer to the Federal government. Under present law, individual taxpayers are required to include in gross income interest received from the Federal government, but they are not allowed to deduct interest paid to the Federal government.[6] This inequality in treatment may cause individual taxpayers to believe that the Federal income tax laws are not fair.

Prior to 1987, interest paid by an individual was generally deductible so long as it was not incurred as a cost of carrying tax-exempt bonds. However, as part of an effort to eliminate the deduction of various personal expenses, the Tax Reform Act of 1986 made most types of personal interest nondeductible. Treasury regulations take the position that nondeductible

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[5] The current interest rate for a large corporate underpayment is 10 percent (so-called "hot" interest), compared with 5.5 percent paid by the Federal government on a large corporate overpayment (so-called "cold" interest). Rev. Rul. 99-53, 1999-50 I.R.B. 657 (Dec. 13, 1999).

[6] This disparity in treatment does not exist for corporations. Under present law, corporations generally are allowed to deduct interest paid to the Federal government and interest received from the Federal government is included in gross income.

personal interest includes interest paid on underpayments of Federal income tax, regardless of the source of the income generating the tax liability.[7]

It is noteworthy that no deduction is allowed under the Treasury regulations even if the interest relates to a deficiency in tax on business activities. Other interest incurred in the course of operating a business generally is deductible. The Tax Court has held the regulation position to be unreasonable, and therefore invalid.[8] However, the U.S. Courts of Appeals have consistently upheld the validity of the regulation,[9] although these courts have expressed some reservations as to its wisdom.

The Joint Committee staff recommends excluding interest paid to an individual on an overpayment of tax to eliminate the inequality in treatment of individual taxpayers and the Federal government. Allowing individual taxpayers to exclude interest on overpayments, rather than deduct interest on underpayments, insures that individual taxpayers will be treated equally, whether or not they itemize deductions.

Abatement of Interest

Under present law, the Secretary of the Treasury is authorized to abate interest in limited instances. Such circumstances include an unreasonable delay by the IRS in the performance of a managerial or ministerial act, a failure by the IRS to contact an individual taxpayer in a timely manner, an erroneous refund by the IRS of $50,000 or less, and during periods when the taxpayer is serving in a combat zone or is located in a designated disaster area.

Numerous situations arise in which the resolution of a taxpayer's case has been delayed as a result of events arising in their dealings with the IRS. By allowing for interest abatement only in specific situations that rarely occur, present law ties the hands of the IRS and prevents it from assisting taxpayers by abating the interest that accumulates during such delays. The circumstances in which the Secretary of the Treasury is authorized to abate interest should be expanded to cover additional situations where the collection of interest from the taxpayer is inappropriate.

The Secretary should be authorized to abate interest that is attributable to unreasonable IRS errors or delays, whether or not related to managerial or ministerial acts.

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[7] Treas. Reg. sec. 1.163-9T(b)(2).

[8] *Redlark v. Commissioner*, 106 T.C. 31 (1996), *rev'd*, 141 F. 3d 936 (9th Cir., 1998).

[9] The validity of the temporary regulation has been upheld in those Circuits that have considered the issue, including the Fourth, Sixth, Seventh, Eighth, and Ninth Circuits.

It is not appropriate to require taxpayers to pay interest for periods when the sole reason the taxpayer's case was not resolved in a timely manner relates to error or delay on the part of the IRS. The present-law rule prevents abatement in situations in which unreasonable delay on the part of the IRS is clearly present, but the reason for the delay does not meet the technical and limited definition of a managerial or ministerial act or the taxpayer cannot identify the specific act on the part of the IRS causing the delay. The present-law rule also serves as an excuse for IRS refusals to consider the abatement of interest. For example, a taxpayer's application for abatement would automatically be rejected under present law if the IRS spent excessive time due to obvious errors by a revenue agent in interpreting and applying the tax laws, an examining agent's choice of which assigned cases to handle at a point in time, or the perceived need of the IRS to resolve other cases first.

The Secretary should be required to abate interest on any erroneous refund not caused by the taxpayer.

Under present law, the Secretary is required to abate interest on erroneous refunds of $50,000 or less, provided the taxpayer has not in any way caused the erroneous refund. The $50,000 limitation should be eliminated and interest abated on any erroneous refund not caused by the taxpayer. If the taxpayer has done nothing to cause the erroneous refund, interest should not be charged until after the IRS requests the return of the money.

The Secretary should be required to abate interest on an underpayment if the underpayment is attributable to erroneous advice furnished to the taxpayer in writing by an officer or employee of the IRS acting in his or her official capacity.

Under present law, penalties and additions to tax (but not interest) must be abated if they are attributable to erroneous advice furnished to the taxpayer in writing by an officer or employee of the IRS acting in his or her official capacity. A taxpayer who follows the erroneous written advice of the IRS should not be charged interest for following that advice.

The Secretary should be granted the authority to abate interest if a gross injustice would result if interest is charged.

The Secretary should not be precluded from preventing a gross injustice solely because the particulars of a situation have not been provided for by law. It is anticipated that this authority would be used infrequently and only in situations in which the taxpayer has not materially contributed to the accrual of the interest.

<u>Interest on disputed underpayments</u>

Taxpayers should be allowed to establish interest-bearing accounts within the Treasury to stop the running of interest on taxes expected to be in dispute with the IRS.

Present law provides limited opportunities for a taxpayer to stop the accrual of interest prior to or during an IRS audit. A taxpayer may make a payment in the nature of a cash bond. However, such a cash bond does not earn interest. Taxpayers and their representatives rarely consider this procedure for these reasons. As a result, taxpayers incur significant interest charges while waiting for their cases to be resolved.

Tax administration would be benefitted by a mechanism that would allow taxpayers to manage exposure to underpayment interest without requiring the taxpayer to prepay tax on disputed items or to make a potentially indefinite-term investment in a non-interest bearing account. The Joint Committee staff recommends that taxpayers should be allowed to deposit amounts in a new "dispute reserve account." A dispute reserve account would be a special interest-bearing account within the U.S. Treasury that could be established by a taxpayer for any type of tax that is due for any period. Amounts could be withdrawn from a dispute reserve account at any time, and would earn interest from the date of deposit at a rate equal to the short-term AFR. If an amount in the dispute reserve account is applied to pay an underpayment of tax, it is treated as a payment of tax on the original deposit date. The dispute reserve account could be especially helpful for lengthy audits with difficult issues or open audits of related passthrough entities.

B. Recommendations Relating to Accuracy-Related Return Standards for Taxpayers and Tax Preparers

Under present law, different penalties may apply to taxpayers and tax return preparers for positions taken on tax returns that do not meet specified accuracy-related standards. The Joint Committee staff recommends (1) harmonizing the standards for taxpayers and tax preparers applicable under the accuracy-related penalties and (2) increasing the amount of the return preparer penalty. The Joint Committee staff believes that these recommendations will improve both the equity and administrability of the accuracy-related penalty system.

<u>Undisclosed tax return positions</u>

The minimum standard for each undisclosed position on a tax return should be that the taxpayer or tax preparer reasonably believes the return position is "more likely than not" the correct tax treatment under the Code.

This standard, which would apply equally to taxpayers and tax preparers, would imply that, at the time the return was signed, there was a greater than 50-percent likelihood that all

undisclosed positions would be sustained if challenged. In light of our recommendations to elevate these standards, the reasonable cause exception for the substantial understatement penalty should be eliminated.

Disclosed tax return positions

The minimum standard for each disclosed position taken or advised to be taken on a tax return should be that the taxpayer or tax preparer has "substantial authority" for such position.

This standard, which would apply equally to taxpayers and tax preparers, would imply that, at the time the return was signed, there was a greater than 40-percent likelihood that all adequately disclosed positions would be sustained if challenged.[10]

Revise tax preparer penalty amounts

The preparer penalty should be revised to better reflect the potential tax liabilities involved. The penalty for understatements due to unrealistic positions should be changed from a flat $250 to the greater of $250 or 50 percent of the tax preparer's fee. The penalty for willful or reckless conduct should be changed from a flat $1,000 to the greater of $1,000 or 100 percent of the preparer's fee.

The accuracy-related and tax preparer penalties are designed to delineate (1) when an erroneous position taken on a tax return should be considered innocent and not subject to penalty, (2) when taxpayers should specifically notify the IRS that they are adopting controversial positions, and (3) when taxpayers are taking unduly aggressive positions and should be penalized for any resulting tax deficiency regardless of disclosure. The flat $250 penalty of present law, for example, may have little deterrent effect if the tax preparer's fee is many times that amount.

Discussion of accuracy-related standards

Because Federal tax law is complex and constantly evolving, it is unrealistic to expect taxpayers to file "perfect" returns, on which every position taken is unquestionably correct. Still,

[10] Under the Joint Committee staff recommendations relating to corporate tax shelters, a higher standard would apply with respect to corporate tax shelter transactions. This higher standard would require, among other things, that the corporate participant believes there is at least a 75-percent likelihood that the tax treatment would be sustained on the merits. For tax shelter transactions not involving corporations, the present-law standard of "more likely than not" would continue to apply as a means to avoid an understatement penalty with respect to disclosed positions.

the U.S. Supreme Court has pointed out that "self assessment...is the basis of our American scheme of income taxation."[11] Self assessment requires a high degree of cooperation from the taxpayer to file an accurate tax return. A self-assessment system will work properly if taxpayers perceive the system to be fair and believe that the costs of noncompliance outweigh the benefits of such noncompliance.

Under present law, a taxpayer is not subject to an accuracy-related penalty for an undisclosed improper return position provided there is "substantial authority" for the position. The regulations describe substantial authority in terms of a spectrum,[12] with most practitioners assuming substantial authority implies a 40-percent chance of success if challenged by the IRS. In assessing whether a position is supported by substantial authority, certain specified sources of authority may be consulted.

Under present law, a taxpayer is not subject to the substantial understatement penalty for a disclosed improper return position provided there is a "reasonable basis" for the position. Most practitioners assume a reasonable basis exists for a position if there is at least a 20-percent likelihood of success if challenged by the IRS.

However, under present law, tax preparers are held to lower standards than taxpayers. For undisclosed return positions, the tax preparer is not subject to the tax preparer penalty if the return position has a "realistic possibility of being sustained," which most practitioners believe falls between substantial authority and reasonable basis standards for taxpayers. If a return position is disclosed, a tax preparer need only ensure that the return position is "not frivolous." The "not frivolous" standard has been interpreted to mean there exists a five- to ten-percent chance of the return position being successful if challenged by the IRS.

The accuracy-related penalty generally is abated if the taxpayer can demonstrate there was a "reasonable cause" for the underpayment. Generally, if the taxpayer relies in good faith on the advice of a tax professional, the taxpayer would satisfy the reasonable cause requirement. Thus, the standards for taxpayers and tax preparers are interrelated and it is inappropriate for tax preparers to be held to a lower standard than taxpayers.

These present-law standards for imposition of accuracy-related penalties on taxpayers and return preparers arguably permit taxpayers to take positions on tax returns that have an inappropriately low chance of success if challenged by the IRS. These low standards have the effect of increasing perceptions of unfairness in our tax system because taxpayers who take aggressive positions on their returns and their advisors are unlikely to be penalized. If taxpayers and preparers are not held to standards which require them to believe information reported on tax

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[11] *Commissioner v. Lane Wells Co.*, 321 U.S. 219, 223 (1944).

[12] Treas. Reg. sec. 1.6662-4(d)(2).

returns is in fact correct, the IRS will have the impossible task of examining greater percentages of returns in order to maintain the fairness of our tax system.

C. Recommendations Relating to the Penalty for Failure to Pay Taxes

The failure to pay taxes penalty should be repealed. Interest would continue to apply to the underpaid amount, but at the single rate of AFR+5 discussed above. An annual late payment service charge would also apply to taxpayers who have not paid their taxes or have not entered into installment agreements in a timely manner.

Under the Joint Committee staff recommendation, the failure to pay taxes penalty would be repealed and taxpayers would be given four months after assessment[13] in which to pay their tax obligations and be charged interest only. At the end of that four-month period, if the taxpayer still has not fully paid the taxpayer's tax obligation, or entered into an installment agreement to pay such obligation, the taxpayer would be charged an annual 5-percent late payment service charge on the remaining outstanding balance. This service charge would be similar to late payment charges that are widely imposed in the private sector. Thus, taxpayers would easily understand the purpose of the charge--to encourage timely payment. To avoid the service charge, taxpayers would have a strong incentive to enter into an installment agreement in a timely fashion, rather than waiting for a long period of time and letting interest continue to mount without making further payments. The repeal of the penalty for failure to pay taxes and its replacement with the service charge would further a policy initiative to encourage the use of installment agreements that was begun by the IRS Reform Act, which reduced this penalty for taxpayers who enter into installment agreements.[14]

The late payment service charge would operate in the following way. If a taxpayer has not entered into an installment agreement by the fourth month after assessment, a 5-percent late payment service charge would be imposed on the balance remaining unpaid at the end of that four-month period. This 5-percent late payment service charge would also be imposed each year on the anniversary of its original imposition on the balance remaining unpaid at that anniversary date, unless the taxpayer has entered into an installment agreement with the IRS and has remained current on that agreement. For example, if an individual files an income tax return on April 15, but the full amount shown as due on that return is not paid with that return, the taxpayer must either pay the remaining taxes or enter into an installment agreement by August 15 to avoid the late payment service charge. Abrogation of an installment agreement by the taxpayer would result in the immediate imposition of the 5-percent late payment service charge.

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[13] This provision would apply to self-assessments (amounts shown on an original return but not paid with that return) as well as assessments later made by the IRS.

[14] Sec. 6651(h).

Taxpayers who enter into installment agreements and who also agree to an automated withdrawal of each installment payment directly from their bank account would not be required to pay the present-law $43 fee for entering into an installment agreement.

The elimination of the $43 user fee for installment agreements for taxpayers who both enter into installment agreements and who agree to use automated mechanisms, such as automated debits from a bank account, to pay their installment payments is designed to increase the certainty of timely payment, simplify the payment process for taxpayers, decrease administrative costs of collection for the IRS, and eliminate what some taxpayers may view as a barrier to entering into an installment agreement.[15]

D. Recommendations Relating to Estimated Tax Penalties

The estimated tax penalty should be repealed and replaced with an interest charge using the single interest rate of AFR+5 discussed above. Many computational details also should be simplified. The threshold below which individuals are not subject to the estimated tax penalty (currently $1,000) should be increased to $2,000 and the calculation of this threshold should be modified to take into account equal estimated tax payments.[16]

Approximately 12 million individuals make estimated tax payments. Many of these individuals find that calculating the correct amount of estimated tax payments is complex and confusing. The Joint Committee staff recommendations would provide significant simplification for many of these individuals.

The Joint Committee staff recommends converting both the individual and the corporate estimated tax penalties into interest charges to more closely conform the titles and descriptions of those provisions with their effect. Because these penalties in fact are computed as an interest charge, conforming their title to the substance of their function may improve taxpayers' perceptions of the fairness of the tax system. The present-law penalties are essentially a time value of money computation that is not punitive in nature. The Joint Committee staff also recommends that no interest on underpayments of estimated tax should be required for individual

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[15] The cost to the IRS of administering these automated payment mechanisms is less than one dollar per payment. *See*, Tax Notes, "OIC, Third-Party Contact Guidance Imminent, *Ex Parte* Guidance Soon," June 14, 1999, at 1544.

[16] In calculating the $2,000 threshold, amounts withheld (such as income tax withholding from wages) would be taken into account as under present law.

taxpayers if the balance due shown on the return is less than $2,000.[17] In calculating this threshold, withholding would continue to be considered as under present law. The Joint Committee staff also recommends that equal estimated payments be included in calculating the threshold. This would considerably simplify the computation of estimated tax payments and interest for many individuals, and eliminate the need for many of these individuals to calculate a penalty on underpayments of estimated tax altogether.

In addition to the recommendations to convert the present-law estimated tax penalty into an interest provision and to increase the threshold from $1,000 to $2,000, the Joint Committee staff recommends making several specific changes to the estimated tax rules that would significantly reduce complexity in calculating the interest charge for failure to pay estimated tax.

The modified safe harbor should be repealed.

Under present law, taxpayers with an adjusted gross income over $150,000 ($75,000 for married taxpayers filing separate returns) who make estimated tax payments based on the prior year's tax generally must do so based on 110 percent of the prior year's tax.[18] By repealing this rule, the same estimated tax safe harbor would apply to all individual taxpayers. Thus, to the extent that the special rule is eliminated, the estimated tax rules would be simplified, because all individual taxpayers would meet the estimated tax safe harbor if they made estimated payments equal to (1) 90 percent of the tax shown on the current year's return, or (2) 100 percent of the prior year's tax.

Eliminate the need for numerous separate interest rate calculations.

Under present law, if interest rates change while an estimated tax underpayment is outstanding, taxpayers are required to make separate calculations of interest for the periods before and after the interest rate change. The Joint Committee staff recommends applying a single interest rate for any given estimated tax underpayment period. This would be the rate applicable to the first day of the quarter in which the pertinent estimated tax payment due date arises.

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[17] No interest would be charged as a result of underpayments of estimated taxes. However, if the full balance due shown on the return is not paid with the return, taxpayers would be charged interest from the due date of the return on the resulting underpayment.

[18] The applicable 110 percent is modified when the prior taxable year begins in 1998 through 2001. The applicable percentage is 105 when the prior taxable year begins in 1998, 108.6 when the prior taxable year begins in 1999, 110 when the prior taxable year begins in 2000, and 112 when the prior taxable year begins in 2001.

The definition of "underpayment" should be changed to allow existing underpayment balances to be used in underpayment calculations for succeeding estimated tax payment periods.

Under the current estimated tax rules, underpayment balances are not cumulative, and each underpayment must be tracked separately in determining the penalty for underpayment of estimated tax. Thus, each underpayment balance runs from its respective estimated payment due date through the earlier of the date it is paid or the following April 15th. This often requires multiple interest calculations for each underpayment. Under the Joint Committee staff recommendation, taxpayers would calculate the cumulative estimated tax underpayment for each period or quarter and would apply the appropriate interest rate as of that date. Thus, only one calculation would be needed for each underpayment period. This change would reduce complexity in calculating the interest on an underpayment of estimated tax by reducing the number of calculations required to compute the interest.

A 365-day year should be used for all estimated tax interest calculations.

Under current IRS procedures, taxpayers with underpayment balances that extend between a leap year and a non-leap year are required to make separate calculations solely to account for the difference in the number of days during each year. By requiring a 365-day year for all estimated tax calculations, this extra calculation would be eliminated.

E. Other Recommendations

Pension-related penalties

The number of potential penalties for failure to file the Form 5500 series annual return should be reduced from six to one. The IRS should have the sole responsibility for enforcement of the Code and ERISA reporting requirements.

This reduction in the number of potential penalties would result from the consolidation of the ERISA and Code penalties for failure to file an annual return, and the repeal of the separate Code penalties for failure to file the required schedules and plan status change notification. The IRS should be designated as the agency responsible for enforcement of the Code and ERISA reporting requirements applicable to pension and deferred compensation plans, thereby reducing from three to one the number of government agencies authorized to assess, waive, and reduce penalties for failure to file the Form 5500 series annual return.

Under present law, the Code and ERISA require a plan administrator of a pension or other funded plan of deferred compensation to file a Form 5500 series annual return with the Secretary of the Treasury, the Department of Labor, and, for some plans, the Pension Benefit Guaranty Corporation ("PBGC"). For failure to file a timely and complete annual return, the

Code imposes on the plan administrator a penalty equal to $25 per day, not to exceed $15,000 per return. In addition, ERISA provides that both the Secretary of Labor and the PBGC may impose on the plan administrator a penalty of up to $1,100 per day. The Secretary of the Treasury, the Secretary of Labor, and the PBGC may waive their respective penalties if the plan administrator demonstrates that the failure to file is due to reasonable cause. Separate Code penalties also apply if administrators fail to file Schedules SSA, Schedule B, or plan status change notification.

The separate Code and ERISA penalty provisions, and the separate Code penalty provisions for Schedule SSA, Schedule B, and notification of a plan status change, complicate the Form 5500 series annual return penalty structure and create the possibility that a plan administrator may face multiple penalties for a failure to file one return. A plan administrator that fails to file an annual return may be required to pay six different penalties to three different government agencies. A plan administrator who seeks abatement of the penalties may be required to demonstrate the existence of reasonable cause to three different government agencies and may receive a different determination from each agency as to the sufficiency of the demonstration.

Penalty for failure to file annual information returns for charitable remainder trusts

The penalty for failure to file annual trust information returns should expressly apply to the failure of a split-interest trust to file Form 5227. The penalty imposed on trusts for failure to file Form 5227 should be set at amounts comparable to the penalties imposed on tax-exempt organizations for failure to file annual information returns.

Under present law, it is not clear that the penalty for failure to file annual trust information returns applies to a split-interest trust's failure to file Form 5227. Form 5227, however, is critical to the enforcement efforts of the IRS as it provides detailed information regarding the financial activities of split-interest trusts[19] and possible liabilities for private foundation excise taxes to which these trusts are subject. Increasing the penalty imposed on trusts that fail to file required information returns and ensuring that all relevant returns are subject to such penalty would encourage voluntary compliance by delinquent filers and would assist the IRS in obtaining information about the activities of such trusts.

[19] Split-interest trusts are trusts in which some but not all of the interest is held for charitable purposes. Although these trusts are not private foundations, they are subject to some private foundation rules.

PART II -- CORPORATE TAX SHELTERS

A. Methodology

The Joint Committee staff recommendations regarding corporate tax shelters are an important component of the penalty and interest study. The Joint Committee staff study focused on the present-law sanctions that relate to the collection of the proper amount of tax liability, such as penalties relating to payment of the proper amount of tax, reporting of income, and failure to provide information retūrns or reports. After reviewing the various interest and penalty provisions, it became clear that a comprehensive study of the present-law penalty provisions applicable to corporate tax shelters was appropriate.

The Joint Committee staff evaluated the effectiveness of the interest and penalty rules applicable to corporate tax shelters in addressing current corporate tax shelter transactions. As part of the review process, the Joint Committee staff analyzed:

(1) The substantive laws in the Code that are designed to, among other things, deter tax-shelter transactions[20] and their interaction with the interest and penalty rules;

(2) The various common-law doctrines used by the courts to evaluate and potentially disallow tax benefits claimed in tax shelter transactions[21] and the imposition of penalties with respect to these transactions; and

(3) The standards of practice that affect certain advisors in connection with tax shelter activity and that are intended to have certain deterrent and punitive aspects.[22]

The Joint Committee staff spent considerable time analyzing recent transactions involving corporate participants that have given rise to legislative or administrative responses. The Joint Committee staff economists analyzed the economic considerations that affect corporate taxpayers' decisions with respect to engaging in tax shelter activity. The Joint Committee staff consulted with representatives of the Treasury Department, and reviewed various comments and proposals that have been made with regard to corporate tax shelters, including:

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[20] Secs. 269, 446, 482 and 7701(l).

[21] The common-law doctrines include the sham transaction doctrine, the economic substance doctrine, the business purpose doctrine, the substance over form doctrine, and the step transaction doctrine.

[22] *See* regulations found in Title 31, Part 10 of the Code of Federal Regulations. In addition, the Joint Committee staff reviewed various standards of practice and rules of professional conduct of the American Bar Association, the American Institute of Certified Public Accountants, and general state licensing authorities.

(1) The Administration's proposals that were included in the FY 2000 Budget, as supplemented by the Treasury White Paper on corporate tax shelters;[23]

(2) H.R. 2255, The Abusive Tax Shelter Shutdown Act of 1999, introduced on June 17, 1999 by Representatives Doggett, Stark, Hinchey, Tierney, Allen, Luther, Bonior, and Farr;[24]

(3) Comments and recommendations submitted by various groups to this Committee and the House Committee on Ways and Means, including groups such as the Tax Executives Institute, the American Bar Association Section of Taxation, the New York State Bar Association Tax Section, and the American Institute of Certified Public Accountants; and

(4) Comments that were submitted to the Joint Committee staff in connection with the Joint Committee staff study.

B. Analysis

In analyzing the effectiveness of the present-law penalty provisions with respect to corporate tax shelters, the Joint Committee staff first addressed two fundamental questions. The first question is whether there is, in fact, a corporate tax shelter problem. If there is a corporate tax shelter problem, the second question is why such a problem exists.

C. The Corporate Tax Shelter Problem

The Joint Committee staff believes that there is a corporate tax shelter problem -- more corporations are entering into highly structured arrangements with little or no economic substance principally to avoid tax. The Joint Committee staff believes the problem is becoming widespread and significant.

Some commentators and interested parties question whether there is a corporate tax shelter problem. They contend that the heightened scrutiny the issue has received in recent years is mostly attributable to recent press reports. These commentators cite the lack of economic data showing a decline in corporate tax receipts as an indication that no problem exists.

Admittedly, much of the evidence in this area is anecdotal, but the importance of this evidence should not be discounted. The parties involved in developing, marketing, or

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[23] These proposals, with some modifications, were included in the President's Fiscal Year 2001 Budget proposal, submitted on February 7, 2000.

[24] Most recently, this proposal was included in an amendment offered by Senator Bob Graham to the Affordable Education Act of 1999. *See* 146 Cong. Rec. S886-87 (Feb. 28, 2000).

63-714 00 - 6

implementing a tax shelter generally benefit by keeping its existence confidential. For example, some firms intentionally limit the sale of a corporate tax shelter to only a few taxpayers in an attempt to shield the arrangement from scrutiny by the Congress and the Treasury Department. The existence of the tax shelter is revealed only when a potential customer or a competitor anonymously discloses the arrangement to a government official.

Recent data suggest that corporate tax receipts are not keeping pace with a growing economy. For example, in fiscal year 1999, corporate income tax receipts actually fell by approximately $4 billion, representing a decline of approximately two percent, from the prior fiscal year[25] at the same time that corporate profits rose by approximately 3.6 percent. The last year in which there was a decline in corporate tax receipts was in fiscal year 1990, a period in which the economy was softening and entering the brief recession that began in the last half of 1990. For reference, aggregate data on corporate income tax receipts and corporate profits are presented in the Appendix to our testimony.

Commentators and interested parties have analyzed the macroeconomic data to reach differing opinions regarding whether there is a corporate tax shelter problem. For example, some argue that the decrease in corporate tax receipts in fiscal year 1999 is evidence that a corporate tax shelter problem exists and is expanding. Others emphasize that corporate tax receipts represent a mixture of current and past corporate tax liabilities, and that the data show that the underlying corporate income tax liability is keeping pace with the corresponding corporate profits.

The Joint Committee staff believes that the data are not sufficiently refined to provide a reliable measure of corporate tax shelter activity. Many tax shelter transactions distort the reported measure of corporate profits in a manner similar to their impact on the corporate tax base. In addition, factors unrelated to corporate tax shelter activity affect the relationship between corporate income tax receipts and corporate profits. These factors include: year-to-year changes in corporate economic losses and carryovers, changes in the timing of tax payments, legislative changes, and the increased use of corporate form that is not subject to the corporate income tax (*i.e.*, S corporations).

The Joint Committee staff believes that direct measurement of corporate tax shelter activity through macroeconomic data is not possible. Instead, a more instructive approach may be to analyze specific tax shelter transactions that have come to light and evaluate their effect on corporate receipts. Because this approach only considers a few of the corporate tax shelter transactions, it necessarily understates the size of the corporate tax shelter problem. This approach, nonetheless, provides a useful reference point for consideration of the size of the problem. In the past three years, the courts have disallowed tax benefits in several high-profile

[25] Budget of the United States Government: Fiscal year 2001.

corporate tax shelter cases. For example, in *ACM Partnership v. Commissioner,*[26] the Third Circuit Court of Appeals disallowed a capital loss claimed in 1991 from a partnership arrangement because the arrangement lacked economic substance. The amount of the tax savings with respect to this case was approximately $30 million. The Joint Committee staff understands that there are at least eight other cases that raise issues similar to those described in the *ACM* case. The Joint Committee staff further understands that the amount in controversy from these cases (which may span several tax years), when added to the tax benefit at issue in *ACM*, would total approximately $1 billion in taxes.

A second recent corporate tax shelter case is *Compaq Computer Corp. v. Commissioner.*[27] In the *Compaq* case, the Tax Court disallowed a foreign tax credit claimed in 1992 with respect to a dividend from stock in a foreign corporation. The taxpayer bought and sold the stock within one hour in an arrangement that was structured to eliminate the taxpayer's economic risk from owning the stock. The disallowed tax credit in the *Compaq* case would have resulted in a tax benefit of approximately $3 million. The Joint Committee staff understands that there are more than 15 other cases that raise issues similar to those described in the *Compaq* case. The Joint Committee staff further understands that, when added to amount at issue in the *Compaq* case, the total amount in controversy with respect to these cases, which may span several tax years, is approximately $400 million in taxes.

A third recent corporate tax shelter case is *Winn-Dixie Stores, Inc. v. Commissioner.*[28] In the *Winn-Dixie* case, the Tax Court disallowed the interest deductions attributable to the taxpayer's 1993 leveraged corporate-owned life insurance ("COLI") program on the grounds that it lacked both economic substance and business purpose. The amount of purported tax savings in the *Winn-Dixie* case was approximately $1.6 million for one year of an arrangement that was intended to yield tax benefits annually over a 60-year period. The Joint Committee staff understands that there are over 100 cases in controversy which raise issues similar to those described in the *Winn-Dixie* case. The Joint Committee staff also understands that the amount in controversy with respect to these cases, which may span several tax years, is expected to be approximately $6 billion in taxes.

Looking only at the three arrangements that were at issue in these cases, it is estimated that these cases represent $7.4 billion in unpaid corporate taxes (approximately $1 billion from *ACM* and similar cases, approximately $400 million from *Compaq* and similar cases, and approximately $6 billion from *Winn-Dixie* and similar cases). The Joint Committee staff is continuing to review and analyze information regarding these cases as well as other tax shelter arrangements.

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[26] 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997).

[27] 113 T.C. No. 17 (Sept. 21, 1999).

[28] 113 T.C. No. 21 (Oct. 19, 1999).

Although these cases represent different tax years, this amount most likely represents a fraction of the corporate tax that the Federal government is not collecting because of corporate tax shelters. In many cases, the corporation that claims the tax benefits from a tax shelter escapes audit, or the tax shelter arrangement goes undetected during an audit. Even when the corporation is audited and the transaction is discovered, the hazards of litigation, the complexities of these transactions, and other factors may cause the IRS to opt for a negotiated settlement. Only a fraction of tax shelter activity actually results in a judicial determination. In addition, as these cases illustrate, several years may pass before a judicial determination is made with respect to a corporate tax shelter transaction, during which time similar transactions go undeterred. Thus, even though the outcome of the recent cases generally is favorable to the government, the case law (1) cannot be viewed as representative of the full magnitude of the problem, and (2) cannot be considered evidence that the corporate tax shelter problem is being contained.

An additional observation regarding the effect of tax shelters on corporate tax receipts bears discussion. The magnitude of the problem, be it a $10 million loss or a $10 billion loss, is a secondary issue in many respects. Practitioners indicate they are spending more of their time advising corporate clients regarding arrangements that are highly suspect, and tax executives complain they are getting "pitched" more and more "aggressive" transactions from promoters and advisors that are solely motivated to reduce the corporation's effective tax rate without any relation to a nontax business purpose or economic substance. Practitioners and corporate tax executives feel pressured to participate in such transactions, particularly when it appears that the corporation's competitor is doing a similar transaction and getting professional advice that such a transaction can avoid penalties because the professional advisor is willing to opine that the transaction is "more likely than not" to succeed. The perception of becoming competitively disadvantaged by others engaging in a tax-motivated transaction could result in more corporations and tax advisors engaging in these types of transactions. If one corporation is permitted to claim an unwarranted tax benefit that its competitors are reluctant to claim, then, in essence, the corporations (and their advisors) that "play by the rules" are being penalized.

Many prominent professional associations, such as the American Bar Association, the New York State Bar Association, the American Institute of Certified Public Accountants, and the Tax Executives Institute, have voiced their concerns with the growing presence of corporate tax shelters and their potentially harmful effects on the Federal income tax system.

D. Why a Corporate Tax Shelter Problem Exists

Critical to a corporation's decision of whether to enter into a tax shelter arrangement is a comparison of the expected net tax benefits with the expected costs of the arrangement. Such a "cost-benefit" analysis takes into account a corporate participant's economic risks in the event the expected net tax benefits fail to materialize. The imposition of a penalty should be a significant feature of the "cost" side of the equation, and the Joint Committee staff focused on the cost-benefit analysis in determining the effectiveness of the present-law penalty regime.

The Joint Committee staff believes present law does not provide sufficient disincentives to engaging in these types of transactions.[29] The cost-benefit analysis is skewed in favor of investing in corporate tax shelter transactions. There are significant potential benefits from entering into a corporate tax shelter transaction with little corresponding cost. The chances of a corporation being subject to a penalty from a corporate tax shelter are small. The Joint Committee staff believes that the cost of entering into abusive tax arrangements should be increased to deter this type of activity.[30] The most effective means of realigning the cost-benefit calculus is to clarify and enhance the present-law penalty regime.

E. Clarifying and Enhancing the Present-Law Penalty Regime

Although the present-law penalty regime includes certain specific provisions aimed at corporate tax shelters, the Joint Committee staff believes that the present-law structure is ineffective at deterring inappropriate corporate tax shelter activity. Nevertheless, the present-law penalty regime provides a useful framework from which refinements and improvements can be made. Moreover, because the policy considerations that gave rise to enactment of that framework in the first place (*i.e.*, deterrence of tax shelter activity) is just as true today, the present-law penalty regime appears to be the appropriate starting point in addressing the undesirable corporate shelter activity. The Joint Committee staff recommendations therefore focus on clarifying and enhancing the present-law corporate tax shelter penalty regime. A meaningful penalty regime would alter the cost-benefit analysis of corporate participants in a manner that will discourage abusive transactions without interfering with legitimate business activity.

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[29] The Joint Committee staff study identified other factors that have contributed to the increasing trend of corporate tax shelter activity. These factors are: (1) the emerging view of a corporate tax department as a profit center; (2) the relatively insufficient risk of penalties or other significant deterrents for entering into such transactions; (3) the role of tax advisor opinions in mitigating any risk of penalties; and (4) the insufficiency of standards of practice and the lack of enforcement of such standards.

[30] Corporations do not act alone in designing ways to avoid paying their fair share of taxes. Many other parties act in concert with the corporate taxpayer to facilitate such devices. As a result, the Joint Committee staff study recommends that the stakes (and standards) should be raised for these other participants as well, and disclosure should be required of promoters of corporate tax shelter activity.

F. Alternative Responses

Maintaining the status quo

Some have argued that no legislative response to the corporate tax shelter problem is necessary; the present-law penalty regime would be effective in deterring corporate tax shelter activity if only (1) the Treasury Department would issue long-overdue guidance with respect to the penalty regime, and (2) the IRS would enforce the existing rules.

Last week, the Treasury Department issued comprehensive regulations regarding the registration of tax shelters by promoters and the disclosure of tax shelter arrangements by corporate taxpayers. In addition, the Treasury Department and the IRS announced the formation of the Office of Tax Shelter Analysis, which will provide a centralized point for the review and analysis of tax shelter transactions.[31] Some will argue that Congress should allow some time for these new regulatory and administrative initiatives to be fully integrated into the tax system before enacting more changes.

The Joint Committee staff believes that the issuance of the regulations, and the creation of the Office of Tax Shelter Analysis, are important steps in the continuing response to the corporate tax shelter problem. Increased disclosure of questionable transactions would be helpful for the IRS in its efforts to enforce the tax law. As stated above, however, in addition to disclosure, the present-law penalty regime also should be strengthened. The new regulations do not (and cannot) modify the present-law penalty structure for either corporate investors in, or promoters of, corporate tax shelters. Accordingly, a legislative response is needed.

Some of the weaknesses in the present-law penalty structure may be attributable to a lack of statutory guidance with respect to recent legislation regarding corporate tax shelters. For example, the Taxpayer Relief Act of 1997 amended the accuracy-related penalty rules to cover any entity, plan or arrangement entered into by a corporate participant if "a significant purpose" is the avoidance or evasion of Federal income tax. There continues to be much uncertainty as to what constitutes "a significant purpose" for the accuracy-related penalty.[32]

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[31] *See* IRS Announcement 2000-12 (Feb. 28, 2000).

[32] Although the regulations issued last week define a "significant purpose of avoiding or evading Federal income tax" for promoter registration purposes, the regulations explicitly reject the application of the same "significant purpose" definition with respect to an accuracy-related penalty. Specifically, the preamble to the regulations (T.D. 8876) states that "[a]lthough the terms of section 6111(d)(1)(A) [the "significant purpose" language] which are part of the definition of a confidential corporate tax shelter, are similar to the definition of tax shelter under section 6662(d)(2)(C)(iii), these temporary regulations are not intended to define a tax shelter for purposes of section 6662, which relates to the imposition of penalties."

In addition, it appears that penalties are rarely collected in connection with tax shelters. The lack of imposition of present-law penalties may be, in part, a result of a lack of statutory guidance. For example, the facts and circumstances necessary to satisfy the reasonable cause exception to the substantial understatement penalty attributable to corporate tax shelters[33] is widely disputed. Some tax professionals believe an opinion from a tax advisor is all that is necessary. Others believe that if the tests in the regulations were enforced, few taxpayers would ever avoid this penalty. Given the wide range of interpretations, it is not surprising that the IRS generally waives the imposition of this penalty whenever a corporate taxpayer produces a favorable opinion letter from a professional tax advisor.

Another shortcoming of the section 6662 penalty for corporate tax shelters is that the penalty generally applies (in the absence of negligence) only if the understatement of tax is "substantial." For a corporation, an understatement is substantial only if it exceeds 10 percent of the tax that is required to be shown on the return (or if greater, $10,000). A corporation therefore can engage in corporate tax shelter activities knowing that it will not be subject to an understatement penalty provided that the tax benefit does not exceed this 10-percent threshold. For a large corporation, this can represent a significant amount. In addition, the penalty applies only if there is an overall underpayment of income tax for the taxable year, regardless of whether the tax return understates taxable income with respect to a specific transaction. As a result, a taxpayer could use overpayment items to offset the underpayment from a corporate tax shelter and thereby avoid a penalty.

Maintaining the status quo also results in greater pressure to address each specific tax shelter transaction separately. Although there has been a flurry of legislative activity aimed at specific corporate tax shelters in recent years, such ad-hoc responses, by their very nature, rarely are enacted in a timely manner. These responses typically do not occur until after there has been significant loss in revenue. Also, because legislative changes generally apply on a prospective basis, corporations that engage in this activity early during the "life cycle" of a corporate tax shelter often retain the inappropriate tax savings. When the changes are not entirely prospective, a fairness concern is raised insofar as taxpayers may not have sufficient notice that the legislative changes will have affected their transaction. And as a realistic matter, the government may never become aware of some transactions that would be considered as abusive corporate tax shelters.

Changing the cost-benefit calculus should deter taxpayers from entering into corporate tax shelters. While it is true that the IRS has won several recent tax shelter cases, litigation is an inefficient deterrent (because of the uncertainties of the audit process, the costs and hazards of litigation, delays in resolution, and similar reasons previously discussed), and the status quo does not provide sufficient disincentives for taxpayers to engage in tax shelter transactions.

The problems with the present-law penalty regime extend beyond taxpayer sanctions. There is little guidance and enforcement of standards for tax shelter opinions. If an advisor

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[33] Treas. Reg. sec. 1.6664-4(e).

provides an opinion to protect a taxpayer from penalty, there is little or no risk of sanction to the advisor if the opinion is later determined to be improper. The Joint Committee staff study includes recommendations on how the current rules with respect to the standards of practice before the IRS, known as Circular 230, should be revised to regulate the conduct of practitioners as it relates to corporate tax shelters. The Treasury Department also recognizes the need to review the rules governing practitioner conduct. Last week, the Treasury Secretary announced that the Treasury Department intends to issue an updated version of Circular 230 within the next six months.[34] The Joint Committee staff agrees that more emphasis must be placed on the professional conduct of tax practitioners as part of a comprehensive response to the corporate tax shelter problem.

A substantive law change

Some believe that clarifying and strengthening the penalty rules would be insufficient unless changes are also made to substantive tax law. The Joint Committee staff believes the substantive rules under present law, including the common law doctrines, provide a sufficient, well-developed body of law for corporations to consider when evaluating tax shelter arrangements. The problem is not that the IRS lacks the necessary tools to challenge the transaction, nor can it be said that each taxpayer was unaware of the common-law doctrines. For example, the courts in each of the cases previously discussed -- the *ACM* case, the *Compaq* case, and the *Winn-Dixie* case -- relied on well-known, long-standing common-law doctrines to disallow the claimed tax benefits. The problem is that, from an economic (*i.e.*, cost-benefit) perspective, the taxpayer is likely to conclude that, under present law, it had little (if any) financial risk by going forward with the transaction. One only needs to look at the imposition of penalties in the cases. No penalties were imposed in the *ACM* case, and no reference to penalties was made in the *Winn-Dixie* opinion. In the *Compaq* case, the Tax Court imposed a negligence penalty under section 6662, though the facts are somewhat unusual in that the taxpayer did not seek an opinion of counsel, and the court noted how the corporate officer did little due diligence (and shredded the spreadsheet). In other words, there seems to be sufficient, well-developed case law that is flexible and adaptable to address the substantive issue of whether a tax shelter exists. What is lacking is a meaningful penalty structure that would significantly alter the cost-benefit calculus.

Another important concern with enacting a substantive rule is the inherent difficulty of crafting a rule that is sensitive to the tax system's reliance on objective, rule-based criteria while

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[34] *See* remarks by Treasury Secretary Lawrence H. Summers, "Tackling the Growth of Corporate Tax Shelters," remarks to the Federal Bar Association, reprinted in 2000 TNT 40-34 (Feb. 28, 2000). The American Bar Association Tax Section also recently suggested strengthening the standards of practice under Circular 230. *See* American Bar Association Section of Taxation, *Report to Amend 31 C.F.R. Part 10, Treasury Department Circular 230, To Deal With "More Likely Than Not" Opinions Relating To Tax Shelter Items Of Corporations*, reprinted in 1999 TNT 211-11 (Nov. 2, 1999).

at the same time does not impede legitimate business transactions. A substantive law change should be precise so as to target abusive transactions but not affect legitimate business transactions. The difficulty lies in crafting a definition of a "tax shelter." There can be significant disputes as to whether a particular transaction is a tax shelter. This is why the Joint Committee staff study identifies certain common characteristics of corporate tax shelter arrangements, referred to as "tax shelter indicators,"[35] which, if present in an arrangement, would result in an understatement penalty only after a determination that the arrangement caused an understatement of the corporate participant's tax liability. It is not enough that the arrangement appears to be a tax shelter; there must be a determination that the tax treatment was improper <u>and</u> the taxpayer must have had less than a high level of confidence that the tax treatment was proper in order for a penalty to be imposed. This relieves much of the pressure of crafting a precise definition of a corporate tax shelter, which would exist if a substantive law change was adopted.

G. Summary

In summary, the cost-benefit analysis should be altered to discourage corporations from entering into abusive transactions without affecting legitimate business transactions. An enhanced penalty structure with more detailed disclosure requirements and more stringent standards for other participants in the corporate tax shelter would strike the appropriate balance and alter the cost-benefit analysis in a manner that would provide a sufficient deterrent effect.

H. Specific Recommendations

The Joint Committee staff recommends the following with respect to corporate tax shelters.

<u>Recommendations that affect corporations which participate in corporate tax shelters</u>

(1) Clarify the definition of a corporate tax shelter for purposes of the understatement penalty with the addition of several "tax shelter indicators." This recommendation builds on the present-law definition of a corporate tax shelter

[35] The Joint Committee staff study identified five common characteristics of modern corporate tax shelter transactions. These characteristics are: (1) an arrangement in which the reasonably expected pre-tax profit is insignificant when compared with the expected tax benefits; (2) the involvement of a tax-indifferent participant; (3) the use of guarantees, tax indemnities and similar arrangements, including contingent fee structures; (4) a difference between tax reporting and financial statement reporting, especially where permanent differences arise; and (5) the lack of any appreciable change in economic position, particularly when a corporation does not take on any additional economic risk. Any corporate transaction which exhibits one of these characteristics ("tax shelter indicators") should be considered to have a significant purpose of avoiding or evading Federal income tax for purposes of an understatement penalty.

found in section 6662 (the accuracy related penalty). Under that definition, a tax shelter exists if a significant purpose of a partnership, or other entity, plan, or arrangement is the avoidance or evasion of Federal income tax. The recommendation expounds upon that definition by providing certain "indicators" that if present will cause a partnership, or other entity, plan or arrangement in which a corporation is a participant to be considered to have a significant purpose of avoidance or evasion of Federal income tax.

The indicators were developed from what we found to be common characteristics of corporate tax shelters. At the same time, so as to ensure that there will be no interruption to legitimate business activity, the list excludes many common characteristics and is narrowly tailored to avoid any overreaching. Most importantly, the indicators themselves do not cause a penalty to be created. The penalty is imposed only if an understatement exists--meaning that a determination has been made (for example, by losing in court) that the tax benefits related to a transaction were improper and not permitted under present law. The indicators are:

(a) The reasonably expected pre-tax profit from the arrangement is insignificant relative to the reasonably expected net tax benefits.

(b) The arrangement involves a tax-indifferent participant, and the arrangement (1) results in taxable income materially in excess of economic income to the tax-indifferent participant, (2) permits a corporate participant to characterize items of income, gain, loss, deductions, or credits in a more favorable manner than it otherwise could without the involvement of the tax-indifferent participant, or (3) results in a noneconomic increase, creation, multiplication, or shifting of basis for the benefit of the corporate participant, and results in the recognition of income or gain that is not subject to Federal income tax because the tax consequences are borne by the tax-indifferent participant.

(c) The reasonably expected net tax benefits from the arrangement are significant, and the arrangement involves a tax indemnity or similar agreement for the benefit of the corporate participant other than a customary indemnity agreement in an acquisition or other business transaction entered into with a principal in the transaction.

(d) The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is reasonably expected to create a "permanent difference" for U.S. financial reporting purposes under generally accepted accounting principles.

(e) The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is designed so that the corporate participant incurs little (if any) additional economic risk as a result of entering into the arrangement.

(2) An entity, plan, or arrangement can still be a tax shelter even though it does not display any of the tax shelter indicators, provided that a significant purpose is the avoidance or evasion of Federal income tax.

(3) Modify the penalty so that, with respect to a corporate tax shelter, there would be no requirement that the understatement be substantial.

(4) Increase the understatement penalty rate from 20 percent to 40 percent for any understatement that is attributable to a corporate tax shelter. The IRS would not have the discretion to waive the understatement penalty in settlement negotiations or otherwise for corporate tax shelters.

(5) Provide that the 40-percent penalty could be completely abated (*i.e.*, no penalty would apply) if the corporate taxpayer establishes that it satisfies certain abatement requirements. Foremost among the abatement requirements is that the corporate participant believes there is at least a 75-percent likelihood that the tax treatment would be sustained on the merits. Another requirement for complete abatement involves disclosure of certain information that is certified by the chief financial officer or another senior corporate officer with knowledge of the facts.

(6) Provide that the 40-percent penalty would be reduced to 20 percent if certain required disclosures are made, provided that the understatement is attributable to a position with respect to the tax shelter for which the corporate participant has substantial authority in support of such position..

(7) Require a corporate participant that must pay an understatement penalty of at least $1 million in connection with a corporate tax shelter to disclose such fact to its shareholders. The disclosure would include the amount of the penalty and the factual setting under which the penalty was imposed.

<u>Recommendations that affect other parties involved in corporate tax shelters</u>

(1) Increase the penalty for aiding and abetting with respect to an understatement of a corporate tax liability attributable to a corporate tax shelter from $10,000 to the greater of $100,000 or one-half the fees related to the transaction.

(2) Expand the scope of the aiding and abetting penalty to apply to any person who assists or advises with respect to the creation, implementation, or reporting of a

corporate tax shelter that results in an understatement penalty if (1) the person knew or had reason to believe that the corporate tax shelter could result in an understatement of tax, (2) the person opined or advised the corporate participant that there existed at least a 75-percent likelihood that the tax treatment would be sustained on the merits if challenged, and (3) a reasonable tax practitioner would not have believed that there existed at least a 75-percent likelihood that the tax treatment would be sustained on the merits if challenged.

(3) Require the publication of the names of any person penalized under the aiding and abetting provision and an automatic referral of the person to the IRS Director of Practice.

(4) Clarify the U.S. government's authority to bring injunctive actions against persons who promote or aid and abet in connection with corporate tax shelters.

(5) Include the explicit statutory authorization for Circular 230 in Title 26 of the United States Code and authorize the imposition of monetary sanctions.

(6) Recommend that, with respect to corporate tax shelters, Treasury amend Circular 230 generally to (1) revise its definitions, (2) expand its scope, and (3) provide more meaningful enforcement measures (such as the imposition of monetary sanctions, automatic referral to the Director of Practice upon the imposition of any practitioner penalty, publication of the names of practitioners that receive letters of reprimand, and automatic notification to state licensing authorities of any disciplinary actions taken by the Director of Practice).

Disclosure and registration obligations

(1) Corporate taxpayer disclosure

(a) 30-day disclosure.--Arrangements that are described by a tax shelter indicator and in which the expected net tax benefits are at least $1 million would be required to satisfy certain disclosure requirements within 30-days of entering into the arrangement.

- The 30-day disclosure would include a summary of the relevant facts and assumptions, the expected net tax benefits, each tax shelter indicator that describes the arrangement, the analysis and legal rationale, the business purpose, and the existence of any contingent fee arrangements.

- The chief financial officer or another senior corporate officer with knowledge of the facts would be required to certify, under penalties

of perjury, that the disclosure statements are true, accurate, and complete.

(b) Tax-return disclosure.--Arrangements that are described by a tax shelter indicator (regardless of the amount of net tax benefits) would be required to satisfy certain tax-return disclosure requirements.

- The tax-return disclosure would include a copy of any required 30-day disclosure.

- The tax-return disclosure also would identify which tax shelter indicators describe one or more arrangements reflected on the return.

(2) Tax shelter registration

(a) Modify the present-law rules regarding the registration of corporate tax shelters by (1) deleting the confidentiality requirement, (2) increasing the fee threshold from $100,000 to $1 million, and (3) expanding the scope of the registration requirement to cover any corporate tax shelter that is reasonably expected to be presented to more than one participant.

(b) Require additional information reporting with respect to the registration of tax shelter arrangements that are described by a tax shelter indicator. The additional information would include the claimed tax treatment and summary of authorities, the tax shelter indicator(s) that describes the arrangement, and certain calculations relating to the arrangement.

PART III -- CONCLUSION

The Joint Committee staff recommendations on interest and penalties are intended to increase compliance and enhance the fairness and administrability of the Federal tax laws. In many cases, the recommendations build on the provisions of, and policies embodied in, the IRS Reform Act.

The Joint Committee staff believes that a corporate tax shelter problem exists, and the problem is becoming widespread and significant. The Joint Committee staff further believes that increasing the penalties for engaging in corporate tax shelters would sufficiently alter the cost-benefit analysis with respect to engaging in such transactions and would provide a measured response to the corporate tax shelter problem.

As stated in our published study, the Joint Committee staff believes that any legislative changes regarding penalties and interest should be undertaken only after careful and deliberative

review by the Congress and the opportunity for input from the public, the Treasury Department, and the IRS. This hearing is an important step in that review process.

I thank the Committee for the opportunity to present the Joint Committee staff recommendations on interest, penalties, and corporate tax shelters, and I would be happy to answer any questions the Committee may have at this time and in the future.

COMPARISON OF JOINT COMMITTEE STAFF AND TREASURY RECOMMENDATIONS RELATING TO INTEREST AND PENALTY PROVISIONS OF THE INTERNAL REVENUE CODE

Scheduled for a Public Hearing
Before the

SENATE COMMITTEE ON FINANCE

on March 8, 2000

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

March 7, 2000

JCX-22-00

CONTENTS

	Page
INTRODUCTION	1
I. INTEREST (secs. 6601-6621)	2
A. Rates on Underpayments and Overpayments	2
B. Federal Income Tax Treatment of Interest on Underpayments and Overpayments	3
1. Individuals	3
2. Corporations	3
C. Interest Netting	4
D. Abatement of Interest	4
1. Unreasonable error or delay by IRS	4
2. Erroneous refunds	4
3. Taxpayer reliance on written IRS statements	4
4. Other abatements	5
E. Dispute Reserve Accounts	6
II. FAILURE TO PAY ESTIMATED TAX (secs. 6654 and 6655)	7
A. Penalty for Individuals and Corporations (secs. 6654 and 6655)	7

Page

B. Exception to Penalty for Individuals (sec. 6654(e)(1)) 7

C. Modified Safe Harbor for Certain Individuals (sec. 6654(d)(1)) 8

D. Applicable Interest Rate for Individuals and Corporations (secs. 6621, 6654(a)(1), and 6655(a)(1)) 8

E. Calculation of Underpayment Balances for Individuals and Corporations (secs. 6654(a) and 6655(a)) 9

F. Estimated Tax Underpayments Extending from Leap Year to Non-Leap Year for Individuals and Corporations .. 9

G. Waiver of Penalty for Failure to Pay Estimated Tax for Individuals (sec. 6654(e)(3)) 10

H. Waiver of De Minimis Penalties for Individuals and Corporations 10

III. PENALTY FOR FAILURE TO PAY TAXES (sec. 6651(a)(2) and (3)) 11

A. In General 11

B. Encourage Installment Agreements 11

IV. PENALTY FOR FAILURE TO FILE TAX RETURNS (sec. 6651(a)(1)) 12

A. In General 12

B. Penalty for Failure to File "No Balance" Returns 12

V. TAX RETURN ACCURACY PENALTIES (secs. 6662 and 6694) 13

A. Standards Applicable to Disclosed Positions 13

Page

1. Taxpayers 13
2. Practitioners 13

B. Standards Applicable to Undisclosed Positions 14

1. Taxpayers 14
2. Practitioners 14

VI. RETURN PREPARER PENALTIES (sec. 6694) 15

A. Unrealistic Position 15

B. Willful or Reckless Conduct 15

VII. PENALTY FOR FILING A FRIVOLOUS TAX RETURN (sec. 6702) 16

VIII. PENALTY FOR FAILURE TO DEPOSIT TAXES (sec. 6656) 17

IX. PENALTIES FOR FAILURE TO FILE FORM 5500 SERIES ANNUAL RETURN FOR PENSION AND OTHER DEFERRED COMPENSATION PLANS 19

X. PENALTY FOR FAILURE TO FILE ANNUAL INFORMATION RETURNS FOR CHARITABLE REMAINDER TRUSTS (sec. 6652(a)(2)(A)) 20

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on March 8, 2000, on the interest and penalty provisions of the Internal Revenue Code. The Internal Revenue Service Restructuring and Reform Act of 1999 directed the Joint Committee on Taxation and the Department of the Treasury to undertake separate studies of such provisions, and make any legislative and administrative recommendations they deem appropriate to simplify penalty administration and reduce taxpayer burden. The staff of the Joint Committee on Taxation released its study[1] on July 22, 1999, and the Treasury Department released its study on October 25, 1999.[2]

This document,[3] prepared by the staff of the Joint Committee on Taxation, provides a comparison of the legislative changes to the interest and penalty provisions of the Code recommended[4] by the Joint Committee staff and the Department of the Treasury.[5]

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[1] 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)* (JCS-3-99), July 22, 1999.

[2] Department of the Treasury, *Report to The Congress on Penalty and Interest Provisions of the Internal Revenue Code*, October 1999.

[3] This document may be cited as follows: Joint Committee on Taxation, *Comparison of Joint Committee Staff and Treasury Recommendations Relating to Interest and Penalty Provisions of the Internal Revenue Code* (JCX-22-00), March 7, 2000.

[4] As used in the "Recommendation" columns of this document, "Retain present law" means that an explicit recommendation was made that present law be retained. "No recommendation" means that no explicit recommendation was made with respect to that item.

[5] This document does not reflect recommendations directly relating to corporate tax shelters.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
I. INTEREST (secs. 6601-6621)			
A. Rates on Underpayments and Overpayments	Different interest rates apply to overpayments and underpayments and depending on whether the taxpayer is a corporation. For individuals and other non-corporate taxpayers, the interest rate on both overpayments and underpayments is equal to the short-term Applicable Federal Rate ("AFR") plus three percentage points. For corporations, the interest rate on overpayments equals the short-term AFR plus two percentage points, unless the overpayment exceeds $10,000 in which case the interest rate equals the short-term AFR plus one-half a percentage point. For corporations, the interest rate on underpayments equals the short-term AFR plus three percentage points, unless the underpayment	Provide a single interest rate equal to the short-term AFR plus five percentage points for underpayments and overpayments of all taxpayers.	Retain present law; rates should be in range of AFR plus two to five percentage points.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
	exceeds $100,000 in which case the interest rate equals the short-term AFR plus five percentage points.		
B. Federal Income Tax Treatment of Interest on Underpayments and Overpayments			
1. Individuals	Individuals are generally required to include overpayment interest received in income, but no deduction is allowed for underpayment interest paid.	Exclude overpayment interest from individuals' gross income.	Retain present law.
2. Corporations	Corporations are generally required to include overpayment interest received in income and allowed to deduct underpayment interest paid.	No recommendation.	No recommendation.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
C. Interest Netting	A special rule provides for a net interest rate of zero to the extent interest is both payable by and allowable to a taxpayer on equivalent amounts of underpayment and overpayment.	Interest netting would not be necessary on a prospective basis, because under the JCT staff recommendation the Federal income tax treatment and interest rate on underpayments and overpayments would be the same.	Retain present law.
D. Abatement of Interest			
1. Unreasonable error or delay by IRS	Interest may be abated if attributable to unreasonable error or delay by IRS in the performance of a ministerial or managerial act.	Allow abatement if interest is attributable to <u>any</u> unreasonable error or delay by IRS.	Retain present law.
2. Erroneous refunds	Interest must be abated if refund did not exceed $50,000, and taxpayer did not cause the refund.	Require abatement for all erroneous refunds the taxpayer did not cause.	Consider modification only in concert with assuring that the IRS has adequate means to recover erroneous refunds.
3. Taxpayer reliance on written IRS statements	If an underpayment results from taxpayer reliance on written IRS statements penalties, but not interest, must be abated.	Require abatement of <u>both</u> penalties and interest if underpayment results from taxpayer reliance on written IRS statements.	Same as JCT staff recommendations, with same restrictions for interest abatement as under present law for penalty abatement.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
4. Other abatements	Abatement of interest is also allowed (and under certain circumstances is required) if the taxpayer is serving in a combat zone or located in a designated disaster area. For individuals, the accrual of interest is suspended if the IRS does not provide notice of the taxpayer's liability within one year (18 months for taxable years beginning before 2004).	Retain present law and also allow abatement if a gross injustice would otherwise result if interest were to be charged.	Retain present law.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
E. Dispute Reserve Accounts	In order to avoid the accrual of interest on a disputed item, the taxpayer may make a non-interest bearing deposit in the nature of a cash bond (as described in Rev. Proc. 84-58).	Permit deposits to be made to an interest bearing account within Treasury to cover tax underpayments related to issues potentially subject to dispute with the IRS. Funds deposited would be treated as a payment of tax if an underpayment of tax is ultimately found. If there is no resulting underpayment or, at the election of the taxpayer, the deposit is withdrawn prior to resolution of the IRS dispute, interest would be paid by the Treasury at a rate equal to the short-term AFR.	No recommendation.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
II. FAILURE TO PAY ESTIMATED TAX (secs. 6654 and 6655)	Individuals generally are required to make estimated tax payments at least equal to (1) 90 percent of current year's tax or (2) 100 percent of prior year's tax. Corporations generally are required to make estimated tax payments at least equal to (1) 100 percent of the current year's tax or (2) 100 percent of the prior year's tax.		
A. Penalty for Individuals and Corporations (secs. 6654 and 6655)	A penalty is imposed by applying the underpayment interest rate to the amount of the underpayment for the period of underpayment.	Repeal penalty and replace with an interest provision.	Retain present law.
B. Exception to Penalty for Individuals (sec. 6654(e)(1))	There is no penalty if the tax shown on the return, reduced by withholding, is less than $1,000. Estimated tax is not considered in determining whether the threshold is satisfied.	Increase threshold to $2,000, and consider estimated tax payments made in equal installments in determining whether the threshold is satisfied.	Retain present law threshold of $1,000, and consider estimated tax payments made under a new proposed simplified averaging method in determining whether the threshold is satisfied.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
C. Modified Safe Harbor for Certain Individuals (sec. 6654(d)(1))	Individuals with prior year's AGI above $150,000 ($75,000 for married individuals filing separately) who make estimated payments based on prior year's tax generally must do so based on 110 percent of prior year's tax.	Repeal the modified safe harbor; thus, all taxpayers making estimated payments based on prior year's tax would do so based on 100 percent of prior year's tax.	No recommendation.
D. Applicable Interest Rate for Individuals and Corporations (secs. 6621, 6654(a)(1), and 6655(a)(1))	The underpayment interest rate is subject to change on the first day of each calendar quarter. A change in rates requires the use of multiple interest rates when calculating the interest on an underpayment of estimated tax.	Apply only one interest rate per estimated tax underpayment.	No specific recommendation, but consider general computational simplifications.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
E. Calculation of Underpayment Balances for Individuals and Corporations (secs. 6654(a) and 6655(a))	Penalty is equal to the underpayment interest rate multiplied by the number of days the underpayment is outstanding, which is the number of days between when the taxpayer should have made the payment and the earlier of (1) actual date of payment or (2) the following April 15 (for calendar-year taxpayers).	Provide that underpayment balances are cumulative; thus, taxpayers would calculate a cumulative estimated tax underpayment for each period.	No specific recommendation, but consider general computational simplifications.
F. Estimated Tax Underpayments Extending from Leap Year to Non-Leap Year for Individuals and Corporations	Under IRS procedures, taxpayers with outstanding underpayment balances that extend from a leap year through a non-leap year must make separate calculations to account for the different number of days in each year.	Require 365-day year for all estimated tax penalty calculations.	No specific recommendation, but consider general computational simplifications.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
G. Waiver of Penalty for Failure to Pay Estimated Tax for Individuals (sec. 6654(e)(3))	A waiver is available to the extent the Treasury Secretary determines that a taxpayer suffered a casualty (e.g., fire or disaster) or other unusual circumstance if imposition of a penalty would be against equity and good conscience. There is no general reasonable cause waiver for the failure to pay estimated tax.	See JCT staff recommendations regarding abatements of interest (pages 4-5).	Permit a reasonable cause waiver for first-time payers of estimated tax, provided the balance due on the return is below a threshold amount (unspecified) and is paid with a timely-filed return.
H. Waiver of De Minimis Penalties for Individuals and Corporations	There is no statutory provision allowing the Treasury Secretary to waive estimated tax penalties below a de minimis amount.	See JCT staff recommendations regarding abatements of interest (pages 4-5).	Provide penalty waiver authority for individual estimated tax penalties below a de minimis amount, e.g., $10 to $20.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
III. PENALTY FOR FAILURE TO PAY TAXES (sec. 6651(a)(2) and (3))			
A. In General	Penalty is one-half percent of net amount of tax due for each month the return is not filed, up to a maximum of 25 percent. Interest also applies to the unpaid tax.	Repeal penalty. Interest would continue to apply.	Retain present law, except increase penalty percentage rate after six months from one-half percent a month to one percent a month.
B. Encourage Installment Agreements	Penalty rate is reduced to one-quarter percent per month for any month an installment agreement is in effect (provided return is timely filed). IRS imposes $43 user fee on installment agreements.	Impose a 5-percent late payment service charge if no installment agreement is in effect by the fourth month after assessment; waive $43 IRS user fee if taxpayer agrees to automated withdrawal of installment payments from bank account.	Reduce penalty rates by one-half for any month an installment agreement is in effect. Consideration should be given to using a fixed interest rate to avoid possible balloon payment at end of agreement.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
IV. PENALTY FOR FAILURE TO FILE TAX RETURNS (sec. 6651(a)(1))			
A. In General	Penalty is five percent of net amount of tax due for each month return is not filed, up to a maximum of 25 percent. This penalty is coordinated with the failure to pay penalty, by reducing the failure to file penalty by the amount of the failure to pay penalty for that month.	Retain present law.	Lower rates to one-half percent for first six months, then increase to one percent; retain 25 percent maximum; eliminate coordination with failure to pay penalty, which has the effect of potentially doubling combined penalties for taxpayers who delay filing and paying for lengthy periods of time.
B. Penalty for Failure to File "No Balance" Returns	No penalty is imposed on the failure to file returns that do not show a balance due the IRS.	No recommendation.	Impose new service charge, possibly only after IRS contact (amount unspecified).

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
V. TAX RETURN ACCURACY PENALTIES (secs. 6662 and 6694)			
A. Standards Applicable to Disclosed Positions			
1. Taxpayers	Penalty may apply if there is no reasonable basis for a disclosed position taken on a return. (Generally, at least a 20 percent likelihood of success if challenged.)	Penalty may apply if there is no substantial authority for a disclosed position taken on a return. (Generally, at least a 40 percent likelihood of success if challenged.)	Penalty may apply if there is no realistic possibility of success on the merits. (Generally, at least a 33-1/3 percent likelihood of success if challenged.)
2. Practitioners	Penalty may apply unless a disclosed position is not frivolous. (Generally, at least a 5 to 10 percent likelihood of success if challenged.)	Penalty may apply if there is no substantial authority for a disclosed position taken on a return. (Generally, at least a 40 percent likelihood of success if challenged.)	Penalty may apply if there is no realistic possibility of success on the merits. (Generally, at least a 33-1/3 percent likelihood of success if challenged.)

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
B. Standards Applicable to Undisclosed Positions			
1. Taxpayers	Penalty may apply if there is no substantial authority for the undisclosed position. (Generally, at least a 40 percent likelihood of success if challenged.)	Penalty may apply unless the taxpayer reasonably believes that the tax treatment is more likely than not the correct tax treatment under the Code. (Generally, more than 50 percent likelihood of success if challenged.)	Penalty may apply if there is no substantial authority for the undisclosed position. (Generally, at least a 40 percent likelihood of success if challenged.)
2. Practitioners	Penalty may apply if there is no realistic possibility of being sustained on the merits. (Generally, at least a 33-1/3 percent likelihood of success if challenged.)	Penalty may apply unless the taxpayer reasonably believes that the tax treatment is more likely than not the correct tax treatment under the Code. (Generally, more than 50 percent likelihood of success if challenged.)	Penalty may apply if there is no substantial authority for the undisclosed position. (Generally, at least a 40 percent likelihood of success if challenged.)

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
VI. RETURN PREPARER PENALTIES (sec. 6694)			
A. Unrealistic Position	If an understatement is due to a position for which there was not a realistic possibility of being sustained on its merits and the position was not disclosed or was frivolous, the preparer penalty is $250.	Impose penalty equal to greater of $250 or 50 percent of preparer's fee.	Similar to JCT staff recommendation, but exact percentage of penalty is unspecified.
B. Willful or Reckless Conduct	If an understatement is due to willful or reckless conduct, the preparer penalty is $1,000.	Impose penalty equal to greater of $1,000 or 100 percent of preparer's fee.	Similar to JCT staff recommendation, but exact percentage of penalty is unspecified.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
VII. PENALTY FOR FILING A FRIVOLOUS TAX RETURN (sec. 6702)	The penalty for filing a frivolous income tax return is $500.	No recommendation.	Increase the penalty to $1,500; permit abatement for first time occurrence if nonfrivolous return is filed within a reasonable period of time after filing the frivolous return.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
VIII. PENALTY FOR FAILURE TO DEPOSIT TAXES (sec. 6656)	There is a four-tier penalty rate structure for failure to deposit taxes: (1) A depositor is subject to a penalty equal to two percent of the amount of the underpayment if the failure is corrected on or before the date that is five days after the prescribed due date. (2) A depositor is subject to a penalty equal to five percent of the amount of the underpayment if the failure is corrected after the date that is five days after the prescribed due date but on or before the date that is fifteen days after the prescribed due date. (3) A depositor is subject to a penalty equal to ten percent of the amount of the underpayment if the failure is corrected after the date that is	No new legislation for at least two years to allow scheduled statutory and regulatory changes to be reviewed and implemented. However, consideration should be given to revising regulations to permit penalty abatement for inadvertent failures occurring when taxpayer changes to a different deposit schedule.	Few intermediate changes should be made at this time to the deposit rules or penalties to provide a sufficient period of time for changes to the deposit rules to take effect. The penalty for failure to use the correct deposit method should be reduced from ten percent to two percent. Consideration should be given to reducing the present-law two percent penalty if failure to deposit is corrected within one banking day.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
	fifteen days after the due date but on or before the date that is ten days after the date of the first delinquency notice to the taxpayer. (4) A depositor is subject to a penalty equal to fifteen percent of the amount of the underpayment if the failure is not corrected on or before the date that is ten days after the date of the first delinquency notice to the taxpayer. Many taxpayers are required to make deposits of taxes; the frequency of the deposits depends on the type of tax and the amount required to be deposited.		

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
IX. PENALTIES FOR FAILURE TO FILE FORM 5500 SERIES ANNUAL RETURN FOR PENSION AND OTHER DEFERRED COMPENSATION PLANS (secs. 6652(d)(2), 6652(e), 6692(e))	The Code and Titles I and IV of ERISA impose 3 separate penalties for failure to file a timely and complete return; the Code imposes separate penalties for failure to file Schedule SSA, Schedule B, and notification of plan status change.	Consolidate the separate Code and ERISA penalties for failure to file timely and complete return into one penalty.	Consolidate the separate Code and ERISA penalties for failure to file timely and complete return into one penalty.
	The IRS, Department of Labor, and Pension Benefit Guaranty Corporation administer the separate penalties.	Designate the IRS as the agency responsible for administration of the consolidated penalty.	Designate the Department of Labor as the agency responsible for administration of the consolidated penalty.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
X. PENALTY FOR FAILURE TO FILE ANNUAL INFORMATION RETURNS FOR CHARITABLE REMAINDER TRUSTS (sec. 6652(c)(2)(A))	Split-interest trusts (and certain other organizations) are required to file Form 1041-A (Trust Accumulation of Charitable Amounts). The penalty for failure to file Form 1041-A is $10 for each day return is not filed, up to a maximum of $5,000 for any one return. Split-interest trusts are also required to file Form 5227 (Split-Interest Trust Information Return). It is not clear under present law whether any penalty applies to the failure to file Form 5227.	Provide that the penalty for failure to file Form 5227 is equivalent to the penalty for failure to file Form 990. Consider increasing penalties applicable to failure to file Form 1041-A.	No recommendation. (However, the President's Fiscal Year 2001 Budget Proposal would impose a penalty for failure to file Form 5227 of $20 for each day the failure to file continues (up to a maximum of $10,000 per return). In the case of a trust with income in excess of $250,000, the penalty would be $100 for each day the failure continues (up to a maximum of $50,000 per return). Any trustee who knowingly fails to file Form 5227 would be jointly and severally liable for the amount of the penalty, unless such failure is not willful and is due to reasonable cause. The proposal would be effective for any return the due date for which is after the date of enactment.)

APPENDIX TO JCX-23-00

NIPA AND FEDERAL INCOME TAX RECEIPTS DATA

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

March 7, 2000

JCX-24-00

NIPA AND FEDERAL INCOME TAX RECEIPTS DATA

This appendix presents data from the recently revised National Income and Product Accounts ("NIPA") along with Federal income tax receipts data covering the period 1988 through 1999. These data are presented on a Federal fiscal year basis in order to coincide with the Federal accounting period.

Table 1 presents the revised Gross Domestic Product ("GDP") series along with recent Federal income tax receipts data. Federal income tax receipts are broken down into individual income tax receipts and corporate income tax receipts. For comparison, the year-to-year percentage growth rates are also shown.

Table 2 presents a NIPA measure of corporate net income, "corporate income before taxes." This NIPA series measures aggregate net corporate income for the U.S.[1] with various adjustments including adjustments to account for underreported and misreported income. Corporate income before taxes employs tax measures of depreciation and inventory accounting. The income series presented in Table 2 is limited to domestic income. Again, year-to-year percentage growth rates are presented below the aggregate figures.

[1] S corporation income is included in NIPA corporate income before taxes.

Table 1. Gross Domestic Product and Individual and Corporate Income Tax Receipts

Fiscal Years 1988 - 1999

[Totals in Billions of Dollars]

Item	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
I. Gross Domestic Product ("GDP") [1]												
A. Total	5016.7	5406.6	5738.4	5927.9	6221.7	6561.2	6948.8	7322.7	7700.2	8182.8	8636.3	9115.5
B. Percent change	N/A	7.8	6.1	3.3	5.0	5.5	5.9	5.4	5.2	6.3	5.6	5.5
II. Federal Income Tax Receipts [2]												
A. Individual and corporate income tax receipts												
1. Total	495.7	549.0	560.4	565.9	576.2	627.2	683.4	747.2	828.2	919.8	1017.3	1064.2
2. Percent change	N/A	10.8	2.1	1.0	1.8	8.8	9.0	9.3	10.8	11.0	10.6	4.6
3. Percent of GDP	9.9	10.2	9.8	9.5	9.3	9.6	9.8	10.2	10.8	11.2	11.8	11.7
B. Individual income tax receipts												
1. Total	401.2	445.7	466.9	467.8	476.0	509.7	543.1	590.2	656.4	737.5	828.6	879.5
2. Percent change	N/A	11.1	4.8	0.2	1.7	7.1	6.5	8.7	11.2	12.3	12.4	6.1
3. Percent of total income taxes	80.9	81.2	83.3	82.7	82.6	81.3	79.5	79.0	79.3	80.2	81.5	82.6
4. Percent of GDP	8.0	8.2	8.1	7.9	7.7	7.8	7.8	8.1	8.5	9.0	9.6	9.6
C. Corporate income tax receipts												
1. Total	94.5	103.3	93.5	98.1	100.3	117.5	140.4	157.0	171.8	182.3	188.7	184.7
2. Percent change	N/A	9.3	-9.5	4.9	2.2	17.2	19.5	11.8	9.4	6.1	3.5	-2.1
3. Percent of total income taxes	19.1	18.8	16.7	17.3	17.4	18.7	20.5	21.0	20.7	19.8	18.5	17.4
4. Percent of GDP	1.9	1.9	1.6	1.7	1.6	1.8	2.0	2.1	2.2	2.2	2.2	2.0

Joint Committee on Taxation

[1] Source: October 28, 1999 Bureau of Economc Analysis release and December 1999 Survey of Current Business.
[2] Source: Budget of the United States Government: Fiscal Year 2001.

Table 2. Corporate Income Tax Receipts and Corporate Income Before Taxes (NIPA)

Fiscal Years 1988 - 1999

[Total in Billions of Dollars]

Item	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
I. Corporate Income Tax Receipts [1]												
A. Total	94.5	103.3	93.5	98.1	100.3	117.5	140.4	157.0	171.8	182.3	188.7	184.7
B. Percent change	N/A	9.3	-9.5	4.9	2.2	17.2	19.5	11.8	9.4	6.1	3.5	-2.1
II. Corporate Income Before Taxes [2]												
A. Total	292.5	305.1	300.9	314.8	351.1	397.9	464.4	544.2	591.9	646.7	666.4	690.1
B. Percent change	N/A	4.3	-1.4	4.6	11.5	13.3	16.7	17.2	8.8	9.2	3.0	3.6

Joint Committee on Taxation

[1] Source: Budget of the United States Government: Fiscal Year 2001.

[2] Source: October 28, 1999 Bureau of Economic Analysis release and December 1999 Survey of Current Business. Income measure does not include either Federal Reserve Bank income or income from sources outside of the United States.

PREPARED STATEMENT OF PAUL J. SAX

Mr. Chairman and Members of the Committee:

My name is Paul J. Sax. I appear before you today in my capacity as Chair of the American Bar Association Section of Taxation. This testimony is presented on behalf of the Section of Taxation. Approval of this testimony by the House of Delegates or the Board of Governors of the American Bar Association has not been sought and, accordingly, it should not be construed as representing the policy of the Association.

The Section of Taxation appreciates the opportunity to appear before the Committee today to discuss the penalty and interest provisions in the Internal Revenue Code and the recommendations contained in the studies prepared by the Staff of the Joint Tax Committee and the Treasury Department. My testimony today will also cover the related subject of corporate tax shelters.

I. PENALTIES AND INTEREST

We believe the recommendations in the penalty and interest studies by the Staff of the Joint Committee on Taxation[1] (hereafter "JCT Study") and Department of the Treasury's Office of Tax Policy[2] (hereafter "Treasury Report") address very important issues. Our testimony today will not include comments on each and every item in the studies. Individual members of the Tax Section would be pleased, however, to provide assistance and comments to members of the Committee and your Staff on any recommendations you might identify.

At the outset, I would like to recognize the time and energy this Committee, the Joint Committee on Taxation, and the Treasury Department's Office of Tax Policy are devoting and have already devoted to examining the Internal Revenue Code's penalty and interest provisions. Your thoughtful consideration of this area is important because the law's approach to penalties and interest affects taxpayers' views of, and thus their compliance with, our self-assessment tax system.

We have limited our specific comments today to five areas: (1) accuracy-related penalties, (2) preparer penalties, (3) interest, (4) the failure to file penalty, and (5) late payment penalties. The accuracy-related and preparer penalties are important because they set the standards for what taxpayers and preparers are permitted to report on returns. Interest and the filing and payment penalties are important because they are the additions to tax that a taxpayer is most likely to encounter and that most commonly create hardship for less well off individual taxpayers. We will address penalties related to corporate tax shelters in the second part of our testimony today.

Before we shift to specific issues, I would like to briefly summarize our views on civil penalties and interest. Penalties should be structured to encourage taxpayers to approach their tax obligations carefully and responsibly, but with due regard for the complexity and sometimes uncertain application of our tax laws. If a penalty is too small, or the taxpayer's duty is expressed in too vague a way, it is unlikely that a penalty will accomplish this goal. On the other hand, if a penalty is too large, or too much is expected of the taxpayer, the penalty may lead to excessive burdens on taxpayers and perceptions that our tax system is unfair. Accordingly, our comments are guided by the views that penalties should be straightforward enough for taxpayers to understand and for the IRS to efficiently administer. Penalties should penalize similarly situated taxpayers similarly and should impose sanctions proportional to a clearly defined transgression. Penalties should reinforce reasonable expectations of taxpayers and should encourage compliance even if untimely.

A. Accuracy-Related and Preparer Penalties

The accuracy-related and preparer penalties set forth the duties of taxpayers and preparers to prepare returns carefully, taking only realistic positions and disclosing those where the tax treatment is unclear or questionable. We think the current structure of these penalties is reasonably sound, but has features that legislation can improve.

1. Reporting Standards for Taxpayers and Preparers

At present, the two penalties are not completely coordinated, since what is expected of preparers is somewhat less than what is expected of taxpayers. Both the

[1] Staff of the 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)* (JCS-3-99), July 22, 1999.

[2] Department of the Treasury, Office of Tax Policy, *Report to The Congress on Penalty and Interest Provisions of the Internal Revenue Code*, October 1999.

JCT Study and the Treasury Report recommend conforming the reporting standards for taxpayers and preparers. However, the JCT Study would set standards for taxpayers and preparers much higher than the standards of current law, while the Treasury Report would set standards at levels nearer those of current law.

a. Undisclosed Positions

At present, Section 6662 penalizes a taxpayer if a position on a return lacks substantial authority and is not disclosed. Section 6694 penalizes a preparer when a position on a return lacks a realistic possibility of being sustained on its merits and is not disclosed. In general, we think that a "substantial authority" standard for undisclosed positions works best for both taxpayers and preparers. The substantial authority standard has now been in the law for 17 years. The regulations defining the standard do an excellent job of guiding both taxpayers and preparers, and a substantial body of case law is developing that gives both taxpayers and preparers useful guidance. Further, the expectation that an undisclosed position should be supported by substantial authority is intuitively reasonable. The objective nature of the standard, which turns on whether adequate legal and factual support for a position exists, avoids messy and difficult inquiries into the taxpayer's state of mind. Accordingly, we support the Treasury Report's recommendation that a "substantial authority" standard be retained in Section 6662 for undisclosed return positions and that Section 6694 be amended to establish this standard for preparers as well.

The Joint Committee Staff recommended changing the standard for undisclosed positions from substantial authority to a reasonable belief that the position taken is "more likely than not" correct. We do not believe that this proposal is an improvement on the "substantial authority" standard; it would be less objective, would encourage difficult factual inquiries into the state of mind of the taxpayer and preparer, could encourage excessive disclosure, and would fail to give adequate weight to the complexity and uncertainty of existing tax law.

b. Disclosed Positions

At present, Section 6662 imposes a penalty on a return position for which adequate disclosure has been made only if, in the case of the taxpayer, the position lacks a reasonable basis. Section 6694 imposes a similar penalty in the case of preparers if the position is frivolous. Historically, this has been the function of the negligence penalty, and the standard for disclosed positions in current law in essence defines a negligence standard.

We believe that the Joint Committee Staff recommendation that the standard for disclosed positions be elevated to "substantial authority" is unwise. We think that it is very important to preserve the essential nature of this expectation of taxpayers and preparers as a negligence standard. The vast majority of taxpayers in this country spend a relatively short period each year preparing and filing their returns. They have a generalized understanding that they must do so carefully and fairly. However, it is doubtful that they ever would spend the time and effort necessary to understand the details of a complex penalty standard. We think it important that the standard for disclosed positions in Section 6662 be viewed as fair and reasonable, and we think that this requires this standard to reflect taxpayers' general understanding that they must be careful and even-handed in preparing their returns. If the standard were elevated, so that a taxpayer was required to do more than one would expect of a prudent but relatively unsophisticated individual, then we think penalty impositions would likely increase because the expectations of our tax system would exceed the behavior that most taxpayers intuitively think is appropriate. We believe that penalizing taxpayers who have acted in a reasonably careful way would create anger toward our tax system.

Our understanding of the Treasury Report's proposal for disclosed positions (other than those involving a tax shelter) is that Treasury would retain the essential "negligence" standard of existing law, but conform the definitions in Sections 6662 and 6694 in the language "realistic possibility of success on the merits." We support this proposal. For the last several decades, the overriding debate with respect to the negligence penalty has been to arrive at a definition of negligence conveying the idea that the conduct expected is more than an empty appearance of compliance, but rather reflects the serious effort that a careful and prudent person should make. We think that the language suggested in the Treasury Report for non-tax shelter positions does this. Further, it would conform Section 6694 to existing standards of professional responsibility promulgated by the ABA and the AICPA.

2. Reasonable Cause Exception

Under existing law, the IRS and the courts have the flexibility to waive a Section 6662 penalty to which a taxpayer may become subject. This waiver authority permits IRS and the courts to take into account a person's education, a personal trag-

edy, or an isolated failure to identify an issue. We think that this waiver authority is critically important to the smooth functioning of Section 6662. The JCT Study, but not the Treasury Report, recommends repealing the reasonable cause exception for substantial understatement penalties. We oppose repeal of the reasonable cause exception because we think that repeal would result in a penalty that is too rigid and inflexible and would eliminate the discretion of the IRS and courts to waive a penalty even when any reasonable view of the situation would support waiver. Repealing the waiver authority also runs counter to the provisions enacted in the IRS Restructuring and Reform Act that vest IRS with more discretion in administering the interest provisions and collecting late payments.

3. Threshold for Imposing the Substantial Understatement Penalty

At present, the substantial understatement prong of the Section 6662 penalty applies, in the case of corporations, only if the understatement at issue exceeds the greater of $10,000 or 10% of tax liability. The practical effect of this threshold is that, for very large corporations with very large tax liabilities, the substantial understatement penalty is seldom applicable.

The Treasury Report, but not the JCT Study, suggests changing the definition of a substantial understatement in the case of corporations to the lesser of $10 million or 10% of the tax required to be shown on the return. This proposal would have the practical effect of making the substantial understatement penalty potentially applicable to very large corporations for any issue that exceeds $10 million in amount. We think that this proposal provides a reasonable way to encourage disclosure of significant issues by large corporations, and we support it.

A change in threshold would, we believe, also be warranted for individuals. At present, the threshold (the greater of $5,000 or 10% of tax liability) may encompass many very small cases for which a more general negligence penalty is more appropriate. We suggest that the existing "greater of" format for this threshold works well, but that the dollar threshold should be raised and the percentage threshold dropped, so that the minimum size of an issue subject to disclosure is increased and it is less likely that the overall size of the taxpayer's liability will prevent the application of the penalty. While we do not feel strongly about any specific numbers, a revised individual threshold along the lines of "the greater of $25,000 or 5% of tax liability" would constitute an improvement over existing law.

4. Amount of Penalty

The percentages at which the Section 6662 penalty is applied are a targeted 20% for the negligence and substantial understatement prongs of the penalty and either 20% or 40% for the valuation penalties, depending on the extent to which the taxpayer's valuation departs from the correct valuation. These are high rates in comparison to the 5% rate at which the negligence penalty was imposed prior to 1989 and the 10% rate at which the substantial understatement penalty was imposed when it was enacted in 1982. The rates were increased in the mid-80's with little empirical support. We think that penalty rates that are too high are more difficult to administer consistently and may have the paradoxical result of making the penalty less effective because of a reluctance to impose it. A review of case law indicates that very few 40% penalties have been imposed over the years. We encourage repeal of the 40% rate for gross valuation misstatements.

5. Fee-based Preparer Penalties

Both studies recommend a fee-based measure for preparer penalties. The Joint Committee suggests that, instead of the current flat $250 penalty, first-tier violations incur a penalty of the greater of $250 or 50% of the preparer's fee, and that the penalty for second-tier violations be the greater of $1,000 or 100% of the preparer's fee rather than a flat $1,000 penalty. Treasury, without recommending specific thresholds, suggests consideration of a fee-based approach because, it contends, current preparer penalties are low compared with the tax liabilities involved and thus discourage IRS assessment on a cost-benefit basis.

Any concern that the preparer penalties are not an effective deterrent to inappropriate conduct should first focus on the effectiveness of the compliance programs for preparers. A review of decided cases suggests that cases involving preparers very rarely arise. A compliance regime that is not effectively policed is unlikely to be improved by increasing sanctions that are infrequently imposed. Tying preparer penalties to a preparer's fee creates significant complexity and enforcement issues. Perhaps the issue of greatest concern is that it seems likely to increase the costs of return preparation, as preparers seek to protect themselves from large penalties. This problem is likely particularly to affect small taxpayers.

In situations in which the preparer performs a variety of services for the taxpayer, such a penalty would require an analysis of what portion of the fee relates

to actual return preparation, in as much as the fee will vary substantially depending on the nature of the client and the extent of the representation. Because the size of the penalty may be substantial but would not vary based on the size of the position in dispute and is calculated on the preparer's gross (rather than net) fee, it seems likely that those subject to the penalty will think it unfair as actually applied. For these and other reasons, we think that a tying of widely applicable preparer penalties to a percentage of the preparer's fee is unwise. We express no view on whether the $250 and $1,000 amounts of these penalties are adequate to support expectations of preparers. However, we would note that the primary factors encouraging professional conduct from preparers are probably the professional standards of conduct of the preparer's chosen profession, the professional liability that a preparer may face from a client for a job poorly done, and the possibility of referral to the IRS's Director of Practice. We are convinced that these factors far more strongly encourage professional and careful conduct and that substantial increases in infrequently asserted penalties are unlikely to elevate conduct substantially.

B. Interest and Payment Penalties

The JCT Study and Treasury Report recommend a number of changes to interest provisions and penalties for failure to file, failure to pay, failure to pay estimated tax, and failure to deposit tax.

1. Interest Provisions

The studies suggest various changes for interest, including (1) eliminating the differential between the interest rate the IRS charges on underpayments and the interest rate the IRS pays on overpayments, (2) pegging the interest rate at the applicable federal rate ("AFR") plus five percent, (3) excluding IRS interest from individuals' income, (4) providing additional interest abatement rules, and (5) instituting "dispute reserve accounts."

a. Elimination of Rate Differential

The JCT Study proposes eliminating the differential between the interest rates charged on underpayments and paid on overpayments to make the system simpler and fairer. In contrast, the Treasury Report recommends retaining the interest rate differential for the time being in view of the recent enactment of the global interest netting rules and because retaining the differential mirrors the commercial sector model. We support the Joint Committee's recommendation to eliminate the rate differential because we believe that a uniform interest rate for under- and over-payments will be perceived as evenhanded, simple and fair, while the rate differential of present law creates significant and unnecessary complexity without any significant compliance benefit.

While we accept as a conceptual matter the Treasury Report's observation that commercial organizations attempt to achieve a profit on their lending and borrowing activities, we think that this observation has little to do with whether a differential in interest rates has a positive effect on tax compliance. Because the relationship between a taxpayer and the IRS is an involuntary one, because it is not always possible for a taxpayer to know whether at the moment the taxpayer is a borrower or lender from the government, and because different taxpayers are able to borrow money from commercial lenders at rates that differ substantially from the underpayment rate, we think it likely that the existing rate differential is viewed as unfair. For taxpayers with complex affairs, the concurrent accrual of the differential rates is a labyrinth of complexity and time is not needed to prove that one can cope with this complexity when a simple solution is available. We strongly encourage the enactment of uniform over- and under-payment interest rates. This will be a significant simplification in the law and is an opportunity to strengthen the image of the tax system as evenhanded and fair.

b. Interest Rate Increase

Both the Joint Committee and Treasury recommend a higher interest rate: the Joint Committee at the AFR plus 5%, and Treasury at the AFR plus 2–5%. While we have no specific recommendation to make on the most appropriate rate, we note that a significant divergence from market rates, in either direction, may result in taxpayer conduct oriented toward the arbitrage of this differential. Thus, if rates are set too low, taxpayers may be slow to pay their taxes, since the government is a convenient source of cheap borrowings. On the other hand, if rates are set too high, taxpayers may think the tax system unfair or may find an overpayment to be a relatively attractive investment. Accordingly, we encourage the interest rate to be set, as nearly as possible, at a rate that approximates a market rate. We are also concerned that, at AFR plus 5%, the underpayment rate will increase by two percent-

age points. This increase will make it more difficult for IRS's Collection Division to resolve the unpaid liabilities of taxpayers who are in financial difficulty.

c. Exclusion of Refund Interest from Income

The JCT Study recommends excluding IRS interest from individuals' income so that the effective post-tax interest rates on underpayments and overpayments are equivalent. Treasury does not agree with this suggestion. We have reservations about making refund interest tax free for individuals, particularly if the interest rate exceeds that of tax-exempt investments. We understand the Joint Committee Staff's view that refund and deficiency interest should receive similar treatment. However, we think this objective would be better served by permitting the deduction of deficiency interest than by excluding refund interest from income. We also note that the present regime, which taxes refund interest but provides no deduction for deficiency interest, is consistent with the law's general treatment of the interest income and the non-business interest expense of individuals.

d. Dispute Reserve Accounts

The JCT Study proposes the establishment of rules for the creation of dispute reserve accounts, which would be special interest-bearing accounts with the Treasury where taxpayers could deposit amounts in dispute. Under present law, a taxpayer can easily recover a disputed amount paid over to the IRS only if the payment was made in the form of a deposit in the nature of a cash bond, and such deposits are returned without interest. We support the Joint Committee Staff's recommendation because the government has the use of the deposit until such time as it is returned to the taxpayer, and the establishment of the mechanism of a dispute reserve account will simplify taxpayers' thinking when faced with a potential controversy.

2. Failure to File Penalty

At present, a failure to file a return results in a penalty of 5% of the unpaid amount each month for the first five months of the delinquency. The Treasury Report recommends imposing a lower penalty over a longer period, but with the same maximum amount. The JCT Study suggests no changes in this area. We support Treasury's proposal. Once the failure to file penalty has fully accrued, it ceases to encourage the filing of the return; in fact, a taxpayer's inability to pay the penalty along with any tax due may deter the filing of the return. Further, we think that this penalty, when added to other charges for noncompliance, may exacerbate delinquent taxpayers' difficulties in returning to a compliant condition. We believe that a penalty that accrues more slowly will help to correct these problems within the current regime.

3. Failure to Pay Penalty

The JCT Study recommends repeal of the failure to pay penalty, replacing it with a five percent annual service charge if the taxpayer does not enter into, and adhere to, an installment agreement by the fourth month after assessment. Treasury, on the other hand, suggests imposing higher penalties, albeit with reductions if the taxpayer makes and follows an IRS payment plan. We think it important that delinquent taxpayers be subject to some significant sanctions for their delinquencies. However, we prefer the Joint Committee's approach, primarily because, in our view, the totality of interest, failure to file, and failure to pay penalties that currently apply in many delinquency situations often functions as an impediment to full and timely resolution of the delinquency, rather than as an incentive to correction.

4. Failure to Pay Estimated Tax

The Joint Committee recommends converting the failure to pay estimated tax penalty to interest because it is essentially a time-value-of-money computation, and calling it interest rather than a penalty may enhance taxpayers' view of the tax system's fairness. Treasury does not support this conversion because it would enable corporations to deduct this charge for the first time. Both studies recommend changes in individuals' estimated tax thresholds and various simplifications. We support converting the estimated tax penalty to an interest charge and endorse measures to simplify the estimated tax rules. We do note that frequent changes in the safe harbor threshold in Section 6654(d)(1)(C)(i) make compliance with estimated tax rules more burdensome and cannot be justified on the basis of broad compliance objectives. Accordingly, we strongly encourage both simplification and permanence in the establishment of these thresholds.

5. Failure to Deposit Tax

Both the Treasury and Joint Committee studies note that the Internal Revenue Service Restructuring and Reform Act of 1998 changed rules in this area, so Treas-

ury suggests just two changes, and the Joint Committee recommends no new legislation be enacted in this area. We view Treasury's penalty-reduction proposals as improvements and encourage Congress to do more to lessen the size of this penalty, which, in our view, is out of proportion to the conduct that it punishes.

Mr. Chairman, that concludes the portion of our testimony on interest and penalties. Before discussing corporate tax shelters, I would be happy to respond to questions from the Committee on this portion of our testimony.

II. CORPORATE TAX SHELTERS

I would now like to turn to the very important subject of corporate tax shelters.[3] Our testimony will use the term "corporate tax shelters" in discussing the very aggressive tax transactions currently being marketed.[4] However, the Committee should understand that this phenomenon is not limited to large, multinational corporate taxpayers; indeed, it is not limited to corporations. Increasingly, tax shelter products are also being marketed to unincorporated business taxpayers, including middle market businesses and wealthy individuals.

My testimony today regarding corporate tax shelters contains three parts: (1) a brief discussion of the Tax Section's initial reactions to the administrative actions taken last week by the Treasury Department and the Internal Revenue Service to address the corporate tax shelter problem, (2) a description of the Tax Section's corporate tax shelter legislative recommendations, and (3) an amplification of certain aspects of our legislative recommendations. But first, I want to say something about the corporate tax shelter problem.

A. The Corporate Tax Shelter Problem

We are aware that you may be told that there is no corporate tax shelter problem and that Congress does not need to take any action. This may be expressed with renewed energy following the administrative actions announced by Treasury and the Internal Revenue Service last week. Mr. Chairman, make no mistake about it. There is a serious problem, and it needs to be dealt with if we are to maintain public confidence in the tax system. Administrative action is very important, but there are limits on what can be accomplished administratively. The magnitude of the problem demands clear and forceful legislative action as well. In the 1970's and early 1980's, when individual tax shelters were in vogue, the vast majority of American people justifiably became outraged when they learned through the press that certain high-income taxpayers were eliminating or substantially reducing their tax liabilities by means of uneconomic and frequently artificial transactions. As the nature, scope and duration of the modern tax shelter abuse becomes more widely understood by the taxpaying public, the American people may justifiably ask their elected representatives why action was not taken to stop this tax avoidance activity when the abuses were brought to the Congress' attention.

Today, transactions that have little or no economic substance, that are designed solely to defer or permanently eliminate tax liability, and that are premised on opinions that either adopt aggressive interpretations of the tax law or are premised on questionable factual assumptions are being marketed to businesses of all sizes and to wealthy individuals. These transactions are not based on Congressionally mandated tax incentives, such as the low-income housing credit, but instead apply aggressive interpretations of the law in situations where the transactions would be dismissed out of hand by the taxpayers if it were not for the tax avoidance benefits of the transactions.

A simple example might illustrate the nature of the abuse with which we are faced. A Fortune 500 company was faced a few years ago with the necessity of paying tax on $445 million of economic gain from a business transaction. An investment bank, on learning of this, approached the company with a tax plan (or "product" in the modern vernacular):

- The company would enter into a partnership with a foreign entity that was not subject to U.S. taxes; the foreign partner would make a large capital contribution and thus initially own a majority of the partnership interests; the partner-

[3] The Section of Taxation has testified regarding corporate tax shelters on three prior occasions. On March 10, 1999, the Section testified before the Subcommittee on Oversight, on April 27, 1999 the Section testified before this Committee and on November 10, 1999 the Section testified before the House Ways and Means Committee. Our testimony today is consistent with this prior testimony.

[4] We also refer to these shelters as "transactions," although recognizing that the taxpayer's investment in a financial or other tax shelter product, or other taxpayer action, may not fit the traditional description of a transaction. We believe all such actions need to be addressed by any legislation.

ship would purchase property, then immediately sell it for a large cash down payment plus a five-year note that was indefinite in amount to bring the transaction within the installment sale regulations applicable to contingent payment sales.

- The regulations in question provide that the basis of property sold for a contingent note is spread ratably over the life of the note. This would create a large taxable gain from the down payment received in the year of the sale, almost all of which would be allocated to the tax-exempt foreign partner. The proceeds from the down payment would be distributed to the foreign partner to terminate its interest in the partnership.
- Since a large taxable gain had been realized by the partnership at the front end—and there was of course no economic gain or loss in the property's value since it had been held only a brief-time—there was a built-in tax loss in the remaining notes receivable. That was left to be enjoyed by the remaining majority partner, the Fortune 500 company.

The result? The company reported a tax loss of $396 million, with no real risk other than transaction costs, and no real opportunity for profit other than the tax benefit. The investment bank was paid a fee of $7 million. We should not underestimate the impact on voluntary compliance by individual taxpayers if they learn large companies can create tax losses of almost $400 million by paying a fee to an investment bank.

These are the facts of the ASA Investerings case in which the Court of Appeals for the D.C. Circuit recently affirmed the Tax Court's rejection of the claimed tax benefits, ASA Investerings Pshp. v. Commissioner, No. 98–1583, 2000 U.S. App. LEXIS 1207 (D.C. Cir. Feb. 1, 2000). It is our belief that these transactions are spreading in the economy to smaller businesses and individual taxpayers, and that without serious government action the level of activity will continue to grow.

We are not in a position to estimate the impact on Federal revenues of the corporate tax shelter activity of the past several years. However, our experience as tax practitioners suggests that the level of tax shelter activity is very substantial. Many of the shelter transactions involve purported tax savings of tens of millions of dollars. Should Congress fail to take appropriate legislative action, taxpayers and their advisors may be emboldened and become even more aggressive.

B. Treasury/IRS Administrative Actions

Although we are still analyzing the administrative actions announced by the Treasury Department on February 28, 2000, we want to be on record as welcoming those actions. They appear to be a measured attempt to deal with the problem.

We applaud the clear burden the proposals appear to place on the promoters of abusive tax shelters, including the requirements that such shelters be registered with the Internal Revenue Service and that lists be maintained of taxpayers that have entered into such transactions. This should have a definite chilling effect on the eagerness of taxpayers to use abusive tax shelter products. We also support the requirement that corporate taxpayers must disclose certain types of transactions on their tax returns utilizing a "short information statement," but we want to carefully consider the proposed scope and content of such required statements. We are concerned both that such statements not unduly burden taxpayers entering into non-abusive transactions and that they be effective in uncovering abusive transactions.

We applaud the pronouncement by the Treasury Department that the new rules are not intended to require disclosure of customary business transactions or transactions with tax benefits that the Internal Revenue Service has no reasonable basis to challenge. We will closely study the mechanics of the proposed rules to determine if, in our view, they are likely to achieve those goals. We look forward to working closely with the Treasury Department and the IRS on such modifications as may be necessary to achieve these goals.

We are particularly pleased that Secretary Summers has committed that Circular 230 will be amended within six months to address the conduct of tax professionals issuing tax opinions that support abusive tax shelter transactions. Our proposal on this topic was submitted to the Treasury Department on October 29, 1999. We understand the role of professionals in these transactions and have evidenced in our proposal our willingness to address it as a part of the problem.

It is important, Mr. Chairman, to recognize that the administrative announcements of February 28, 2000 necessarily are limited to the statutory authority within which the Internal Revenue Service must operate. For example, the tax shelter registration requirement is inapplicable unless the transaction is offered "under conditions of confidentiality." This requirement of section 6111(d) of the Code may be avoided, some will assert, by informal understandings and subtle economic compulsion that do not rise to the level of "conditions." In addition, the requirement to

maintain investor lists authorized by section 6112 of the Code is supported only by penalties under section 6708, which are limited to $50 per investor left off the list, with an aggregate annual cap of $100,000. Such a penalty structure cannot be expected to deter promoters of tax products expecting annual profits in the millions. Nor does the Code provide any specific penalty for failure to comply with the new tax return disclosure regime proposed in the February 28, 2000 administrative announcements.

C. Legislative Recommendations

Clearly, Mr. Chairman, there is a limit on what the Internal Revenue Service can do under existing law. Under the best of circumstances, it cannot detect all questionable transactions, it cannot devote audit resources to challenge all transactions it does detect, and it cannot litigate all of the cases that should be litigated. If the marketing of aggressive tax shelter transactions is to be constrained, it is vitally important to put added pressure on the marketing process.

The marketing of these transactions is predicated on the odds favoring success. Promoters understand that the IRS may be unable to detect and challenge more than a small fraction of transactions. They also view applicable penalties as relatively minor and probably avoidable. They put these factors together to make a compelling case that the transaction makes economic sense, even though the transaction would not withstand judicial scrutiny. Taxpayers often believe that they have little to lose other than transaction costs by entering into an aggressive tax shelter. Even if the claimed benefits are disallowed, they believe that they will be able to settle out the penalties and will be no worse off (other than transaction costs) than they would have been if they had not entered into the transaction.

Our legislative recommendations are intended to accomplish four objectives. First, to encourage the private sector—taxpayers, tax advisors, and those who market corporate tax shelters—to carefully scrutinize the facts and the legal analysis of proposed transactions and consider carefully the appropriateness of the transactions under the law. Second, to level the audit playing field by assuring that the largest and most aggressive of these transactions are disclosed to the Internal Revenue Service on the tax return. Third, to make it clear to the Internal Revenue Service that Congress places emphasis on auditing and challenging questionable transactions. Fourth, to legislatively endorse a reasonable interpretation of the economic substance doctrine—an interpretation that we believe constitutes present law. We think these four objectives may be furthered by the following legislative actions.

1. Require specific, clear reporting for a "large tax shelter"

We recommend the enactment of a new Section 6115 of the Internal Revenue Code that would require the following tax return disclosure for a "large tax shelter," as defined.

- A detailed description of the facts, assumptions of facts and factual conclusions (including conclusions regarding the business or economic purposes or objectives of the transaction) that are relied upon to support the manner in which the transaction is reported on the tax return;
- A description of the due diligence performed to ascertain the accuracy of such facts, assumptions and factual conclusions;
- A statement signed under penalties of perjury by the taxpayer's chief financial officer or comparable senior corporate officer with a detailed knowledge of the business or economic purposes or objectives of the transaction that the facts are true and correct as of the date the return is filed, to the best of such person's knowledge and belief. If the actual facts varied materially from the facts, assumptions or factual conclusions relied upon, the statement would need to describe such variances;
- Copies of any written material provided in connection with the offer of the tax shelter to the taxpayer by a third party;
- A full description of any express or implied agreement or arrangement with any advisor, or with any offeror, that the fee payable to such person would be contingent or subject to possible reimbursement if the anticipated tax benefits are not obtained; and
- A full description of any express or implied warranty from any person with respect to the anticipated tax results from the tax shelter.

The disclosure required by new Section 6115 would impose greater corporate and personal accountability than the reporting required under the new tax return disclosure regime proposed in the February 28, 2000 administrative announcements. In addition, if a taxpayer fails to satisfy the Section 6115 disclosure requirements for a "large tax shelter," a new Section 6716 would impose a $50,000 penalty. If the nondisclosure were determined to be willful, criminal penalties also would apply.

The penalty should be a no-fault penalty relating solely to the failure to disclose information on the tax return. Neither the amount of the new Section 6716 penalty nor its applicability should be dependent on whether or not the transaction in issue results in a tax deficiency. Moreover, the nondisclosure penalty would be totally unrelated to any penalty to which the taxpayer might be subject under Section 6662.

We believe the proposed Section 6716 penalty should be subject to a reasonable cause exception permitting abatement of the penalty if the taxpayer establishes that it exercised due diligence in attempting to accurately report the relevant information (e.g., that it had appropriate fact-gathering procedures in place and that it did its best to follow them).

2. Broaden the substantial understatement penalty to cover outside advisors, promoters and "tax indifferent parties"

In any situation in which the substantial understatement penalty of existing law is imposed on the taxpayer, a penalty also should be imposed on any outside advisors who rendered favorable tax advice or opinions used in the promotion of the tax shelter, and promoters who actively participated in the sale, planning or implementation of the tax shelter. The same type of penalty should also be imposed on any "tax indifferent party," unless any such party can establish that it had no reason to believe the transaction was a tax shelter with respect to the taxpayer. The penalty should not be imposed on advisers who rendered opinions that comply with our proposed Circular 230 amendments.

Such penalties should be set at levels commensurate with the fees or benefits such parties stood to realize if the transaction were successful. In addition, separate procedural rules should be provided to assure such parties of due process, similar to the rules applicable in the case of penalties on tax return preparers.

3. Define "large tax shelter" for purposes of proposed disclosure requirement

The definition of "tax shelter" presently contained in section 6662(d)(2)(C)(iii) should be retained. The term "large tax shelter" would be defined as any tax shelter involving more than $10 million of tax benefits in which the potential business or pre-tax economic benefit is immaterial or insignificant in relation to the tax benefit that might result to the taxpayer from entering into the transaction. In addition, if any element of a tax shelter that could be implemented separately would itself be a "large tax shelter" if it were implemented as a stand-alone event, the entire transaction would constitute a "large tax shelter."

4. Clarify that, where the economic substance doctrine applies, the non-tax considerations must be substantial in relation to the potential tax benefits

Most courts, as well as careful tax advisors, apply the economic substance doctrine by weighing the potential tax and non-tax results of a contemplated transaction. We think this is entirely consistent with long-standing congressional intent, and we recommend that Congress codify the weighing requirement of the better case law. We believe that codification of this rule is desirable to provide a clear statement of the standard generally applied by courts under the economic substance doctrine, and would prevent reliance on unclear or conflicting judicial articulations of that standard in rendering opinions on tax-driven transactions. In this regard, we were pleased to see that the D.C. Circuit's opinion in ASA Investerings rejected arguments that de minimis nontax economic attributes are sufficient to sustain a tax-motivated transaction. Any such codification would not, however, displace current law where the business purpose test is currently applied without a weighing of the tax and business objectives, such as the business purpose rules applied in the context of section 355 and in most tax-free corporate acquisitions.

5. Articulate a clear Congressional policy that existing enforcement tools should be utilized to stop the proliferation of large tax shelters

Congress should make clear its view that examination of large tax shelter transactions by the Internal Revenue Service should be considered a tax administration priority. This should include the application of both civil and criminal penalties when appropriate.

D. Amplification of Certain Legislative Recommendations

1. Return Disclosure Requirement

a. Rationale

We seek to achieve two objectives in proposing enactment of a "large tax shelter" return disclosure requirement. The first objective is to reduce the incentive to engage in transactions that would not withstand scrutiny on the ground that the likelihood of detection is small. Many tax shelter products and transactions are com-

prised of purportedly separate transactions or steps, often intended to obscure the overall transaction and frequently involving steps both within and outside the United States. As such, these transactions are extremely complex and often impossible to detect through information contained in a tax return, even by an experienced revenue agent. We believe Congress should mandate specific tax return disclosure obligations that will lessen the significant role that the likelihood of escaping detection currently plays in the corporate tax shelter equation. On the assumption that a return disclosure system is designed to be compliance friendly, as we believe it can be, the argument that legitimate transactions may be affected should be considered with a healthy dose of skepticism. Whether legitimate in the eyes of the taxpayer or not, we would ask what is inappropriate about fair disclosure in a tax return context, even if the transaction is legitimate?

The second objective of the proposed return disclosure requirement is to encourage taxpayers and their advisors to pay careful attention to the actual facts underlying the proposed transaction prior to its consummation. We remain concerned, as we have previously testified, that often the facts assumed in analyzing the tax shelter are not the facts that actually occur. We believe the return disclosure requirement will underscore the importance of the actual facts of the transaction and encourage the taxpayer and its advisors to more carefully scrutinize the transaction in advance.

b. Certification by a senior officer

We believe the proposed senior officer certification is an extremely important component of the return disclosure requirement for two reasons. First, the senior business people within the organization who likely were involved in implementing the transaction, and, thus, who likely are most familiar with the actual facts, will be involved in preparation of the certification.[5] It will be in the direct interest of the senior officer to assure such involvement, and there will be much less risk that the taxpayer's return position will be based on other than the actual facts.

Second, because these transactions by definition are large (we suggest a $10 million reporting threshold) and because they are very aggressive, we think it is appropriate to encourage the taxpayer's senior management to personally consider the proposed transaction. If the chief financial officer or a comparable senior officer knows that he or she will be required to execute the certification, we expect the officer will be much more interested in being personally advised of the transaction and of its risks before it is consummated.

Because of the potentially serious civil and criminal penalties that could result to a corporate officer who commits perjury by executing an inaccurate certificate, the legislation should provide appropriate separate administrative and judicial procedures that will accord the officer full due process. To this end, procedures should be established for reviewing officer certification issues that are independent of the audit process.

Mr. Chairman, the Tax Section attaches particular importance to the proposed large tax shelter return disclosure requirement because we believe it has the potential to accomplish two important objectives: (1) reduce the incentive to rely on nondiscovery by the IRS and (2) encourage a more careful factual and legal analysis of the transaction on the front end, before the transaction is consummated. A disclosure requirement which has this effect will make a significant contribution to tax administration and the American people's confidence in the tax system.

2. Affirmation of Economic Substance Standard

We are aware that certain advisors have taken the position that any amount, even a de minimis amount, of risk, profit or other economic return is sufficient to satisfy the judicial economic substance doctrine. While we are confident that this view does not reflect present law, it is important to foreclose such assertions. It is for this reason that we make the relatively modest suggestion that Congress legislatively affirm that when a court determines the economic substance doctrine applies, the taxpayer must establish that the non-tax considerations in the transaction were substantial in relation to the potential tax benefits.

Our recommendation does not require the Congress to adopt a definition of economic substance or specify the particular circumstances in which the doctrine is relevant. We think both of these matters are best left to the courts where judicial discretion can be applied on a case-by-case basis. However, we think it is appropriate

[5] Some unincorporated businesses that will be subject to the reporting requirement may not have officers. Thus, it will be important for the legislation, or the legislative history, to make it clear that in such circumstances the certification must be executed by the person with responsibilities comparable to those of a senior corporate officer.

and important for the Congress to affirm what we believe to be current law, namely, that the non-tax considerations in the transaction must be substantial in relation to the potential tax benefits. It would also be helpful if Congress would make it clear that in evaluating the non-tax aspects of a transaction, such as potential economic profit, all of the costs associated with the transaction, including fees paid to promoters and advisors, should be taken into account.

To be clear, we do not support codification of any particular formulation of the economic substance doctrine. We believe it would be prohibitively difficult to codify the doctrine without creating untold and unintended effects to ordinary business transactions and possibly even missing transactions that ought to be covered. Rather, we propose to leave to the courts when and how to apply the doctrine. Our narrow proposal is simply that Congress confirm that de minimis non-tax benefits will not sustain a tax motivated transaction and instead that economic attributes must be substantial in relation to tax benefits, as ASA Investerings decided.

One of the arguments that we expect the Committee will continue to hear from opponents of corporate tax shelter legislation is that the Internal Revenue Service already has the tools to deal with corporate tax shelters on its own, without legislation. Last week's administrative steps by the Treasury Department and the Internal Revenue Service will be cited as examples of action that could have been taken long ago; the argument will be made that no legislation is appropriate at least until the effectiveness of such administrative attempts can be gauged. Recent court decisions in the Commissioner's favor may be cited as additional proof to support this point of view.

We urge the Committee not to accept these assertions. The administrative actions are important and they should be welcomed by the Committee. But legislation is needed to fill in the gaps that are beyond the power of the Treasury and IRS. Ours is a self-assessment system. It works best when taxpayers are motivated to take their return reporting obligations seriously. We think it is important to modify the behavior of taxpayers, their tax advisors and those involved in the marketing of tax shelters through an improved self-policing system. Changes to Circular 230 will help. Increased reporting requirements and audit activity by the Internal Revenue Service is very important. But, Congress also has a responsibility. We urge the Committee to take the lead by adopting legislation along the lines we recommend. As you proceed in your deliberations, please know that members of the Tax Section are prepared to lend a helping hand.

CONCLUSION

Mr. Chairman, thank you for the opportunity to appear before the Committee today. I will be pleased to respond to any questions.

PREPARED STATEMENT OF ROBERT H. SCARBOROUGH

My name is Robert Scarborough, and I appear in my capacity as Chair of the Tax Section of the New York State Bar Association. The Tax Section's membership includes about 3,000 tax lawyers who work in private practice, in businesses and in government. Each year the Tax Section, through its Executive Committee, prepares several dozen reports analyzing proposed tax legislation and regulations, and other tax law topics, for submission to federal, state and local government officials.

We believe that the two subjects of today's hearing—corporate tax shelters and penalty provisions in the Internal Revenue Code—are closely related. Changes to current penalty rules can play a major part in addressing the serious issues presented by corporate tax shelters. My statement today focuses on this relationship, and does not consider other questions raised by proposed reforms of current penalty rules.

As part of our function of commenting on proposed legislation, the Tax Section submitted two reports last year on proposals dealing with corporate tax shelters in the President's FY 2000 budget.[1] In these reports, we stated that there are serious and growing problems with aggressive, sophisticated and, in some cases, artificial transactions designed almost entirely to achieve a particular tax advantage. We also supported changes to current accuracy-related penalty rules as a partial response to those problems.

Since we submitted our reports last year there have been a number of developments relevant to these issues, including release of studies of corporate tax shelters

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[1] New York State Bar Ass'n Tax Section, Report on Corporate Tax Shelters, April 23, 1999; New York State Bar Ass'n Tax Section, Report on Certain Tax Shelter Provisions, June 22, 1999.

and penalty reform by both the Staff of the Joint Committee on Taxation[2] and the Treasury Department.[3] Early last month, the Administration released its FY 2001 budget, which includes proposals similar to those in last year's budget and in the Treasury study on corporate tax shelters. Most recently, on February 28 the Internal Revenue Service issued temporary regulations imposing new disclosure rules, and it announced other measures.[4] Although in my statement today I will generally be restating positions the Tax Section has already taken publicly, I will also take into account these more recent developments.

Tax shelters take many complex forms, but in general they are transactions entered into to reduce tax, without meaningful economic risk or potential for profit, by exploiting noneconomic features of the tax law in unintended ways. They often involve shifting income to tax-exempt parties, and often are marketed to a number of different corporations.

In addition to lost tax revenues, proliferation of corporate tax shelters has a corrosive effect on the tax system. The constant promotion of largely or wholly artificial transactions breeds significant disrespect for the law, encouraging responsible corporate taxpayers to expect such transactions to be the norm, and to follow the lead of other taxpayers who have engaged in them.

The roots of the tax shelter phenomenon are complex and varied. One is the nature of the tax law, which is filled with noneconomic and sometimes arbitrary distinctions between transactions and instruments that differ little in substance; taxpayers have strong financial incentives to take advantage of structural flaws in the law. Another cause is innovation in financial engineering, which has made it easier to manage risk, thereby minimizing the real economics of complicated transactions that arbitrage discontinuities in the tax law.

A third cause—on which I want to focus—is the cost-benefit calculation faced by corporate executives considering shelter transactions. As the Staff of the Joint Committee on Taxation has stated, "[a]nother factor contributing to the proliferation of corporate tax shelters is that, in many cases, the expected tax benefits from the tax shelter far outweigh the associated costs."[5] In weighing these costs, taxpayers must of course consider the risks that the Internal Revenue Service will detect the transaction and successfully dispute the interpretation of the law on which it relies. Taxpayers generally recognize that the legal basis of these transactions is far from certain; applicable technical rules may be unclear and common law requirements of "economic substance" and "business purpose" may not be met. Taxpayers also recognize, however, that the government faces significant resource constraints and cannot deal quickly with tax-motivated transactions either by issuing guidance on applicable substantive law or by detecting and challenging them.

Even if a shelter transaction is detected and successfully challenged, there is unlikely to be any downside other than denial of the tax benefit sought and payment of interest at a slightly increased rate. It is generally believed that no penalty will be imposed under current law if the corporation relies on an opinion of a professional tax advisor. Internal Revenue Code section 6662 imposes a penalty of 20 percent on the portion of any underpayment attributable to any substantial understatement of income tax, with certain exceptions. Section 6664, however, provides that the penalty does not apply to any portion of an understatement for which there is reasonable cause and the taxpayer acted in good faith. Regulations provide that this standard generally is met in the case of a corporate tax shelter if the corporation relies on the opinion of a professional tax advisor that analyzes the pertinent facts and authorities and unambiguously states that the advisor concludes that there is a greater than 50-percent probability that the tax treatment sought will be upheld if challenged by the Internal Revenue Service.[6] Although reliance on an opinion is not dispositive under these regulations, taxpayers obtaining such an opinion generally would not view the risk of a penalty as significant. Both the Joint Committee Staff and the Treasury Department, in the studies they released last year, have ex-

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[2] Staff of the Joint Comm. 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) (JCS–3–99), July 22, 1999 ("JCT Study").

[3] Department of the Treasury, The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals, July 1999 ("Treasury White Paper"); Department of the Treasury, Office of Tax Policy, Report to The Congress on Penalty and Interest Provisions of the Internal Revenue Code, October 1999.

[4] Tax Shelter Disclosure Statements, 65 Fed. Reg. 11,205 (2000); Requirements To Maintain List of Investors in Potentially Abusive Tax Shelters, 65 Fed. Reg. 11,211 (2000); Corporate Tax Shelter Registration, 65 Fed. Reg. 11,215 (2000).

[5] JCT Study at 211.

[6] Treas. Reg. §1.6664–4(e)(2).

pressed the view that the section 6662 penalty is not a significant deterrent under current law, due to reliance on "more likely than not" opinions.[7]

Because the cost-benefit calculation faced by corporations is a major cause of the tax shelter phenomenon, we believe that measures to change this calculation must play an important role in dealing with it. This calculation can be changed in several different ways. It can be changed by increasing the risk that a transaction will be identified for challenge by the government. The calculation can also be changed by increasing the cost if a transaction is successfully challenged, both by increasing the amount of penalties and by making it more difficult to avoid them.

The measures announced by the Service on February 28 will certainly facilitate its efforts to detect and respond quickly to tax shelters. They include (i) tax shelter registration regulations to implement section 6111(d), (ii) requirements that corporations entering into tax shelters file disclosure with their returns, (iii) requirements that shelter promoters maintain lists of investors, and (iv) establishment of a new Office of Tax Shelter Analysis within the Internal Revenue Service. The new office, if it is given adequate resources, will provide a valuable service not only to the government in enforcing the law, but also to taxpayers if it ensures that examining agents apply consistent standards.

The new regulations may also make it more difficult for taxpayers that are successfully challenged to avoid the accuracy-related penalty of section 6662, by limiting the exception for taxpayers who rely in good faith on a professional's opinion. The preamble to the new disclosure rules warns that failure to make required disclosures may show lack of good faith for purposes of the penalty.

The Internal Revenue Service cannot, of course, increase penalties or impose a strict liability standard for tax shelters without Congressional action. The Treasury Department thus has proposed legislation raising the section 6662 penalty to 40 percent for items attributable to corporate tax shelters and imposing strict liability. The penalty would be reduced to 20 percent if the taxpayer has satisfied certain disclosure requirements. The 20-percent penalty for disclosed items could be completely avoided if the taxpayer also had a "strong chance" of sustaining its position and acted in good faith.

The Tax Section supports the approach of this legislative proposal. In our report last April we supported increasing the substantial understatement penalty for corporate tax shelter items to above 20 percent, with no exception for reasonable cause or good faith, if the taxpayer has not made disclosure. In fact, in our report we expressed support for a strict liability penalty, but at a substantially lower level, even where the taxpayer has made disclosure. Thus, the approach we endorsed last year would have gone farther than the Treasury's most recent legislative proposal, which would not impose strict liability if the taxpayer has made disclosure.

We acknowledge that increasing accuracy-related penalties for tax shelters and narrowing or eliminating exceptions will put considerable pressure on the definition of those transactions. Changes of the kind the Treasury has proposed, and we have endorsed, may also increase significantly the leverage of Internal Revenue Service agents in some audits of corporate taxpayers. Because we believe it is crucial to increase the risk associated with entering into corporate tax shelters, however, we concluded on balance that these effects are acceptable provided (a) the penalty is imposed only if the taxpayer's position ultimately is not sustained as a matter of substantive law, (b) the amount of the penalty is reduced if the transaction is disclosed on the taxpayer's return, and (c) the penalties are limited to corporate tax shelters, as appropriately defined. In addition, to ensure that the threat of heightened sanctions is not used inappropriately or inconsistently in audits, consideration might be given to requiring Internal Revenue Service National Office coordination of their use, perhaps through the new Office of Tax Shelter Analysis.

We would like to emphasize that it is particularly important to define transactions subject to heightened penalties in a manner that distinguishes artificial transactions, designed to produce a tax benefit only, from legitimate corporate tax planning. We believe that a distinction must be drawn between (a) planning that structures a business transaction in a tax-efficient way, even if such planning takes advantage of noneconomic legal rules, (b) and largely or wholly artificial transactions entered into solely to produce tax benefits. We would not support measures that ignore this distinction or define corporate tax shelter in an overly broad way.

The definitions used in the tax shelter registration regulations and in the new disclosure rules issued on February 28 are quite expansive. The Tax Section has not yet had an opportunity to review these definitions carefully, and we expect to submit our report to the Treasury and Internal Revenue Service commenting on them sometime during the next few months.

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[7] JCT Study at 214–216; Treasury White Paper at 90.

One of the reports we submitted last year included a detailed and precise definition of the type of transaction we believe should be subject to heightened penalties and strict liability. We would be pleased to work with Congress to develop a definition of transactions that should be subject to such sanctions.

We believe the focus of efforts to deal with the corporate tax shelter problem should be on changes to penalty and disclosure rules. We do not support at this time proposals to change substantive law with general anti-avoidance rules that override specific technical rules. There is little evidence that current law judicial doctrines of economic substance and business purpose are inadequate to allow the government successfully to deal with tax shelters in litigation, once they are detected and challenged.

We also oppose at this time adoption of proposals that would either (a) impose an excise tax on fees received in connection with corporate tax shelters, or (b) impose tax on income allocable to tax-indifferent parties.

Mr. Chairman, thank you for the opportunity to appear before the Committee today. I will be pleased to answer your questions.

PREPARED STATEMENT OF CHARLES W. SHEWBRIDGE, III

Good morning. I am Charles W. Shewbridge, III, Chief Tax Executive for BellSouth Corporation in Atlanta, Georgia. I appear before you today as the President of Tax Executives Institute, the preeminent group of corporate tax professionals in North America. The Institute is pleased to present testimony on two related, but independent, issues—(1) reforming the Internal Revenue Code's general interest and penalty provisions (including the standards to which taxpayers and practitioners are held), and (2) addressing the critically important issue of corporate tax shelters, by ensuring that taxpayers, practitioners, and promoters have sufficient incentive to comply with the law without unduly interfering with legitimate business transactions.

After providing an overview of developments since this Committee held an April 1999 hearing on the corporate tax shelter provisions of the President's Fiscal Year 2000 budget and briefly summarizing TEI's conclusions and recommendations, this statement separately provides detailed comments on the two subjects of today's hearing. First, we focus on the recommendations made last year by the staff of the Joint Committee on Taxation and the Department of the Treasury relating to the Internal Revenue Code's interest and penalty provisions generally (other than those relating to corporate tax shelters). Next, we turn to the various proposals, including those in the Administration's Fiscal Year 2001 budget, that have been made in respect of corporate tax shelters.

BACKGROUND

Tax Executives Institute was established in 1944 to serve the professional needs of in-house tax practitioners. Today, the Institute has 52 chapters in the United States, Canada, and Europe. Our more than 5,000 members are accountants, attorneys, and other business professionals who work for the largest 2,800 companies in the United States and Canada; they are responsible for conducting the tax affairs of their companies and ensuring their compliance with the tax laws. TEI members deal with the tax code in all its complexity, as well as with the Internal Revenue Service, on almost a daily basis. Most of the companies represented by our members are part of the IRS's Coordinated Examination Program, pursuant to which they are audited on an ongoing basis. TEI is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. Our background and experience enable us to bring a unique and, we believe, balanced perspective to the interest and penalty provisions of the Internal Revenue Code in general and the subject of corporate tax shelters in particular.

THE EVOLVING LANDSCAPE

Last April, my predecessor as President of Tax Executives Institute (Lester D. Ezrati of Hewlett-Packard Company) presented testimony to this Committee on the corporate tax shelter provisions of President Clinton's Fiscal Year 2000 budget. Although acknowledging that the Administration had identified a significant issue requiring action, TEI's testimony last spring urged Congress to move cautiously before enacting legislation.

TEI's plea for caution was prompted not only by our conclusion that the IRS had already taken several effective steps toward stanching abusive transactions, but also by our concern that the cumulative effect of the Administration's proposals could well be to impede legitimate business transactions and to undermine the effective administration of the tax law by impairing the audit process. Quite candidly, we were also concerned that, inasmuch as the Treasury Department and IRS had not undertaken to quantify the scope of the so-called corporate tax shelter program or even to define what was meant by the term "corporate tax shelter," the Administration might legitimately be criticized as engaging in a "ready, fire, aim" exercise. Before rushing to judgment, TEI recommended, Congress should ensure that it had a complete picture of the facts—the extent of the problem, the reasons for the problems, the tools at the Treasury Department's and IRS's disposal to deal with the problem, and the consequences (both intended and unintended) that might flow from the potpourri of proposals put forth by advocates of change.

Several things have occurred since that April hearing that are worthy of note. First, as already noted, both the Treasury Department and the staff of the Joint Committee on Taxation completed comprehensive studies on corporate tax shelters (as well as on the interest and penalty provisions of the Code generally).[1] Second, the IRS continued to challenge over-aggressive tax-reduction schemes and the courts sustained those efforts, thereby vivifying the economic substance and business purpose tests of the common law. Third, the Administration did not rigidly hew to its original proposals but instead responded positively to the comments and suggestions made by TEI and others. Although certain aspects of the Treasury's revised legislative proposals (as reflected in the President's Fiscal Year 2001 budget) remain problematic, they have clearly been improved. Fourth, the IRS established an Office of Tax Shelter Analysis to collect and analyze information on the depth and breadth of questionable transactions. And finally, just last week, the Treasury Department moved decisively to support the IRS's enforcement efforts by issuing comprehensive proposed and temporary regulations to enhance disclosure requirements by both promoters and taxpayers and by promising to revise the standards of conduct to which lawyers, accountants, and other tax advisers are held.

Tax Executives Institute believes that these developments, in the aggregate, are quite positive. In our view, they confirm the soundness of the call last year that Congress proceed prudently and base its actions not on isolated cases and narrow (albeit disturbing) anecdotes, not on rhetoric, but on reality. TEI views this hearing as the next step in the process.

SUMMARY OF TEI RECOMMENDATIONS

A. Penalty and Interest Provisions

Mr. Chairman, based on media reports, "corporate tax shelters" are the flavor of the week, attracting attention and in some instances triggering overreaction in terms of the size and significance of the problem. Although TEI agrees that the subject of corporate tax shelters is important, we believe it is extremely important not to give short shrift to the other subject on the agenda today: the important work done by the Treasury Department and the staff of the Joint Committee on Taxation on the penalty and interest provisions of the Code. TEI's recommendations and conclusions can be summarized, as follows:

- The interest-rate differential should be repealed in its entirety and the interest charged on under- and over-payments should be equalized.
- The rate of interest on under- and overpayments should equal the applicable federal rate plus no more than two or three percentage points.
- The estimated tax penalty should be converted to an interest charge and a safe harbor should be created for all taxpayers, corporations and individuals.
- The Internal Revenue Service's ability to abate interest should be expanded.
- A dispute reserve account to suspend the running of interest while an issue is disputed by the taxpayer and the IRS should be established. TEI believes the proposal has great promise, not only because it would advance the principle that interest should be paid for the use or forbearance of money but because it would encourage the early payment of amounts in dispute.

[1] See Office of Tax Policy, U.S. Department of the Treasury, The Problem of Corporate Tax Shelters: Discussion, Analysis, and Legislative Proposals (July 1999); Staff of the 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) (JCS–3–99) (July 22, 1999) (hereinafter cited as the "Joint Committee Study"); Office of Tax Policy, U.S. Department of the Treasury, Report to the Congress on Penalty and Interest Provisions of the Internal Revenue Code (October 1999) (hereinafter cited as the "Treasury Report").

- The Code's penalty regime should encourage disclosure by taxpayers. The standards for imposing penalties should be harmonized and consistently applied. Further, there should be a realization that certainty and fairness of application play a more prominent role in encouraging compliance than reflexively increasing penalty rates.
- The pension-related penalties should be consolidated for enforcement purposes under a single government agency.

B. Corporate Tax Shelter Proposals

From the outset, TEI has acknowledged that over-aggressive tax-advantaged products are being marketed and agreed that this poses a challenge to the efficacy of the tax system. The Institute firmly believes that the key to stopping such abuses is the effective administration of the tax law. To be sure, the law should be changed if the law needs to be changed, but a plethora of new penalty provisions—or the codification of the economic substance doctrine—is no substitute for strong, but fair, enforcement of the laws that are already on the books. In other words, TEI believes that the IRS must do more to challenge and curtail questionable transactions, including raising practitioner standards, and where appropriate, asserting penalties more frequently. For this reason, the Institute applauds the announcement that the IRS has created an Office of Tax Shelter Analysis to identify, quantify, and develop comprehensive approaches to dealing with tax shelters (including the issuance of needed guidance). Without the IRS's focused involvement in the process—without its input on defining the nature and scope of the problem and the administrative steps that it can and should take under current law—TEI regrets that legislative proposals to stanch tax shelter activity ex ante will miss the target and impede legitimate transactions.[2]

In addition to believing that a much clearer definition is needed of the term "tax shelter,"[3] TEI offers the following summary of its conclusions and recommendations concerning corporate tax shelters:

- Adoption of substantive tax provisions with subjective standards (e.g., a so-called super section 269 provision or codification of the business purpose test or economic substance doctrine) is unnecessary, would be difficult to effect (because of the drafting challenges it would pose), and would be counterproductive.
- To facilitate the administration of the law (i.e., the examination of transactions and the publication of timely guidance shutting down abusive transactions), tax shelter promoters and taxpayers should be obliged to provide meaningful, albeit measured, disclosure of transactions.
- An effective early warning disclosure regime (pre-tax return filing) requiring promoters to register their products may well require new legislation, though we commend the Treasury Department on the steps it took last week in issuing proposed and temporary regulations under sections 6011 and 6012 of the Code.
- As for taxpayers, enhanced return disclosure requirements could be implemented by regulation or administrative rule. "Indicators" or "filters" that prompt a requirement to register or disclose a transaction or that trigger taxpayer penalties for non-disclosure should be objective and easy to apply. The Treasury Department's recently issued regulations under sections 6011 (as well as section 6001) significantly advance the debate over the proper standards for disclosure.[4]
- Proposals for a separate attestation of a transaction by a senior corporate officer, especially when accompanied by the imposition of personal liability for the filing of an inaccurate attestation, should be rejected. The proposals could lead to examinations of attestations rather than examinations of transactions, and greatly impair the audit process.

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[2] TEI remains concerned that the unintended adverse consequences flowing from overbroad or poorly drafted proposals could be significant. This point was underscored by Thomas J. Smith, IRS Director of the Heavy Manufacturing, Construction, and Transportation Industry, during a recent conference on IRS Modernization Conference. In response to a question, Mr. Smith reported that some IRS employees had erroneously characterized research tax credit claims as "corporate tax shelters."

[3] Without a clear definition, it will be impossible to craft careful, targeted solutions that do not either adversely affect legitimate business transactions or disrupt the examination process. This is true whether the definition relates to a substantive proposal, such as the proposed codification of the economic substance test; to a penalty provisions; or "merely" to a provision requiring registration or disclosure of a "reportable transaction" where one or more factors (née indicators o. filters) are present.

[4] Hence, the Treasury regulations set forth relatively straightforward criteria for determining whether a transaction is a "reportable transaction" subject to disclosure. Although TEI has not yet completed its analysis of the regulations (and whether the proposed standards should be revised or narrowed), it agrees that such an approach is appropriate.

- Proposals to increase the accuracy-related penalty from 20 to 40 percent in respect of tax shelters or to eliminate the reasonable cause exception should be rejected.
- To the extent a problem exists with the current penalty regime, TEI believes it lies not in the penalty being too low, but too high, combined with the lack of consistent, meaningful enforcement activity by the IRS in appropriate cases. In our view, the proposal to reduce the penalty from 40 percent to a still high 20 percent in those situations where the transaction is disclosed provides a hollow incentive to taxpayers.
- The Institute questions the efficacy of the "highly confident" standard proposed by the staff of the Joint Committee on Taxation because it presumes a greater degree of precision than exists with the current tax law. Moreover, we are concerned that a proliferation of penalty standards will spawn greater complexity in the administration of the penalty regime. Finally, the risk-reward profile for tax-shelter promoters should be significantly modified.
- In recognition of the complexity of the tax law and to provide an incentive for disclosure of transactions, a reasonable cause exception to the imposition of penalties should be retained. To deter opinion shopping and ensure that opinions are based on the actual facts of a transaction rather than unjustified assumptions, the scope of the reasonable cause exception should be clarified.
- In addition, consideration should be given to adopting a new penalty on tax practitioners and concomitantly strengthening Circular 230 to increase accountability by heightening practitioner standards of conduct. Thus, we commend Treasury Secretary Summers for committing the Administration to issuing revised regulations within six months.

INTEREST AND GENERAL PENALTY PROVISIONS

A. Background

TEI has long believed that the Code's interest and penalty provisions are unduly complex and inequitable, and they impose unreasonable burdens on both taxpayers and the government. The interest provisions can operate in an unfair manner and are difficult to administer, especially when taxpayers have overlapping periods of under- and overpayments. In many cases, the provisions (such as the estimated tax provisions) have served as an inappropriate penalty, rather than as recompense for the time value of money.

Moreover, the calculation of interest itself—with its restricted interest provisions and requirements for compounding and netting—is inordinately difficult and leads to errors by both the government and the taxpayer. Almost every TEI member can recount a protracted tale, if not a horror story, of convoluted, complicated, and ultimately incorrect interest calculations. For good reason, taxpayers doubt the IRS's ability to compute interest accurately, and they frequently incur significant expense in hiring outside consultants to review interest charges—often without the benefit of a print-out of the IRS calculations. We recognize that much of the cause of the problem lies in the IRS's computer system (which is in the process of being replaced), but we believe the IRS can take immediate steps to assist taxpayers now—for example, by providing copies of interest calculations.[5]

In respect of the Code's general penalty provisions, TEI believes that they should be simple, fair, and easy to administer. Unfortunately, the tax law has moved away from this concept in the last decade where penalty has been piled upon penalty to target specific areas such as transfer pricing and corporate tax shelters. Rather than being straightforward, direct, and effective, penalties have become almost as complicated as the underlying provisions they seek to enforce. Dangerously, too, the enactment of new, or racheting up of existing, penalties deprives the system of proportionality while representing a politically expedient way of raising revenues without increasing "taxes."

The tax law seems to have lost track of the concept that penalties should be applied only in cases of willful (or volitional) noncompliance, and not for every error or omission. The current structure does not effectively distinguish between the two, but instead places taxpayers who unintentionally fail to meet some requirement in the same category with those who willfully decide not to comply.

It is clearly time for an in-depth review of the Code's interest and penalty provisions. TEI commends Chairman Roth and the Finance Committee for scheduling

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[5] Section 6631 of the Code (added by the Internal Revenue Service Restructuring and Reform Act of 1998) requires that individual taxpayers be provided with interest calculations after December 31, 2000. TEI submits that this provisions should apply to all taxpayers and should be implemented as soon as possible.

this hearing to determine the effectiveness of the current interest and penalty regime and to consider recommendations for reform.[6]

B. Interest Provisions

1. Elimination of the Interest-Rate Differential

Section 6621 of the Code establishes the rate of interest to be paid on over- and underpayments of tax. The rate on overpayments of tax by a corporation is the federal short-term rate plus 2 percentage points; the underpayment rate is the federal short-term rate plus 3 percentage points.[7] "Large corporate underpayments" are subject to an interest equal to the federal short-term rate, plus 5 percentage points (the so-called hot interest provision).[8] Thus, the rate of interest the government charges corporate taxpayers on tax deficiencies is higher than the rate of interest the government pays on refunds.[9]

The different interest rates for over- and underpayments, coupled with the differences for large corporations, have spawned another major complexity in the tax law—interest netting. The situation arises when taxpayers both owe money to and are owed money by the government (but the debts bear interest at different rates) and is a common occurrence for large corporations that may have overpayments and underpayments of different taxes for several years as the result of multi-year and overlapping audits. For example, an IRS determination, say in Year 8, that a taxpayer should have deducted an expense in Year 1 instead of Year 2 could trigger an interest charge owing to the interest-rate differential, even though the taxpayer was a net creditor of the government during the entire period.

In the IRS Restructuring Act, Congress established a net interest rate of zero where interest is payable on equivalent amounts of over- and underpayments of tax.[10] Taxpayers must affirmatively request and—at least at present—calculate the adjustments needed to achieve a zero net interest rate. Although this provision ameliorates the inequity caused by the difference in interest rates, it does not provide a full measure of relief. It is also an extremely complex provision to administer.

Tax Executives Institute supports elimination of the interest-rate differential. When the differential was enacted, two reasons were given for applying different rates to under- and overpayments: (i) financial institutions do not borrow and lend money at the same rate, and (ii) the differential between the tax interest rate and the market rate might cause taxpayers either to delay paying taxes or to overpay

[6] Both the Joint Committee staff and the Treasury Department make several recommendations concerning the interest and penalty provisions as applied to individual taxpayers. Given the composition of its membership and the business-tax focus on its activities, TEI has not addressed these recommendations, but suggests that many of them—such as the Joint Committee staff's recommendation that overpayment interest be excluded from the income of individual taxpayers—are worthy of consideration.

[7] The IRS Restructuring Act eliminated the differential in respect of individual taxpayers, but not corporations.

[8] The higher large corporate underpayment interest rate applies only to periods after the "applicable date." The calculation of the applicable date differs. If the deficiency procedures apply, the applicable date is the 30th day following the earlier of the date on which (a) the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in IRS's Office of Appeals or (b) the statutory notice of deficiency is sent by the IRS. If the deficiency procedures do not apply, the applicable date is 30 days after the date on which the IRS sends the first letter or notice that notifies the taxpayer of the assessment or proposed assessment.

[9] Under section 6621(a)(1), the interest rate on corporate tax overpayments that exceed $10,000 is only AFR plus 0.5 percentage points, as opposed to AFR plus 2 percentage points. (This provision was enacted in 1994 as part of the Uruguay Round Agreements Act, Pub. L. No. 103–465, 108 STAT. 4809, and accordingly is often referred to as "GATT" interest.) Thus, the potential difference between the interest rate for under- and overpayments for corporations is 4.5 percentage points. Although the GATT interest rate is effective for purposes of determining interest for periods after December 31, 1994, the IRS has embraced an unduly narrow interpretation of the statute, applying the lower rate to overpayment interest accruing before the statute's effective date. IRS Service Center Advice Memorandum 1998–014 (April 24, 1997). Indeed, the 1997 memorandum represents a change in position for the IRS, which originally determined that overpayment interest accrued through December 31, 1994, would not be subject to the lower GATT rate. The statutory GATT interest provisions and the IRS' narrow interpretation operate to exacerbate the unfairness of the interest-rate differential.

[10] The provisions applies to interest for periods beginning after July 22, 1998. In addition, the provision applies if: (i) the statute of limitations has not expired with respect to either the underpayment or overpayment; (ii) the taxpayer identifies the overlapping periods for which the zero rate applies; and (iii) the taxpayer requests the netting before December 31, 1999. In Rev. Proc. 99–43, the IRS clarified the transition rule by providing that—assuming that both statutes of limitations were open on July 22, 1998—a taxpayer must file a claim requesting application of the net rate of zero by December 31, 1999, only if both the applicable statutes will have expired before that date.

them, depending upon the rate of interest accruing.[11] Contrary to the views expressed in the Treasury Report (at 121), TEI submits that these reasons—even if valid in 1986—are no longer applicable. Taxpayers do not deliberately "lend" money to the government. If such practices ever occurred, they were effectively put to an end nearly two decades ago by changes to the manner in which, and the rate at which, interest is calculated.[12] Moreover, returning to one rate of interest for both under- and overpayments will greatly reduce or eliminate the need for netting, thereby significantly simplifying the law and freeing up both taxpayer and IRS resources. Finally, the proposed statutory amendment would address the inequities arising from the "same taxpayer" rule, pursuant to which under- and overpayments by related entities (such as with foreign sales corporation and related supplier adjustments) do not result in an overall increase in tax liabilities, but because of the different rates on over- and underpayments, interest may be owed.

Thus, the Institute believes that the elimination of the interest-rate differential would complete the reform effort Congress undertook in 1998. See Joint Committee Study at 73. Equalizing the rates would "provide a better mechanism for achieving the equivalent effective interest rate goal than the net zero interest rate approach of current law." Id. at 76. It would also make the benefits of the equivalent effective interest rates available to all taxpayers, not just those capable of preparing the complicated calculations.

TEI therefore recommends that the interest-rate differential be eliminated for all taxpayers.

2. Rate of Interest

Equalizing the interest rates on under- and overpayments raises the issue of the appropriate rate of interest to be charged. Current law imposes various rates of interest, ranging from the short-term applicable federal rate (AFR) plus 0.5 (for overpayments) to 5.0 (for underpayments) percentage points. The Joint Committee study recommends equal rates of AFR plus 5.0 percentage points (Joint Committee Study at 73), whereas the Treasury study recommends an underpayment rate of AFR plus 2.0 to 5.0 percentage points (and an overpayment rate of AFR plus 2.5 percentage points) (Treasury Report at 8).

A rate of AFR plus 5.0 percentage points (essentially 11 percent in today's market) is equivalent to the "hot interest" rate that applies to large corporate underpayments. TEI questions whether this high rate is appropriate for all or even any taxpayers. As the Joint Committee Study confirms (at 76), large corporations are generally able to borrow money at a much lower rate. For example, a corporate taxpayer with an "AA" credit rating can borrow money today in the commercial paper market at 5.85 percent for 30 days—an amount slightly lower than the current short-term AFR (6.45 percent). The current interest rate system—with its provisions for above-market interest and "hot" interest—operates essentially as a penalty. We recognize that a blended rate is necessary for ease of administration. We also recognize that, purely from a tax policy standpoint, an argument can be made that interest rates should be skewed, if anything, to encourage overpayment.[13] Nevertheless, we submit the goal should be to approximate a market rate of interest because the purpose of the interest provision should be to do no more than reflect the time value of money. TEI respectfully suggests that a rate of AFR plus 2.0 or 3.0 percent would be much closer to reality.

3. Abatement of Interest

Under section 6404(e) of the Code, the Treasury Secretary is granted the discretion to abate the assessment of all or any part of interest due for any period on (i) a deficiency attributable in whole or part to any unreasonable error or delay by an IRS officer or employee acting in an official capacity when performing a ministerial or managerial act, or (ii) a tax payment, to the extent that any unreasonable error or delay in such payment is attributable to an IRS employee or officer acting in an official capacity being erroneous or dilatory in performing a ministerial or managerial act. An error or delay may be taken into account only (i) if no significant aspect of such error or delay can be attributed to the taxpayer involved, and (ii) after the IRS has contacted the taxpayer in writing with respect to such deficiency or pay-

[11] H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 849 (1985) (hereinafter cited as "1985 House Report"); S. Rep. No. 99-313, 99th Cong., 2d Sess. 184 (1986) (hereinafter cited as "1986 Senate Report").

[12] Before 1982, interest rates on tax overpayments and underpayments were adjusted only once every two years; now they are adjusted on a quarterly basis.

[13] That is to say, if the interest rate is to provide an incentive either to overpay or to underpay one's taxes, the incentive should be toward encouraging overpayment.

ment. There is also limited authority to abate interest in respect of erroneous refunds or reliance on erroneous written advice of IRS personnel.

Both the Joint Committee staff and the Treasury Department agree that the IRS's authority to abate interest should be expanded, though Treasury's recommendation is more circumscribed.[14] The Joint Committee staff recommends that the IRS be permitted to abate interest in cases of gross injustice. Joint Committee Study at 91–92. Although the "gross injustice" standard establishes a high threshold, adoption of the Joint Committee staff's recommendation would mark the first time abatement would be permitted on general equitable grounds. TEI believes that the recommendation should be adopted, but suggests that the IRS's administration of this standard be monitored to determine whether the threshold should be lowered.

Furthermore, the Joint Committee staff recommends that abatement occur for periods attributable to any unreasonable IRS error or delay. Joint Committee Study at 91–92. This provision thus eliminates the managerial or ministerial acts requirement, which creates complex factual issues that themselves can lead to audit disputes and litigation. The legislative history of the interest-abatement provision confirms that Congress did not intend the provision to be used routinely to avoid payment of interest, but rather that the provision should operate in instances where the denial of abatement would be widely perceived as grossly unfair.[15] There may well be instances where the denial of an abatement request may be unfair, but the taxpayer fails to meet the standards set forth in the statute.

TEI therefore supports the Joint Committee staff's recommendations in respect of the abatement of interest and suggests that consideration be given to expanding its reach.

4. Dispute Reserve Account

In general, interest on under- and overpayments continues to accrue during the period that a taxpayer and the IRS dispute a liability. Under section 6404(g) of the Code, the accrual of interest on an underpayment is suspended if the IRS fails to notify an individual taxpayer in a timely manner, but interest will begin to accrue once the taxpayer is properly notified. No similar suspension is available for other taxpayers.

Taxpayers that are unable to promptly resolve their disputes with the IRS face limited choices. The taxpayer can continue to dispute the amount owed and risk paying a significant amount of interest, it can pay the disputed amount and claim a refund, or it can make a deposit in the nature of a bond.

The Joint Committee staff recommends that taxpayers be permitted to deposit amounts in a special "dispute reserve account" within the Treasury Department. Joint Committee Study at 97. Access to the account would be permitted upon notice to the IRS. According to the study, the account "would allow taxpayers to better manage their exposure to underpayment interest without requiring them to surrender access to their funds or requiring them to make a potentially indefinite-term investment in a non-interest bearing account." Id. at 99. It would also preserve the taxpayer's access to the U.S. Tax Court while encouraging the prepayment of disputed amounts. Interest paid on the account would be set at a rate that would provide reasonable compensation to the taxpayer for the use of its money, but should not encourage the use of dispute reserve accounts as an alternative to investment in other short-term instruments. Id. at 100.[16]

The Joint Committee staff's recommendation is a significant improvement over the cash bond requirement of current law. TEI recommends that it be adopted because it would advance the principle that interest should be paid for the use or forbearance of money and also encourage the early payment of amounts in dispute. Moreover, TEI recommends that interest accrue on amounts deposited in the account at the rate established for under- and overpayments of tax.

C. Estimated Tax Penalty

1. Penalty in Lieu of Interest

Under section 6655 of the Code, corporate taxpayers are subject to a penalty if they fail to estimate their tax liability and make quarterly deposits equal to either (i) 100 percent of their actual tax liability, or (ii) 100 percent of their prior year's tax liability. The "prior year's tax" option is generally not available to for so-called

[14] The Treasury Department recommends that the abatement provision be expanded only in respect of reliance on erroneous written advice from the IRS. Treasury Report at 137.

[15] 1985 House Report at 844–45; 1986 Senate Report at 208–09.

[16] The Treasury Report does not address this issue.

large corporations—roughly, corporations whose taxable income is $1 million or more in any of the preceding three years. The estimated tax penalty is imposed in lieu of an interest charge on the underpayments of tax.

Because of the lack of a meaningful safe harbor, the large corporate taxpayer generally faces the following choice:

- Paying a penalty for underestimating its liability, or
- Overpaying its taxes (in order to avoid the penalty).[17]

The second option—which large corporations are generally required to choose not only by internal business conduct policies but by the desire to avoid penalties—does not come without cost. The cost is the effective denial of interest on the amount of the compelled overpayment by operation of section 6611(e), which provides that interest on an overpayment will not begin to run until the filing of a claim for refund.[18] The rules thus act as a "non-penalty" penalty for corporations.

TEI agrees with the recommendation that the estimated tax penalty be converted to an interest charge at the rate provided under section 6621 of the Code, which would make the interest deductible by corporate taxpayers. See Joint Committee Study at 114–15.[19] The estimated tax penalty is, in reality, a charge for the time value of money and the law should reflect this fact. It is simply bad tax policy to disguise an interest charge as a penalty.

TEI therefore supports the Joint Committee staff's recommendations. We also agree with its recommendation (at 118–19) that, in the pursuit of simplification, the interest rates should be aligned so that, for any given estimated tax underpayment period, only one interest rate applies, i.e., the interest applicable on the first day of the quarter in which the estimated payment due date arises.

2. Safe Harbor

TEI is disappointed that neither the Joint Committee Study nor the Treasury Report addresses the need for an estimated tax safe harbor for corporate taxpayers. Because they are not permitted to utilize the prior year's tax safe harbor, large corporations must base their quarterly deposits on estimates of their current year's tax liability. Estimating taxes is not an exact science. The existing task is literally impossible in light of the complexity of the tax laws, the rapidity with which they have been changed in recent years, the cyclical nature of many businesses, and the numerous adjustments to financial income that can accurately be done only annually.

TEI submits that there is no valid tax policy reason for denying large corporations the availability of the prior year's tax rule under section 6655. We therefore recommend that a safe harbor, based on a percentage of the prior year's (or the average of a group of prior years') liability, be established for large corporate taxpayers.

D. Non-Shelter Penalties

1. Accuracy-Related Penalties

Currently, the Internal Revenue Code imposes a hodgepodge of penalties to encourage taxpayers to file accurate returns. These penalties employ a variety of standards, ranging from "more likely than not" (section 6662(d)(2)(B)(i)) and "reasonable basis" (section 6662(d)(2)(B)(ii)) for taxpayers, to "realistic possibility of being sustained" (section 6694(c)) and "not frivolous" (section 6694(a)) for return preparers. The less stringent standards are generally applicable for positions that are disclosed on a return. See Joint Committee Study at 152, Table 7 ("Summary of Existing Standards for Tax Return Positions").

Section 6662(a) imposes a 20-percent penalty on the portion of an underpayment attributable to any of the following: (i) negligence or disregard of rules or regulations; (ii) a substantial understatement of income tax; (iii) a substantial valuation overstatement; (iv) a substantial overstatement of pension liabilities; or (v) a substantial estate or gift tax valuation understatement. The accuracy-related penalty was enacted in 1989 to replace several other penalties, including the negligence, substantial understatement, and valuation overstatement penalties. The penalty is

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[17] The estimated tax rules provide an annualization method that may be employed to avoid any penalties. Determining annualized tax liability and quarterly estimated payments under section 6655(e), however, remains far from simple. This process effectively requires taxpayers to prepare five "mini" returns for their estimated tax payments plus their final return. By reinstating the prior year's liability safe harbor, Congress could remove the uncertainty associated with the determination of tax liability from the quarterly estimating and payment process.

[18] The filing of a tax return could constitute a claim for refund, but most calendar-year large corporations will not file returns until close to September 15 (the extended due date of their return), though any outstanding tax would have to be paid no later than March 15. Thus, there could be, at a minimum, a six-month period during which no interest would accrue on the amount of the overpayment.

[19] But see Treasury Report at 81 (recommending retention of current law).

generally not imposed with respect to any portion of the underpayment for which there is reasonable cause if the taxpayer acted in good faith. I.R.C. §6664(c)(1).

For corporations, an understatement for any taxable year is "substantial" if it exceeds the greater of $10,000 or 10 percent of the tax required to be shown on the taxpayer's return. I.R.C. §6662(d)(1). An exception to the penalty is provided for items in respect of which there is substantial authority or adequate disclosure of the taxpayer's position.[20]

The Code also imposes a two-tiered penalty on tax return preparers in respect of positions not having a "realistic possibility" of being sustained on the merits. Specifically, if the position results in an understatement, a penalty will be imposed unless the preparer takes steps to ensure the disclosure of the position and the position is "not frivolous." I.R.C. §§6694 (a) and (c).

The Joint Committee staff and Treasury Department both recommend that penalty standards be harmonized, though they approach the issue in different ways. Their reports focus on two issues:

- The appropriate standard imposed on taxpayers and tax return preparers.
- The appropriate standard imposed for disclosed and undisclosed return positions.

The Joint Committee staff recommends that, for both taxpayers and return preparers, the minimum standard for each undisclosed position on a tax return be that the taxpayer or preparer must reasonably believe that the tax treatment is "more likely than not" the correct tax treatment under the Code. Joint Committee Study at 153. For disclosed positions, the Joint Committee staff would require both substantial authority and adequate disclosure and would eliminate the reasonable cause exception of section 6664(c)(1). Joint Committee Study at 154–155, Table 8 ("Proposed Standards for Tax Return Positions"). Thus, under the Joint Committee staff's proposal, the standard in respect of disclosed positions would move from the disjunctive (substantial authority or disclosure) to the conjunctive (substantial authority and disclosure).

In contrast, the Treasury Department would retain the "substantial authority" standard for undisclosed positions and raise the standard for disclosed items to a "realistic possibility of success" for both taxpayers and tax return preparers. Treasury Report at 108.

The multitude of standards now contained in the Code—more likely than not, realistic possibility of being sustained, substantial authority, reasonable basis, not frivolous—is undeniably confusing and has reduced taxpayers, practitioners, and preparers to assigning mathematical probabilities to each standard and then divining (to the extent possible) whether a proposed return position meets or exceeds the applicable standard. The clarity suggested by the use of mathematical probabilities, however, is a false one, for the tax law is marked by many things, but mathematical precision is rarely one of them.[21]

These concerns notwithstanding, TEI believes that some adjustment to and harmonization of taxpayer, practitioner, and preparer standards is appropriate to encourage the filing of more accurate returns. We question, however, whether sufficient attention has been paid to the effect of raising the standard in respect of undisclosed positions to "more likely than not" (as the Joint Committee staff suggests). Such an approach may unleash a torrent of disclosures that consumes valuable IRS resources and distracts revenue agents from issues more worthy of their scrutiny. Thus, although we appreciate the surface appeal of the statement that "'more likely than not' is a simple threshold that is easily understood" (Joint Committee Study at 153), we are concerned about how an "at least probably correct" standard (id.) will be applied in practice. As the Joint Committee staff notes, it is unrealistic to expect taxpayers to file a perfect return. Id. at 152. TEI is concerned that taxpayers may find themselves facing penalties where, several years after they grappled with

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[20] Special rules apply in respect of "tax shelters," where the penalty can be avoided only if the taxpayer establishes that, in addition to having substantial authority, it reasonably believed that the treatment claimed was more likely than not the proper treatment of the item; adequate disclosure has no effect on the application of the penalty in respect of tax shelters. These provisions are discussed in the following section of this statement.

[21] TEI is also concerned about how meaningful a difference exists between the two proposed standards. What is the difference between the Joint Committee staff's recommendation of a "substantial authority" standard—which is defined as a 40-percent probability of success—and the Treasury Department's "realistic possibility of success standard—which is defined as a 33-1/3 percent probability? We submit that it would be almost impossible to analyze a proposed transaction with such precision. More troublesome, we foresee situations in which a taxpayer's (or practitioner's) good faith judgment that a position satisfies the higher (40 percent) standard could be second-guessed by a revenue agent who concludes, also in good faith, that the possibility of success was 6.5 percentage points lower.

the vagaries and interstices of the tax law, a revenue agent or court concludes—with the benefit of hindsight—that the taxpayer erred in concluding its position was "at least probably right."[22] (This concern is heightened in light of the Joint Committee's recommendation that the reasonable cause exception of current law be repealed.) If a taxpayer has substantial authority for a return position—e.g., if a court decision or regulation supports its position—no disclosure should be necessary in order to avoid a penalty. See Treasury Report at 108.[23]

Moreover, we do not believe that the case has been made for raising the standard for disclosed positions in respect of taxpayers from a reasonable basis to either a realistic possibility of success standard (as the Treasury proposes) or a substantial authority standard (as the Joint Committee staff proposes). Again, the Institute is concerned that raising the standard would be counterproductive. It may prompt taxpayers, out of an abundance of caution, to laden down their tax returns with myriad disclosure forms, thereby greatly diminishing the value of any particular "needle" in the burgeoning "haystack." Overwhelming the system with disclosures will not aid the administration of the law.[24]

2. Pension Benefit Penalties

Current law imposes several penalties in respect of the failure to file the Form 5500 series (the annual return/report for pension plans). The penalties are imposed by the IRS (under Code section 6652(e)), the Department of Labor (under DOL Reg. §2560.502(c)–2(d)), and the Pension Benefit Guarantee Corporation (PBGC) (under PBGC Reg. §4071.3).

The Joint Committee staff recommends the consolidation into one penalty of the present-law

penalties imposed by the Internal Revenue Code and ERISA for failure to file the Form 5500 series. Joint Committee Study at 161. The penalty that would result from this consolidation would be no less than the existing ERISA penalty for failure to file. In addition, the staff would designate the IRS as the agency responsible for enforcing the reporting requirements and replace the Labor Department's voluntary compliance program with a similar program administered by the IRS. This would reduce from three to one the number of government agencies authorized to assess, waive, and reduce penalties for failure to file. Other penalties imposed for the failure to file certain reporting forms would also be eliminated. Id. The Treasury Department also supports consolidation of the penalties, but recommends that the administration of the penalties rest with the Department of Labor. Treasury Report at 141.

In TEI's view, consolidating the penalties would be a marked improvement over current law. It would simplify the Form 5500 series penalty structure, reduce the number of potential penalties for failure to file, strengthen incentives to comply, and encourage voluntary compliance by delinquent filers while retaining the most significant of the present-law penalties for failure to file. On balance, we favor the Joint Committee staff's proposal to have the IRS responsible for administration of the streamlined regime.

E. Miscellaneous Recommendations

1. Standards Applicable to IRS Personnel

The Joint Committee staff makes several recommendations concerning the administration of the tax law by the IRS, including a revision of the standards applicable to IRS personnel under Rev. Proc. 64–22, 1964–1 C.B. 689, which among other things provides that IRS employees should not adopt a strained construction of the Code. As the Joint Committee staff notes, "the standards of conduct applicable to

[22] After all, the person making the decision whether the taxpayer was "at least probably right" (i.e., revenue agent, Appeals officer, or court) would not even reach that question until concluding that the taxpayer was wrong on the merits.

[23] Given the additional recommendation to increase the amount of the preparer penalty—from a two-tier penalty of $250 or $1000 per return to 50 or 100 percent of the fee (Joint Committee Study at 156)—TEI wonders whether sufficient attention has been focused on the potential adverse effect of the higher standards on compliance.

[24] The Joint Committee Study (at 156) acknowledges that no empirical evidence exists on whether or how effectively the IRS uses the taxpayer disclosures made under current law, and it recommends that the IRS be required to maintain records on its own usage of taxpayer disclosures. TEI supports this recommendation and suggests that, pending the gathering and analysis of information on the effectiveness of current law, Congress not rush to judgment on the need to legislatively require more and more detailed disclosures.

the IRS are an important component of taxpayers' perceptions of the relative fairness of the administration of the tax laws." Joint Committee Study at 167.[25]

TEI agrees that the standards to which IRS employees are held should be clarified. We also agree with the Joint Committee that some employees may have misconstrued the quoted language from Rev. Proc. 64–22—which also appears several places in the Internal Revenue Manual (IRM)—to suggest that a revenue agent's position need not be reasonable, it just cannot be strained. As the Joint Committee's report puts it: "[I]t may appear that an inappropriately low standard of conduct is applicable to the IRS." Joint Committee Study at 167. Thus, the Joint Committee staff recommends that the standards be revised to incorporate a higher standard of behavior by the IRS, similar to that for practitioners.

TEI agrees that a higher standard of conduct for IRS personnel is appropriate and recommends adoption of the Joint Committee staff's recommendation.

2. Failure-to-Deposit Penalty

The Joint Committee staff and Treasury Department make several recommendations concerning the four-tier failure-to-deposit penalty under section 6656(b). Although both suggest that no new legislation be enacted in this area for two years—in order to give the recent statutory changes time to be evaluated—the Joint Committee staff adds that the Treasury Department should consider revising its deposit regulations concerning events that trigger a change in the deposit schedule in a later calendar quarter. This would give the IRS an opportunity to notify the taxpayer of the change in status before it takes effect. It would also give the depositor time to recognize its new obligations and adjust its operating procedures accordingly. Both studies also recommend that the IRS continue to work with payroll service providers to expedite resolution of problems where a single error or mishap may affect multiple taxpayers. Joint Committee Study at 139–140; Treasury Report at 96.

TEI supports these recommendations, but suggests that consideration be given to implementing a mechanism to identify third parties who can provide an oral response to the IRS and receive information in return—without resorting to the time-consuming method for obtaining a power of attorney. Based on reports from our members, TEI understands that at least one District Office has experimented with including a unique identifying number on each notice of proposed penalty. If a caller responds to the notice and provides the name and employer identification number (EIN) of the taxpayer and the identifying number, the IRS assumes the caller is authorized to discuss the matter, eliminating the need for a power of attorney and providing a swift resolution of any questions. TEI recommends that such a procedure be implemented.

CORPORATE TAX SHELTERS

A. Background

As a professional association of in-house tax executives, TEI offers a different perspective on corporate tax shelters from other organizations. The Institute does not represent the so-called tax shelter promoters and developers (including investment bankers) who either sell or facilitate the transactions. Nor do we represent the professional advisers (be they attorneys or accountants) who opine on the legitimacy of the arrangements. Rather, TEI's members work directly for the corporations that regularly enter into business transactions that require an analysis of their tax benefits and burdens. These companies have professional staffs dedicated to minimizing their tax liability while ensuring compliance with the law. To this end, these companies evaluate particular transactions (whether developed by their own staffs or brought to the companies by outside advisers or promoters), decide whether or not these offerings pass muster—not only in terms of the substantive requirements of the tax law but, importantly, in terms of their own business needs and corporate culture—and, if they proceed, report the transactions on their tax returns and defend them on audit. Ultimately, of course, these companies face potential exposure to sanctions (and public opprobrium) should their analysis of a transaction not be sustained. In other words, TEI's members are in the thick of it. We along with the government have the most at stake in trying to craft an equitable tax system that is administrable.

Although I am here today on TEI's behalf, I wish to provide some context for my testimony about my role as Chief Tax Executive for BellSouth Corporation. I have been a tax professional for nearly 30 years, and have been employed by BellSouth for half of that period. As the company's senior tax official, I am ultimately respon-

[25] The Treasury Report is silent on this issue.

sible for the more than 55,000 federal, state, local, and foreign returns that BellSouth files each year. The company's aggregate tax payments for 1999 exceeded $4 billion.

Given the size of that number, it should go without saying that I take my job seriously. In discharging my duties, I oversee a staff of more than 100 individuals. We see our job as twofold—first, to ensure BellSouth's compliance with the state, local, federal, and international tax laws and, second, to serve the company's shareholders by ensuring that we pay only the taxes required by law. This second facet of the job is not new and it is not something that we shrink from defending. Concededly, some proponents of change pejoratively describe today's tax department as a "profit center," but the truth of the matter is that the desire to reduce—and the legitimacy of reducing—one's tax liability is as old as the Rosetta Stone[26] and as legitimate as seeking shelter from the cold or rain.[27] Thus, although TEI agrees that action is necessary to address the tax shelter problem, we believe those who wish to consign corporate tax departments to the role of scriveners, filling out tax returns, fundamentally misunderstand the historical, and we submit wholly proper, role of inhouse tax professionals.

TEI believes that those who proceed on the assumption that tax executives neither understand nor willingly embrace our professional and legal responsibility to ensure our companies' compliance with the tax laws do us, our companies, our shareholders, and—equally important—the tax system a disservice. To be sure, there may be taxpayers who willfully or inadvertently cross over the line, just as there may be practitioners, promoters, revenue agents, government lawyers, and others who do the same. We question, however, whether there is sufficient empirical evidence to call the problem pandemic.[28] Let there be no mistake: TEI supports reasonable administrative, judicial, and legislative steps to address the tax shelter issue, but the steps must be measured, targeted, and based on fact, not feeling. Thus, we take to heart the suggestion that inflamed rhetoric and untempered generalizations have no place in this debate. Moreover, while it is true that public confidence in the tax system may decline if the tax system does not respond to noncompliance or to sham transactions, we also believe that public confidence can be equally impaired by the enactment of overreaching and overbroad legislation.

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[26] Charles Adams, For Good and Evil: The Impact of Taxes on the Course of Civilization 15–25 (1993).

[27] That tax planning by itself violates no moral code or substantive provision of the tax law has long been confirmed by the courts. Perhaps the most famous formulation of this axiom is Judge Learned Hand's: "[A]nyone 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), aff'd, 293 U.S. 465 (1935) ("The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.").

[28] While recognizing that the precise level of noncompliance owing to so-called tax shelter activity may be difficult to quantify, TEI is very much concerned about broad statements of the enormity of the problem without empirical support. We are pleased that the IRS recently announced its intention to attempt to identify the scope of the problem. Assuming the methodology of the IRS's initiative is sound (and does not rely on revenue agents and others self-defining tax shelters as any transaction that produces a tax benefit they disagree with), it should meaningfully contribute to the process. On a related subject, TEI is also concerned about claims that the decline in corporate tax receipts is attributable to tax-shelter activity. To our mind's eye, the unsubstantiated claims approach demagoguery and seem more intended to obscure than illuminate the important, and complicated, issues raised by this subject.

An objective analysis of the causes for declining corporate tax receipts and rising book profits would likely disclose a number of complex factors. Understanding the phenomenon requires a thorough analysis of book and tax accounting differences—a topic as complex as the Code itself. For example, there are many instances where the Code requires substantial one-time book charges (for plant closings, restructurings, environmental cleanups, or simply to change the book accounting treatment for liabilities such as pensions or retiree health care) to be deferred and deducted over time. Many companies accrued massive book charges for such items in the early 1990s and are only now claiming the related tax deductions. At the same time, companies have made significant investments in productive capital equipment in the 1990s. The tax law permits much more rapid recovery of the costs through accelerated depreciation. There are likely other significant contributing factors as well, including book and tax differences in the treatment of foreign-source income, nonqualified stock options, and loss or tax credit carryforwards (especially alternative minimum tax, foreign tax, and research credits). Finally, there may be other causes for the decline in corporate tax receipts such as the increasing use of pass-through entities, statistical aberrations arising from large one-time refunds (for tax litigation arising in prior tax years), or declines in the IRS's enforcement activities.

B. Nature and Scope of the Perceived Problem

Before enacting expansive legislation dealing with corporate tax shelters, Congress is well advised both to ask and to answer the question "What is meant by the term 'corporate tax shelter'?" It is not a question whose answer can be assumed. It is likewise not a question whose answer can be put off indefinitely. Whether you view the solution as lying in increased disclosure, the enactment of an economic substance doctrine or business purpose test, the imposition of new penalties, or "just" the racheting up of the IRS's enforcement activities, the definition must be both knowable and known. Although progress has been made on this issue in the last year, TEI continues to question whether sufficient progress has been made to justify all the Administration's legislative proposals.

Thus, TEI remains concerned that some of the Treasury Department's (and the Joint Committee staff's) proposals rely too much on amorphous and unworkable concepts that pose challenges to tax administration and may well sweep into the "tax shelter" net many legitimate transactions for the simple reason that they produce a tax benefit to the taxpayer. Unless the definition (or target) is clear—or, at least, considerably clearer than it currently is—there will remain too great a possibility that the vague label "tax shelter" will be invoked as a shibboleth to cut off debate.[29] To be sure, the effect of such a broad-brush approach may be to prevent certain abusive transactions, but it may also be to vitiate a taxpayer's right to minimize its tax obligations without first examining the facts and circumstances of a particular transaction and then assessing how its business purpose and economic substance comport with the explicit provisions of the Internal Revenue Code. Thus, TEI submits that any legislative action addressing abusive or over-aggressive transactions must acknowledge the role of legitimate tax planning to minimize corporate tax expense. Legitimate tax planning can include transactions undertaken solely for tax reduction purposes, such as financing a company with the issuance of debt rather than equity, and a taxpayer should not have to proceed through litigation to validate legitimate tax planning.

We have gone on at some length about the definitional problems not because we seek to impede any meaningful action by the Treasury Department, IRS, and Congress, but rather because we take seriously our obligation to help improve the system. TEI agrees that the current situation cannot be ignored. As tax executives, we see the challenge to the tax system every day. The unrelenting complexity of the law breeds opportunity.[30] The interaction of various intricate provisions of the Internal Revenue Code leads to uncertainty for taxpayers about the proper limits of tax planning and the line between legitimate and illegitimate transactions. Moreover, the uncertainty encourages some—especially those who stand to reap substantial fees and rewards with little or no risk of loss—to abuse or game the system. While the evidence is only anecdotal, TEI is very much concerned that abusive products or transactions are being developed, marketed, and purchased. In our view, this phenomenon poses a challenge to the efficacy of the tax system. If the problem of abusive products or engineered transactions is not effectively addressed, the integrity of the tax system may be weakened or, at a minimum, the perception of the tax system's fairness impaired. Hence, action is required.

At the same time, there is no simple, easy solution to the corporate tax shelter "problem." The key is realistically assessing the causes of the problems and then designing measured, balanced approaches to dealing with them without adding even more complexity to the already overburdened tax law. In the final analysis, rules must be developed that encourage all participants to exercise self-restraint. Ultimately, it is the corporation that is responsible for what is reported on its tax return, but in our view it is wrong to suggest that the problem lies only with taxpayers themselves and that the solutions should be directed only at them. Accord-

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[29] For example, we note that Thomas J. Smith, Director of the IRS's Heavy Manufacturing, Construction, and Transportation Industry, reported in January that, as part of the IRS's data-gathering process, it had discovered that some agents had erroneously characterized research tax credit claims as "corporate tax shelters."

[30] TEI believes it is necessary to recognize the part that Congress, the Treasury Department, and the IRS each play in creating an environment in which so-called corporate tax shelters can flourish. Each of the government players, too, bears responsibility—for how the law reads (warts, "discontinuities," and all), how it is interpreted, and how it applies. Thus, TEI must acknowledge its frustration that the Administration has not sought to address either the complexity that characterizes the tax law or the unfair, one-sided provisions that, while crafted for a "pro-government" purpose, are often turned on their head by taxpayers in what is later deemed to be a tax shelter. For example, the contingent payment regulations that the taxpayer invoked in the ACM case were drafted by the government in a manner to be used against taxpayers; the taxpayers in that case simply tried to utilize the rules for their own benefit. An evenhanded rule would not have presented even the opportunity for abuse.

ingly, TEI is pleased that the Treasury Department, the staff of the Joint Committee on Taxation, and others have concluded that attention must be paid to both the promoters of tax-advantaged products and to the outside advisers whose opinions facilitate the marketing of such products. We are certainly not claiming that sophisticated taxpayers are "victims," but in our view the solutions must reach the organizations and advisers who put unduly aggressive "products" into play.[31]

C. The Manner in which the IRS and Courts Have Addressed Tax Shelters

The question must be asked whether the Treasury Department has sufficiently demonstrated that the provisions of the current tax code are inadequate to stanch the perceived growth of tax shelters. TEI agrees that there is a powerful array of tools available to address abuses—from substantive provisions already in the tax code, to the authority to issue notices and regulations to enhance disclosure and halt specific abuses, to the ability to target transactions for litigation using one or more common-law anti-abuse doctrines. Just last week, the Treasury Department demonstrated the breadth of its array, moving to issue tax shelter registration and customer list regulations (directed at promoters), tax shelter disclosure regulations (directed at taxpayers), and acted to shut down a so-called debt straddle.[32]

Experience teaches that these tools can be and have been successfully invoked to curb questionable transactions. For example, there have been a number of cases in which the courts have upheld the IRS's challenge to the business purpose or economic substance of a transaction that generated significant tax benefits.[33] Although we may not subscribe to the view that all of these decisions involved "corporate tax shelters," we believe that the cases illustrate the arguments and resources—and power—the IRS can successfully bring to bear when it concludes that taxpayers have engaged in improper transactions.

In addition, the Treasury Department and the IRS have not been reticent to issue regulations, rulings, and announcements challenging the purported tax benefits of certain transactions. For example, Rev. Rul. 99–14, 1999–13 I.R.B. 3, addresses so-called lease-in/lease-out (LILO) real estate transactions, which often involve the leasing of property by a foreign party, often a municipality, to a U.S. taxpayer, followed by the sublease of the same property by the U.S. taxpayer to the foreign party. Explaining that the transactions are structured to produce significant tax benefits based on the deduction of prepaid rent with little or no business risk, the ruling states that the IRS will scrutinize LILO transactions for lack of economic substance and, where appropriate, recharacterize these transactions for tax purposes based on their substance.[34] Most recently, the IRS issued Rev. Rul. 2000–12 to curb so-called debt straddle transactions.

Finally, the Treasury has proven effective in persuading Congress to act to amend the Internal Revenue Code where legislation is necessary to prevent taxpayers from receiving unintended benefits. An example of such legislation is the amendment last year of section 357(c) to prevent the artificial creation of basis. See Pub. Law No. 106–36, §3001 (1999).

Nonetheless, TEI believes that more can and should be done to encourage the IRS to employ—within the bounds of sound administrative practices and the exercise of

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[31] TEI also believes that, since the problem extends beyond corporate taxpayers (with some of the suspect products' being sold to partnerships and individuals), any solution crafted by Congress should not be confined to corporations.

[32] T.D. 8875, T.D. 8876; Rev. Rul. 2000–12; Notice 2000–15; and Announcement 2000–12.

[33] See, e.g., ACM Partnership v. Commissioner, 73 T.C.M. 2189 (1997), aff'd in part, rev'd in part, 157 F.3d 231 (3rd Cir. 1998), cert. denied, 119 S. Ct. 1251 (1999); *ASA Investerings Partnership v. Commissioner,* 76 T.C.M. 325 (1998), aff'd, ———F.3d——— (D.C. Cir. Feb. 1, 2000); *United Parcel Service of America, Inc. v. Commissioner,* T.C. Memo No. 268 (1999); Compaq Computer Corporation v. Commissioner, 113 T.C. No. 17 (Sept. 21, 1999); *IES Industries v. United States,* No. C97–206 (N.D. Iowa, Sept. 22, 1999); *Winn-Dixie Stores, Inc. v. Commissioner,* 113 T.C. No. 21 (Oct. 19, 1999); and *Saba Partnership v. Commissioner,* T.C. Memo. 1999–359 (Oct. 27, 1999).

[34] Some examples of the Treasury Department's and the IRS's using their regulatory power to challenge certain classes of transactions include the partnership anti-abuse regulations (Treas. Reg. §1.701–2), the anti-conduit financing regulations (Treas. Reg. §1.881–3 and Prop. Reg. §1.7701(1)–2), and recently proposed regulations concerning fast-pay stock (Prop. Reg. §1.7701(1)–3). Moreover, the Treasury Department and the IRS have acted to pre-empt many transactions by formally announcing an intention to issue regulations attacking transactions with which they disagree. Examples of such administrative notices include those involving fast-pay stock (Notice 97–21, 1997–1 C.B. 407), foreign tax credit transactions (Notice 98–5, 1998–3 I.R.B. 49), and transactions involving foreign hybrid entities (Notice 98–11, 1998–6 I.R.B. 13). The Treasury has on occasion made its notices retroactive, which by itself dissuades taxpayers from undertaking transactions that the government might deem abusive. The foregoing list is not exhaustive, but it does illustrate the Treasury's and the IRS's willingness and ability to challenge abusive transactions without new legislation.

managerial discretion and congressional oversight—its current statutory and common law substantive and administrative tools to curb transactions that are perceived as tax shelters. This includes the assertion of existing penalties in appropriate cases. The IRS must identify its workload requirements in order to determine staffing needs. Thus, we support the IRS's current initiative, through its just established Office of Tax Shelter Analysis, to identify and quantify potentially troubling corporate transactions. If that review determines that the majority of the "shelters" are in specific areas, then targeted solutions can be enacted.

Moreover, Congress must bear up to its responsibilities and ensure that the IRS is consistently well-funded with appropriations. To be effective, the IRS must have a well-trained workforce, and nowhere is this more true than with respect to the complex transactions that have been challenged as corporate tax shelters. Congress should ensure that the IRS has stable funding to meet its ongoing training needs.

D. Additional Steps that the Administration Can Take Under Current Law

Before enacting new legislation, the Finance Committee is right to ask whether there are additional steps that can be taken under current law. TEI believes there are. More fundamentally, we believe that there are administrative and regulatory steps the Treasury Department and the IRS must take even if legislation is enacted to enhance the disclosure of questionable transactions or otherwise address the tax shelter issue. Stated differently, the tax shelter problem is not one that Congress alone can cure. There is no legislative panacea, no single step or series of steps that Congress can take and thereby relieve the Treasury and the IRS of their ongoing responsibility.

TEI is pleased that the Treasury Department has moved to implement Congress's 1997 decision to require the registration of corporate tax shelters. The Institute has not yet completed its analysis of the proposed and temporary regulations issued last week, but we are convinced that the regulations (even if requiring revision) will help the IRS obtain useful information about corporate transactions that should be audited and then take additional action—through enforcement proceedings, regulatory changes, or targeted legislative action. TEI is not yet in a position to wholeheartedly endorse all the specific provisions of the Treasury's recent regulations involving the disclosure of "reportable transactions" by taxpayers on their tax returns. We do, however, endorse the Treasury's taking the initiative to promulgate the regulations and thereby test whether current law is sufficient to satisfy the government's need for additional information.

These commendable steps notwithstanding, TEI believes the Treasury and the IRS can do more under current law. For example, questions could also be asked about the government's use of section 7408, which gives the government the authority to enjoin tax shelter promoters, and section 7609(f), concerning the issuance of so-called John Doe summonses to promoters. (The requirement in the Treasury's temporary and proposed regulations for promoters to prepare and retain client lists should facilitate the issuance of such summonses.) Moreover, the Treasury can move to revise the standards of conduct that govern return preparers and other practitioners—a step that Secretary Summers announced last week would be taken.

Perhaps more important, some have questioned whether the IRS has made adequate use of section 269, which authorizes the IRS to disallow tax benefits in respect of acquisitions made to evade or avoid income tax. Surely before enacting a greatly expanded section 269 to disallow deductions, credits, exclusions, or other allowances obtained in tax shelter transactions (or before codifying the business purpose doctrine or economic substance test), the Treasury Department and the IRS should be called into account for its current use—or disuse—of section 269. Similarly, we suggest that before Congress acts on proposals to double the accuracy-related penalty, it should receive testimony from the IRS on both how frequently the current 20-percent penalty has been asserted (and sustained by the courts) and whether there is any evidence that the level of the penalty is insufficient to encourage compliance.[35]

Stated simply, TEI believes that there can be no substitute for an effective enforcement program by the IRS. No statute or series of statutes, no single or group of ex ante pronouncements, can eliminate the need for a well-trained workforce that has the financial resources and the managerial will to get the job done. In other words, the Institute believes the Administration should utilize all appropriate enforcement tools currently at its disposal, including the wider use of focused informa-

[35] It may well be that compliance is affected more by the certainty (or uncertainty) of application than by the level of the penalty.

tion document requests and the assertion of penalties in appropriate cases.[36] The Treasury Department should also consider whether an amendment to the applicable penalty regulations—most notably, Treas. Reg. 1.6664-4(c), relating to a taxpayer's ability to rely on an adviser's opinion in establishing its eligibility for the reasonable cause exception—is appropriate.[37] The regulations that were issued last week are a step in the right direction.

E. The Need to Ensure that Any Legislation Is Focused and Not Counterproductive

To the extent Congress determines legislation is necessary, TEI believes that it must be measured and restrained. Any response must carefully balance the benefit of any legislative proposal against the possible adverse consequences, including the likelihood that the provision would unduly interfere with routine business transactions and legitimate tax planning, impose needless complexity, and inevitably operate as a tax increase. It is imperative that Congress not overreact and enact a general anti-abuse rule (sometimes referred to as a "super section 269" provision) that would permit IRS agents to disallow transactions based solely on a subjective finding that the taxpayer had a significant purpose of tax avoidance in entering into a transaction. Such a provision would be exceedingly disruptive to ordinary business transactions and tax planning..

We also think that care should be taken not to enact far-reaching legislation without assessing whether the Treasury's and IRS's administrative actions are producing the desired result. TEI believes that a major portion of the problem can be successfully addressed through enhanced disclosure, and further believe that the Treasury Department's recent regulations, especially those involving promoters, go a long way toward addressing gaps in current law. Before enacting new legislation, we urge Congress to assess whether these changes are sufficient and, if not, work to fine tune them, rather than to "pile on" one provision after another. Stated differently, the solution to this problem likely does not lie in adding pages to the Code.

1. The Economic Substance Doctrine Should Not Be Codified

TEI believes that it would be counterproductive for Congress to codify the economic substance doctrine, as proposed by the Administration in its Fiscal Year 2001 budget. Adopting a test such as that proposed by the Treasury Department will prove at once both overinclusive (ensnaring transactions that are wholly legitimate) and underinclusive (failing to catch some abuses that should be stopped). Determining whether the present value of "the reasonably expected pretax profit" from a transaction is "insignificant" relative to the "reasonably expected federal income tax savings" a transaction may generate is a highly subjective inquiry. Indeed, even the Treasury Department recognizes that this proposed standard cannot be applied to financing transactions. (The Treasury thus proposes a special rule for such transactions, which in our view is equally cumbersome.)

The economic substance doctrine was developed by the courts to supplement, or provide a backstop, to the Internal Revenue Code's substantive provisions. It is clear from the recent IRS victories in court that, when the IRS becomes aware of a potentially abusive transaction, the courts are willing to utilize the doctrine (or the related judge-made rules concerning shams, business purpose, substance over form, and step transaction) to prevent abuse. TEI is concerned that codifying the common law doctrines would further complicate and confuse the system and undermine not only legitimate tax planning but the courts' willingness and ability to apply other judicial doctrines in the event the codified rule does not reach a particular type of transaction.

2. The Focus Should Be on Meaningful Disclosure

Disclosure of information to the IRS is a most effective element of tax enforcement. Corporations are already required to reconcile their book and taxable incomes

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[36] Concomitantly with the controversy about corporate tax shelters, the IRS has built an impressive track record in cases it perceives as abusive. See, e.g., Jacobs Engineering Group, Inc. v. United States, 97-1 U.S.T.C. ¶50,340, at 87,755 (C.D. Cal. 1997), aff'd 99-1 U.S.T.C. ¶50,335, at 87,786 (9th Cir. 1999); The Limited, Inc. v. Commissioner, 113 T.C. No. 13 (1999), as well as the cases listed in footnote 32. What was missing was the IRS's willingness and ability to successfully assert penalties against sophisticated taxpayers. Significantly, the IRS has begun to assert and the courts sustain penalties against large corporate taxpayers. See Compaq Computer Corp. v. Commissioner, 113 T.C. No. 17 (1999) and United Parcel Service of America v. Commissioner, T.C.M. No. 268 (1999). This is a significant development, for it not only underscores the continuing vitality of the common law business purpose doctrine and economic purpose test but cannot help but prompt otherwise aggressive taxpayers to modify their behavior.

[37] For example, revised regulations could provide that a taxpayer may not rely on the opinion of a professional adviser that fails to contain a complete and accurate description of the facts underlying the transaction.

on Schedule M–1 of the tax return.[38] Indeed, the examination of corporate taxpayers generally centers around the book and tax differences disclosed on that schedule. During the course of an examination, taxpayers must expend considerable resources explaining, justifying, and supporting the differences. As a result, it is odd that the Treasury and Joint Committee staff both focus on book-tax differences as an indicator of a corporate tax shelter. These differences are not so much "indicators" as they are an unavoidable byproduct of the Internal Revenue Code that Congress—often with Treasury's direct support—has crafted. Mr. Chairman, I do not believe my company had any corporate tax shelters on the 1998 tax return that was filed last September. But I do know that we had more than 125 separate items disclosed on our company's Schedule M–1 reconciling book and tax income.

The country's largest 1,700 companies are subject to continual audit by the IRS as part of the CEP program, but proponents of legislation downplay the significance of this. Hence, the Joint Committee staff's study states that "audits of large corporations typically follow an agreed agenda of issues that is negotiated by the IRS and the corporate taxpayer" and both the Treasury Department and the Joint Committee staff refer repeatedly to the "audit lottery." See, e.g., Joint Committee Study at 212. Taxpayers do strive to work cooperatively with the IRS, but they certainly are not capable of "walling off" some issues from examination. In practice, it is the IRS audit team that determines what transactions will be scrutinized. It is the IRS audit team that determines what information it needs. And it is the IRS audit team that ultimately determines what adjustments to propose. Any implication that large corporate taxpayers can win the "audit lottery" by narrowing the scope of the audit does not reflect the realities of the examination process. Mr. Chairman, you and the Committee may be assured that when large taxpayers have a new, non-routine Schedule M–1 item on their return, it will be examined.

3. Possible Expansion of Disclosure Requirements

One notable deficiency in the current system is the lack of downside risk to those who promote corporate tax shelters.[39] The Treasury Department moved to address this shortcoming last week by promulgating proposed and temporary regulations under sections 6111 and 6112.[40] TEI believes that promoter disclosure could effectively operate as an "early warning" system that enables IRS and the Treasury Department to evaluate "engineered transactions" and to issue guidance—whether in the form of notices, rulings, or regulations—shutting them down before they proliferate. This will also enable the IRS to marshal its resources and focus on examining transactions, including those undertaken by non-CEP taxpayers (individuals and middle-market and small companies) for whom the perception of the risk of detection is, in fact, skewed by the "audit lottery."

TEI believes that an effective system will impose the obligation for early disclosure on the promoter.[41] Because taxpayers will be required to make a detailed disclosure on their tax returns in order to avoid penalties, we do not support the imposition of a duplicate early disclosure requirement on taxpayers.[42] As previously sug-

[38] Under section 6662, disclosure can have the effect of immunizing taxpayers from the accuracy-related penalty, but disclosure will not have this effect if a tax-shelter item is involved. Ironically, then, current law has the perverse effect of discouraging disclosure of such items.

[39] Thus, TEI agrees with the Joint Committee staff and Treasury Department that the tax system may require adjustments to better balance the cost-benefit analysis undertaken by promoters. Otherwise, a promoter may have little incentive to stop marketing abusive products. We note that some have argued that promoter fees are the "oxygen" vital to the fire of tax shelter products and they have therefore proposed that promoter penalties should be as much as 50 percent of the fees earned on the product and, further, that they be crafted so that the promoters cannot avoid the incidence of the penalty by passing on the risk to clients. While TEI believes that these proposals merit consideration, the Institute has not yet completed its analysis. We do believe, however, that should new promoter penalties be enacted, they should afford promoters an independent review process that is separate from the examination of the taxpayer's return. Moreover, any legislation should make it clear that where a taxpayer implements a sound tax planning idea in an abusive manner, penalties should not be imposed on promoters.

[40] Because section 6111(d) focuses on confidential corporate tax shelters, it may not prove sufficient.

[41] TEI believes that a key to an effective early warning system involving promoters is the development of clear "triggers" for disclosure. Although the Institute has not completed its analysis of the Treasury Department's just-released proposed and temporary regulations, we are heartened by the general approach, including the provision allowing promoters to seek a ruling whether their particular transaction must be registered. The purpose of promoter disclosure, of course, is to alert the IRS that it might wish to examine the transaction or to issue guidance on the tax treatment the IRS intends to accord to the transaction.

[42] The Treasury's legislative proposal calls for the taxpayer to disclose particular transactions twice—once on or before the unextended due date of its return (in a filing with the IRS National Office) and a second time when it files its return (by attaching a statement to its return). TEI

gested, for early disclosure to have the intended salutary effect, the IRS and the Treasury must undertake to analyze and take appropriate action on the disclosed transactions.

In addition, TEI believes steps can be taken to enhance the value of return disclosures by taxpayers themselves, even beyond the requirements set forth in the proposed and temporary regulations released last week. One means of ensuring that IRS examiners will not miss issues, even in respect of CEP taxpayers, is to require a taxpayer to attach a copy of the promoter's disclosure notice to the taxpayer's return. Furthermore, the specific types of information that must be disclosed on the return in respect of certain transactions could be specified, either by Congress in the statute or in regulations.[43]

4. The Senior Corporate Officer Attestation Proposal Should Be Rejected

It has been proposed that Congress require the Chief Financial Officer or another senior officer to certify that the facts disclosed (or reported on a return) about a tax-shelter transaction are true and correct. Indeed, some proponents of legislation have characterized such an attestation requirement as essential to any successful effort to curb abusive tax shelters. TEI regrets that this attestation proposal misses the mark. It misapprehends the role of the tax department as well as the CFO, it impugns the integrity and professionalism of both, and it ignores how an attestation provision would adversely affect the examination process. TEI strongly opposes its enactment.

Stated bluntly, the senior officer attestation proposal obfuscates the issue because it proceeds from a faulty premise that companies do not enter into major transactions knowingly and that the people who prepare and sign billion-dollar corporate returns do so cavalierly. Corporate tax returns are already filed under penalties of perjury. While I will not presume to speak for all my peers, I assure you that when I signed BellSouth's 1998 federal income tax return last September, reflecting federal income tax payments of $1.6 billion, I took my return-signing duty seriously. As one commentator noted: "[I]f the corporate tax manager does not have full knowledge of the facts of the corporation's tax-motivated transactions, why is he signing the return? And if he does not know what is going on, why is anyone's signature on the extra form necessary, except for show?"[44] Equally important, it is totally without basis for proponents to say that a company's CFO and the other senior officers who might be subject to the attestation provision would permit abusive transactions but for the sanctions that might flow from the proposal.[45]

Mr. Chairman, TEI's objections to the attestation proposal go beyond its denigration of the professionalism of corporate tax directors. The proposal poses a serious threat to the efficient operation of corporate tax return preparation and, especially, the examination processes. If enacted, the proposal could lead to focusing not on the underlying transaction but on the attestation. Hence, the key would not be whether a transaction passes muster under the law, but rather "what did the senior officer know and when did he know it?" Such inquiries could well result in intrusive or threatening examination practices that the IRS Restructuring Act was enacted to prevent.[46] Indeed, the proposal could easily spawn suspicion and distrust about the

questions whether the case has been made for requiring taxpayer disclosure other than with the tax return. This is especially the case in light of the Treasury's actions in respect of promoter disclosure.

[43] TEI has not yet completed its analysis of the proposed and temporary disclosure regulations, but we support the objective, transaction-focused approach taken by the Treasury Department.

[44] Lee Sheppard, "Slow and Steady Progress on Corporate Tax Shelters," Tax Notes 194 (July 12, 1999). Some proponents of the attestation requirement have previously expressed surprise at TEI's opposition to the proposal, suggesting that the requirement would take in-house tax professionals "off the hook" by transferring responsibility to the CFO or another senior corporate officer. Whether short sighted or not, we take our professional responsibility to our companies and to our tax system too seriously to support such a "pass the buck" strategy.

[45] A proposal in the Administration's Fiscal Year 2001 budget would hold the corporate officer personally liable for any misstatements on a "reportable transaction" disclosure statement; moreover, heightened penalties would apply where fraud or gross negligence affect the misstatement. The budget proposals, however, are lacking in detail about the nature and scope of the primary personal liability penalty and the heightened penalty for fraud or gross negligence.

[46] Specifically, we are concerned that revenue agents might use the possible assertion of penalties against the CFO as a lever in their negotiation of the underlying tax treatment with the corporate tax director. Thus, the discussion could go, as follows: "If you don't concede the merits of this transaction, I am going to refer your boss's attestation to the criminal investigation division." Although according the attesting officer due process rights in respect of any penalty asser-

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entire return preparation and examination process comparable to that which existed during the era of the infamous "Eleven Questions" (relating to facilitation payments to foreign persons) in the 1970s.

For the foregoing reasons, we urge Congress to reject the senior officer attestation proposal.

5. Changes to the Tax-Shelter Related Penalties Structure Must Be Measured

Although TEI believes that the primary focus of Congress should be ensuring meaningful and timely disclosure of transactions, we recognize that a comprehensive approach to this subject requires an examination of the Code's penalty provisions, including most particularly the accuracy-related penalty and the multitude of standards governing taxpayers, tax practitioners, and tax-return preparers. In proceeding, we urge Congress to keep in mind the following:

a. We cannot help but comment on the complexity of the proposed penalty regime set forth in the Joint Committee Study. Although seeking to consolidate and simplify the various standards to which taxpayers, preparers, and promoters are subject, the Joint Committee staff was forced to create an 11 x 5 matrix to explain the proposal. Joint Committee Study at 245. Concededly, one of the columns is devoted to listing current law, but it remains that the proposal is highly complicated and supposes a level of mathematical precision that does not exist in respect of what in many cases are essentially judgment calls—does a transaction legitimately reduce taxes?

b. TEI is very much concerned about proposals to increase the accuracy-related penalty in respect of certain tax shelter transactions to 40 percent. Indeed, we suggest that a fundamental problem with the administration of the current 20-percent penalty is that it is so high that it is rarely asserted against corporate taxpayers. Where penalties are disproportionate compared with the conduct involved, agents may be inhibited from asserting such penalties. Witness, for example, the penalty for errors involving qualified plans before the intermediate sanction rules were enacted. Because the stated penalty—revocation of exempt status—was uniformly considered too harsh, agents rarely ever asserted it.[47] Thus, while administrative steps should be taken to address the certainty of application, we do not at this time believe the level of the accuracy-related penalty should be increased.

c. TEI believes that taxpayers should generally not be subject to penalties if they make a complete and meaningful disclosure about a product or transaction in the tax return and satisfy the applicable standard. If the taxpayer fails to disclose a transaction that is subsequently deemed to be a tax shelter and the taxpayer does not prevail on the merits, the taxpayer should be subject at most to a 20-percent understatement penalty where it has substantial authority for its treatment of an item. On the other hand, if a taxpayer fails to disclose a transaction that should be disclosed because it meets objective disclosure criteria and the taxpayer prevails on the merits of the issue, it may be appropriate to impose an information-reporting type penalty on the taxpayer, the rate of which should not generally be linked to the tax benefits at issue.

d. Given the complex nature of the tax law, TEI believes the enactment of a strict liability penalty is wholly inappropriate. Penalties should be designed either to punish purposeful misbehavior or to provide an incentive to behave properly. Accordingly, we support the retention of the reasonable cause exception. We do, however, believe the scope of the exception should be clarified. Hence, TEI believes that opinion standards should be revised for purposes of the reasonable cause exception. Before relying on an adviser's opinion to avoid a penalty, the taxpayer must be able to demonstrate that the opinion is based on the actual facts of the taxpayer's transaction and not an assumed set of facts.

e. As noted in the section of this statement relating to interest and penalty reform generally, TEI believes some adjustment to and harmonization of taxpayer, practitioner, and preparer standards is appropriate to encourage the filing of more accurate returns. We have concerns, however, about the proposals

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tion is important, we question whether that alone will ensure the provision is not used improperly. Similar concerns make us less than sanguine about requiring companies to publicly disclose tax penalties above a certain dollar threshold in their financial statements, as the staff of the Joint Committee on Taxation has proposed. Joint Committee Study at 225.

[47] A collateral effect of the excessive pension plan penalty was to discourage taxpayers from disclosing and correcting errors for fear that the action could result in disqualification. With the advent of the employee plans compliance resolution system and its graded rewards and penalties (i.e., intermediate sanctions and penalties), taxpayers are much more willing to voluntarily disclose errors for administrative resolution.

to raise the standards, in respect of both shelter and non-shelter items. Regrettably, the complexity of current law would be exacerbated under the Joint Committee staff's proposal to engraft a "highly confident" standard on the Code, which the staff defines as a 75-percent or greater likelihood of success on the merits if challenged. Joint Committee Study at 240. At one level, we are concerned that the combination of the "highly confident" and "more likely than not" standards may unleash a torrent of disclosures that consumes valuable IRS resources and distracts revenue agents from issues more worthy of their scrutiny. Equally important, we are concerned the imposition of higher standards will leave taxpayers facing penalties where, several years after they grappled with the vagaries and interstices of the tax law, a revenue agent or court concludes—with the benefit of hindsight—that the taxpayer erred in concluding its position was "at least probably right" (under the "more likely than not standard") or "highly confident."[48] This concern is especially pronounced in light of the Joint Committee staff's recommendation that the reasonable cause exception of current law be repealed. Joint Committee Study at 239.

F. Steps to Ensure that Legitimate Business Transactions Are Not Impeded

Care must be taken to ensure that new or existing enforcement tools brought to bear on corporate tax shelters do not interfere with legitimate business transactions or make more difficult the application of an already complex income tax. This should be a primary consideration of the Committee. If legislation is enacted that is overbroad or unclear—if it does an insufficient job of defining what is acceptable and what is unacceptable—it is the corporate community as a whole that will suffer.

TEI believes that the recommendations contained throughout this testimony address this issue, but in summary we offer the following:

1. The definition of corporate tax shelter cannot be assumed. It must be known. Thus, while we agree that there will not be as much "pressure" on the definition if a disclosure-based proposal is adopted (as opposed to changes to the Code's substantive provisions), the problems do not disappear. Unless the "indicators" or "triggers" are objective or relatively easy to apply, there will be a likelihood not only of massive disclosures ("just to be safe") but of potential abuse by revenue agents or courts using hindsight to impose penalties. Neither of these developments would be good for tax administration. For this reason, we support the objective approach adopted by the Treasury Department in its proposed and temporary disclosure regulations, though some revision or narrowing of the regulations may be appropriate to guard against their interfering with legitimate transactions or unduly burdening taxpayers.

2. To the extent a broad disclosure regime is adopted, any requirement for "early warning" disclosure should be imposed on promoters rather than taxpayers. This would ensure that promoters of tax shelters will have an incentive not to market abusive transactions, without unduly burdening taxpayers. Taxpayers, however, should be subject to more meaningful return disclosure requirements.

3. Congress should reject the Siren's song of senior corporate officer attestation. So, too, should it reject the allure of doubling penalty rates. The IRS and Treasury would be better advised to develop effective audit strategies and to build the case for the appropriate assertion of a penalty.

4. The standards for taxpayers, preparers, and advisers should be harmonized.

There are no magical solutions to the corporate tax shelter phenomenon. TEI believes the keys are (1) encouraging clear and meaningful disclosure by tax-shelter promoters and taxpayers; (2) substantially changing the risk-reward profile for tax-shelter promoters; and (3) clarifying that tax "opinions" based on assumed facts and circumstances unrelated to the taxpayers' will not be sufficient to excuse taxpayers from disclosure or understatement penalties. Solutions to the tax shelter dilemma must be carefully targeted and should not exacerbate the problem by adding further complexity to the Internal Revenue Code or by transforming a putatively neutral IRS examination process into an adversarial—even prosecutorial—search for "bad actors."

CONCLUSION

Tax Executives Institute appreciates this opportunity to present its views on the interest and penalty provisions of the Internal Revenue Code. Any questions about the Institute's views should be directed to either Michael J. Murphy, TEI's Execu-

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[48] It should also be recognized that the person making the decision whether the taxpayer was "at least probably right" or assessing the correctness of the taxpayer's "highly confident" claim (i.e., revenue agent, Appeals officer, or court) would not even reach that question until concluding that the taxpayer was wrong on the merits.

tive Director, or Timothy J. McCormally, the Institute's General Counsel and Director of Tax Affairs. Both individuals may be contacted at (202) 638–5601.

PREPARED STATEMENT OF JONATHAN TALISMAN

INTRODUCTION

Mr. Chairman, Senator Moynihan, and distinguished Members of the Committee: Thank you for giving me the opportunity to appear before you today to discuss two important issues—the interest and penalty provisions of the Internal Revenue Code and the problem of corporate tax shelters.

On October 25, 1999, the Treasury Department issued a report on the interest and penalty regime in the Internal Revenue Code. The report was mandated by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA98). The report reviewed the administration and implementation of those provisions and made appropriate legislative and administrative recommendations. I will focus on the main aspects of this report later in my testimony. However, I would first like to address the problem of corporate tax shelters.

In the past, the Committee on Finance has reacted quickly and appropriately with legislation when confronted with issues that posed grave consequences to the tax system, such as the use of tax shelters by individuals in the 1970's and 1980's and, more recently, the development of particular abusive transactions. As indicated by Secretary Summers
this morning, we believe that the use of corporate tax shelters currently represents the most serious compliance problem facing our tax system.

My testimony today will focus on the reasons for our concerns, the steps Treasury, the Congress, and the IRS have undertaken to date to address this problem, why this current approach is inadequate and legislation is necessary, and what our legislative proposals entail.

I. Corporate Tax Shelters

A. General Discussion and Background

Over the last several years, the Treasury Department has become increasingly aware and increasingly concerned about the proliferation of corporate tax shelters. These concerns range from the short-term revenue loss to the tax system, to the potentially more troubling long-term effects on our voluntary income tax system. In its FY 2000 Budget, released in February 1999, the Administration made several proposals to inhibit the growth of corporate tax shelters. These proposals generated significant commentary from the corporate and tax practitioner community.

In July 1999, the Treasury Department issued its White Paper, The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals. This report discussed more fully the reasoning underlying the Budget proposals relating to corporate tax shelters, provided a description and analysis of the comments on the Budget proposals, and provided, in light of these comments, refinements to those proposals. These refined proposals are contained in the Administration's FY 2001 Budget proposals.

There have been several other important developments regarding corporate tax shelters since the issuance of our FY 2000 Budget proposals approximately a year ago. The staff of the Joint Committee on Taxation has issued its report on the penalty and interest provisions of the Internal Revenue Code. In its report, the staff found that "the corporate tax shelter phenomenon poses a serious challenge to the efficacy of the tax system." Similar sentiments have been expressed by the American Bar Association, the American Institute of Certified Public Accountants, the New York State Bar Association, the Tax Executives Institute, and many respected tax executives and practitioners in testimony before the tax-writing committees and other presentations.

The Treasury and the IRS have issued administrative guidance curtailing the use of specific abusive transactions in the past year, including "fast pay" stock, "LILO" transactions, "BOSS" transactions, "chutzpah trusts," and debt straddles. In 1999, Congress enacted legislation addressing corporate tax shelters involving the use of certain liabilities to inflate the adjusted basis of assets. The IRS has won significant victories in court,[1] successfully arguing that the transactions purportedly giving rise to certain tax benefits should not be respected because the transactions did not pos-

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[1] See e.g., Compaq Computer Corp. v. Comm., 113 T.C. No. 17 (1999); IES Industries v. U.S., No. C97–206 (N.D. Iowa 1999); Winn-Dixie Stores, Inc. v. Comm., 113 T.C. No. 21 (1999); Saba Partnership v. Comm., T.C. Memo 1999–359 (1999).

sess economic substance. Most recently, Treasury and the IRS issued temporary and proposed regulations requiring registration of confidential corporate tax shelters, maintenance of lists of shelter participants, and reporting of certain transactions having characteristics common to corporate tax shelters.

With these developments in mind, I would like to emphasize the following points in my testimony today.

First, despite these efforts, corporate tax shelters continue to be a substantial and ongoing problem. While Congress, the Treasury Department and the IRS take action to stop particular transactions as they are uncovered, many abusive transactions remain undiscovered and numerous new transactions are created all the time. Our new disclosure regulations primarily address the visibility of corporate tax shelter transactions. Disclosure will help the IRS identify and deal with abusive transactions more quickly and effectively. It also is our hope that the disclosure requirements will deter corporate taxpayers from entering into tax shelters. However, in the absence of Congressional action, we do not believe the regulatory disclosure requirements are sufficient to address fully the problem of corporate tax shelters, because they do not adequately affect the cost/benefit analysis a corporation undertakes when deciding whether to participate in a particular transaction.

Second, the ad hoc and piecemeal approach that Congress, the Treasury Department, and the IRS have employed in the past to address corporate tax shelters is inadequate. Admittedly, recent court decisions denying the purported tax benefits of certain shelter transactions are important. However, litigation is costly and inefficient. Moreover, these decisions are after-the-fact actions against shelters—they do not prevent the design, marketing, and implementation of new and different shelters. Furthermore, even though Congress has enacted certain legislative changes curbing certain types of shelters, these statutory prohibitions can sometimes be avoided by making certain adjustments to a transaction to avoid the impact of the revised statutory provisions. A global legislative solution is needed to prevent abusive, tax-engineered transactions before they occur. The Treasury Department believes this global solution should include four parts: increased disclosure, changes to the substantial understatement penalty, codification of the economic substance doctrine, and sanctions on other parties to the transaction.

Third, there are substantial similarities between the Treasury Department's proposals and other proposals to curb corporate tax shelters. For example, the staff of the Joint Committee on Taxation agrees that there should be increased disclosure by participants, increased penalties on understatements attributable to undisclosed transactions and tightening of the reasonable cause exception, and sanctions on other parties to the transaction. As discussed more fully in the White Paper, the American Bar Association and the New York State Bar Association proposals contain several elements similar to those in the Administration's proposal. Finally, H.R. 2255, introduced by Mr. Doggett, also contains an approach similar to the Administration's proposal, including the codification of the economic substance doctrine. We commend Mr. Doggett for his leadership.

Finally, the proposed legislation would be inadequate without effective enforcement. The Internal Revenue Service is undergoing a substantial restructuring. This restructuring will concentrate IRS resources relating to corporate tax shelters, enabling it to identify, focus on, and coordinate its efforts against corporate tax shelters in a more efficient manner, while instituting and maintaining appropriate taxpayer safeguards. The enactment of corporate tax shelter legislation, combined with the efforts of the restructured IRS, will deter abusive transactions before they occur and uncover and stop these transactions to the extent they continue to occur.

The balance of my testimony with respect to corporate tax shelters will elaborate on these points.

B. Reasons for Concern

Corporate tax shelters are designed to, and do, substantially reduce the corporate tax base. Moreover, corporate tax shelters breed disrespect for the tax system—both by the parties who participate in the tax shelter market and by others who perceive unfairness. A view that well-advised corporations avoid their legal tax liabilities by engaging in tax-engineered transactions may cause a "race to the bottom." The New York State Bar Association recently noted this "corrosive effect" of tax shelters: "The constant promotion of these frequently artificial transactions breeds significant disrespect for the tax system, encouraging responsible corporate taxpayers to expect this type of activity to be the norm, and to follow the lead of other taxpayers who have engaged in tax advantaged transactions." If unabated, this will have long-term consequences to our voluntary tax system far more important than the revenue losses we currently are experiencing in the corporate tax base.

Finally, significant resources—both in the private sector and the government—are currently being wasted on this uneconomic activity.[2] Private sector resources used to create, implement and defend complex shelter transactions are better used in productive activities. Corporations distort their business decisions to take advantage of tax shelter opportunities. Similarly, the Congress (particularly the tax-writing committees and their staffs), the Treasury Department, and the IRS must expend significant resources to address and combat these transactions.

C. Corporate Tax Shelters and the Corporate Tax Base

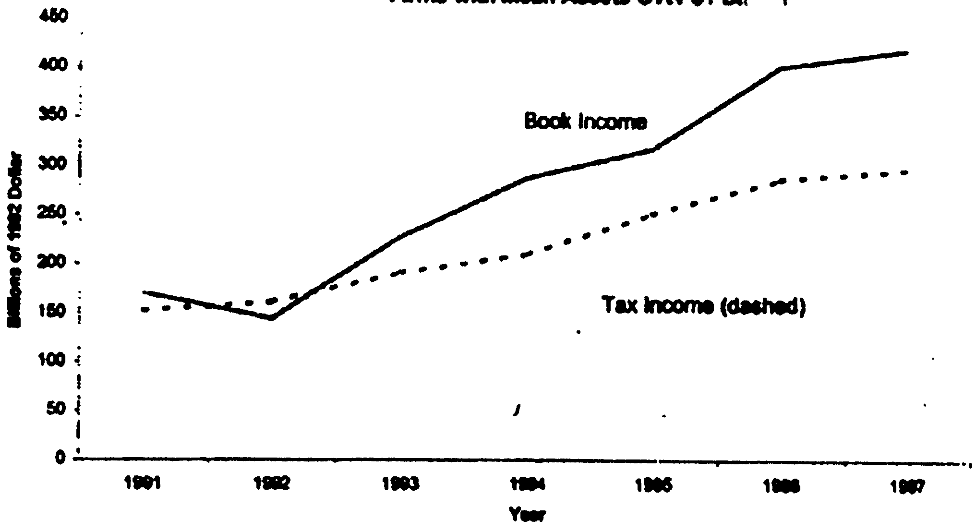
Some have argued that the growth of corporate income tax receipts demonstrates that corporate tax shelters cannot be a problem. Of course, the size of the problem is not indicated by the amount of corporate tax receipts, which vary over time for a number of reasons, but by the difference between actual tax payments and those that would be remitted absent corporate tax shelters. That difference is impossible to measure directly, but the increasing difference between the income taxpayers report on their corporate tax forms (taxable income) and the income they report to shareholders (book income) appears to be consistent with the increasing use of corporate tax shelters.

One feature of many tax shelters is that they reduce taxable income and taxes without reducing book income. Corporate taxpayers report their book income on Schedule M–1 of Form 1120. Such data show that the difference between book income and taxable income for large corporations (average assets greater than $1 billion) increased between 1991 and 1997.[3] Current income reported on corporate tax returns (total receipts less total deductions) represented a much smaller share of book income (calculated as book income after tax, plus Federal taxes, less tax-exempt income) in 1997 than in the early 1990's. (See Figure 1.) Thus, even though corporate income reported on tax returns has increased markedly in the 1990's, book income has increased even faster. It is unclear how much of the divergence between tax and book income reflects tax shelter activity, but the data are clearly consistent with other evidence that the problem is significant.

[2] As Peter Cobb, former Deputy Chief of Staff of the Joint Committee on Taxation recently stated: "You can't underestimate how many of America's greatest minds right now are being devoted to what economists would all say is totally useless economic activity."

[3] All estimates are based on a balanced panel of 745 corporations with mean asset size in excess of $1 billion, in 1992 dollars, over the years 1991 through 1997. Corporate tax data are only available through 1997. We did not use data before 1991 for this comparison because depreciation data from Schedule M–1 are not available before 1991. In addition, the detailed book data from before 1991 seem inconsistent with the post-1990 data, perhaps because of an accounting method change.

Figure 1.
Book and Tax Corporate Income
Firms with Mean Assets Over $1 Bil[illegible]

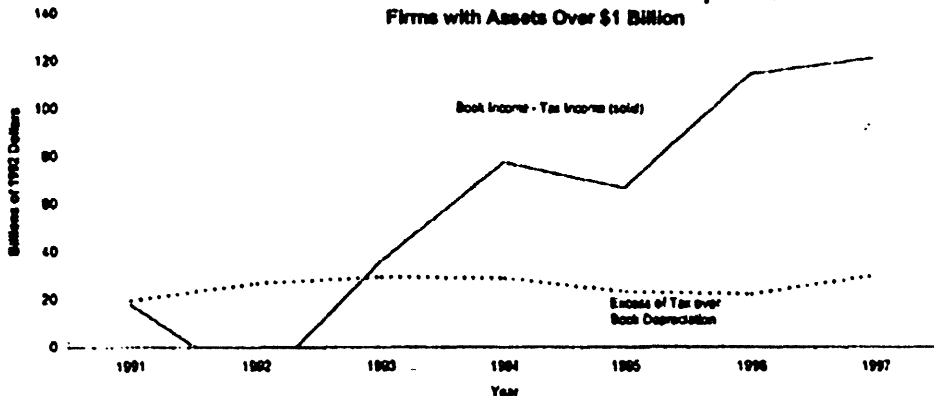


Book Income = After-tax book income from Schedule M-1 + Federal taxes - tax exempt interest
Tax Income = Total Receipts - Total Deductions
Corporations excluding S corporations, RICs, REITs, and Foreign Corporations
Source: Internal Revenue Service, Statistics of Income

Book and tax measures of income can diverge for many reasons that are unrelated to tax shelters. For example, increases in the rate of new investment can cause book and taxable income to diverge because tax depreciation is accelerated compared with book depreciation. But depreciation does not seem to be a significant factor. Figure 2 shows that the difference due to depreciation has changed little over the last several years while the difference between book and tax income continues to climb. Hence, the depreciation discrepancy is not a significant factor behind the divergence between the two income measures in recent years.[4]

[4] Other factors contribute to the gap between book and tax measures of income, including 1) the differential impact of the business cycle on the two measures, 2) increases in foreign based income that are reflected in book but not tax income and 3) differences in accounting treatment for stock options and their increased importance as a component of executive and employee compensation.

Figure 2.
The Difference Between Book and Tax Corporate Income
Firms with Assets Over $1 Billion



Book Income = After-tax book income from Schedule M-1 + Federal taxes - tax exempt interest
Tax Income = Total Receipts - Total Deductions
Corporations excluding S corporations, RICs, REITs, and Foreign Corporations
Source: Internal Revenue Service, Statistics of Income

D. Ad Hoc Approach to Corporate Tax Shelters

To date, most attacks on corporate tax shelters have targeted specific transactions and have occurred on an ad hoc, after-the-fact basis—through legislation, administrative guidance, and litigation. In the past few years alone, Congress, the Treasury Department and the IRS have taken a number of actions to address specific corporate tax shelters. These include:

1. Two provisions enacted in 1996 and 1997 to prevent the abuse for tax purposes of corporate-owned life insurance (COLI).[5] Collectively, these two provisions were estimated by the Joint Committee on Taxation to raise over $18 billion over 10 years. As the then Chief of Staff of the Joint Committee on Taxation stated: "When you have a corporation wiring out a billion dollars of premium in the morning and then borrowing it back by wire in the afternoon and instantly creating with each year another $35 million of perpetual tax savings, that's a problem. . . . I think we were looking at a potential for a substantial erosion of the corporate tax base if something hadn't been done."[6]

2. Legislation enacted in 1998 to eliminate the ability of banks and other financial intermediaries to avoid corporate-level tax through the use of "liquidating REITs."[7] The Treasury Department's Office of Tax Analysis (OTA) estimated that eliminating this one tax shelter product alone would save the tax system approximately $34 billion over the next ten years.

3. The IRS ruling[8] addressing so-called lease-in, lease-out transactions, or "LILO" schemes. Like COLI, these transactions, through circular property flows and cash flows, offered participants millions of dollars in tax benefits with no real economic substance or risk. Based on the transactions we have been able to identify to date, OTA estimates that eliminating this tax shelter saved $10.5 billion over ten years.

4. Legislation signed into law on June 25, 1999, aimed at section 357(c) basis creation abuses.[9] In these transactions, taxpayers exploited the concept of "subject to" a liability and claimed increases in the bases of assets that resulted in bases far in excess of the assets' values.

[5] Pub. L. No. 104–191, §501 (1996); Pub. L. No. 105–34, §1084 (1997)

[6] Kenneth Kies, Transcript of Federal Bar Association's Fourth Invitational Biennial Conference on the Tax Legislative Process, reprinted in 97 Tax Notes Today 21–38 (Jan. 31, 1997).

[7] Pub. L. No. 105–277, §3001(a) (1998).

[8] Rev. Rul. 99–14, 1994–14 I.R.B. 3.

[9] Pub. L. No. 106–36, §3001 (1999).

5. Regulations[10] addressing fast-pay preferred stock transactions. These financing transactions purportedly allowed taxpayers to deduct both principal and interest. It was reported that one investment bank created nearly $8 billion of investments in a few months.

6. Notice 98–5[11] dealing with foreign tax credit abuses.

7. Recent administrative actions taken with respect to the "BOSS" transaction[12] and debt straddles,[13] the latter of which has been described as a "heads, I win; tails, I win" proposition for the taxpayer.

8. The Government's victories in several important corporate tax shelter cases—ACM Partnership v. Commissioner[14] and ASA Investerings Partnership v. Commissioner,[15] and those cases mentioned in footnote one of this testimony. In these cases, the courts disallowed tax benefits from transactions that lacked economic substance.

Addressing corporate tax shelters on a transaction-by-transaction, ad hoc basis, however, has substantial defects. First, because it is not possible to identify and address all (or even most) current and future sheltering transactions, this type of transaction-by-transaction approach is inadequate. There will always be transactions that are unidentified or not addressed by the legislation. As Treasury Secretary Lawrence H. Summers said: "Treasury and the IRS have come to understand new tax shelters only by capturing them on audit, picking up reports in the trade press, receiving anonymous tips and finding irregularities on tax returns. What we see, we can act upon. What we cannot see, by definition, we cannot act upon. But what we fear is that visible corporate tax shelters are only the tip of a very large iceberg."[16]

Second, although the IRS has recently won some important cases involving corporate tax shelters, reliance on judicial decisions, which taxpayers may attempt to distinguish, is not the most efficient means of addressing corporate tax shelters. Litigation is expensive and time-consuming, both for the government and taxpayers, and frequently does not provide a coherent set of rules to be applied to subsequent transactions. Tax Court Judge Laro, speaking on his own behalf before the Tax Executives Institute last year,[17] acknowledged that the courts have provided little guidance on the amount of economic substance or business purpose sufficient for a transaction to be respected. He stated that such concepts "may require further development in the case law," but highlighted the difficulty with such an approach when he said that judges "decide cases one at a time. . .and don't make tax policy."

Third, addressing tax shelters on a piecemeal basis complicates the tax law. In the past few years alone, Congress has passed numerous provisions to prevent specific tax shelter abuses. The layering of provision upon provision may lead one to believe that there is a rule for every situation and thus what is not specifically proscribed is, by negative inference, allowed. In time these specific rules themselves are used in unintended ways to create corporate tax shelters.[18]

Fourth, a legislative strategy that deals with tax shelter transactions on a piecemeal basis calls into question the viability of current rules and standards, particularly the common law tax doctrines such as sham transaction, business purpose, economic substance and substance-over-form. Finally, reliance on a transaction-by-transaction legislative approach to corporate tax shelters may embolden some promoters and participants to rush shelter products to market on the assumption that any Governmental reaction would be applied only on a prospective basis.

E. Temporary and Proposed Regulations

On February 28, 2000, the Treasury Department and the IRS issued three sets of temporary and proposed regulations requiring promoters to register confidential corporate tax shelters and to maintain lists of investors and requiring corporate taxpayers to disclose large transactions that have characteristics common to corporate

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[10] Treas. Reg. §1.7701(l)–3.

[11] 1998–3 I.R.B. 49.

[12] Notice 99–59, 1999–52 I.R.B. 761.

[13] Rev. Rul. 2000–12, 2000—— I.R.B. ——.

[14] 73 T.C.M. (CCH) 2189 (1997), aff'd in part, rev'd in part, 157 F.3d 231 (3d Cir. 1998), cert. denied 119 S.Ct. 1251 (1999).

[15] 76 T.C.M. (CCH) 325 (1998), aff'd, —— F.3d —— (D.C. Cir., Feb. 1, 2000).

[16] Lawrence H. Summers, "Tackling the Growth of Corporate Tax Shelters," Federal Bar Association, February 28, 2000.

[17] BNA Daily Tax Report (Oct. 28, 1999), G–2.

[18] So far this year, we have shut down by administrative action so-called "chutzpah trusts" which were similar to a structure shut down by Congress in 1997 and permutations of the section 357(c) product that Congress addressed in 1999. In addition, we are now hearing about "son of LILO" transactions.

tax shelters. In addition, the IRS announced it has created an Office of Tax Shelter Analysis (described below) to serve as the focal point for efforts to gather and analyze information relating to tax shelter activity and to coordinate appropriate responses. Together, these actions will enable the IRS to more quickly and effectively address transactions used to claim tax benefits that are not properly allowable under the Internal Revenue Code.

General scope and effect of new disclosure requirements

In general, the three regulations are designed to provide the IRS with better information about tax shelters and other tax-motivated transactions through a combination of registration and information disclosure by promoters and tax return disclosure by corporate taxpayers. The regulations are intended to require disclosure of transactions that should be subject to careful scrutiny by the IRS. The regulations are designed not to require disclosure of customary business transactions or transactions with tax benefits that the IRS has no reasonable basis to challenge. The regulations do not alter substantive tax rules, and thus disclosure under the regulations does not affect the legal determination whether tax benefits claimed by taxpayers are allowable.

Registration of tax shelters by promoters

The first set of regulations is issued under section 6111(d) of the Code as enacted by the Taxpayer Relief Act of 1997. These regulations require tax shelter promoters to register with the IRS transactions (1) that have been structured for a significant purpose of tax avoidance or evasion, (2) that are offered to corporate participants under conditions of confidentiality, and (3) for which the tax shelter promoters may receive fees in excess of $100,000.

The promoter registration requirements apply to confidential corporate tax shelters offered for sale after February 28, 2000. In general, registration of a confidential corporate tax shelter is required not later than the day that the first offering for sale of interests in such shelter occurs. However, as a transition matter, no registration is required to be filed until 180 days after February 28, 2000.

List maintenance requirements for promoters

The second set of regulations, issued pursuant to section 6112 of the Code, requires promoters of corporate tax shelters to maintain lists of investors and copies of all offering materials and to make this information available for inspection by the IRS upon request. These requirements apply to transactions that have been structured for a significant purpose of tax avoidance or evasion (as defined under section 6111(d)), whether or not offered under conditions of confidentiality and whether or not the promoter fees may exceed $100,000.

These new list maintenance requirements apply to interests in corporate tax shelters acquired by investors after February 28, 2000. However, as a transition matter, the IRS will not ask to inspect the lists or offering materials until 180 days after February 28, 2000.

Reporting requirements for corporate taxpayers

The third set of regulations is issued pursuant to section 6011 of the Code and requires corporate taxpayers to disclose their participation in "reportable transactions" by attaching a short information statement to their income tax returns. In general, a separate statement will be required for each reportable transaction for each taxable year in which a corporation's federal income tax liability is affected by its participation in such a transaction. For the first taxable year in which a statement is attached to a taxpayer's return, a copy of the statement must be filed with the IRS in Washington, D.C. All of the information required to complete the statement should be readily available to taxpayers at the time their returns are filed.

Disclosure is generally required only for transactions that are expected to reduce a taxpayer's income tax liability by more than $5 million in a single taxable year or more than $10 million in multiple years and that have characteristics common to corporate tax shelters. However, these thresholds are lowered to $1 million and $2 million for certain transactions identified through published guidance as "listed transactions" (discussed below). Reporting generally is not required for customary business transactions or transactions with tax benefits that the IRS has no reasonable basis to challenge.

In general, disclosure is required only for reportable transactions entered into after February 28, 2000. However, disclosure is required for a listed transaction entered into on or before February 28, 2000 if the tax benefits of the transaction are first claimed on a return filed after February 28, 2000.

Notice 2000–15: Listed transactions

Under the regulations, promoter registration and taxpayer disclosure generally are required for certain listed transactions. The specific transactions currently designated as listed transactions are identified in Notice 2000–15, which was issued concurrently with the temporary and proposed regulations. The Treasury and the IRS have determined that each of those listed transactions involves a significant tax avoidance purpose and that the intended tax benefits are subject to disallowance under existing law. The list set forth in Notice 2000–15 may be supplemented from time to time, when other such tax avoidance transactions are identified.

F. Administration's Legislative Proposals

In its FY 2000 and 2001 Budgets, the Administration made several proposals designed to inhibit the growth of corporate tax shelters. These proposals build upon the common characteristics of corporate tax shelters and focus on the following areas:

(1) increasing disclosure of corporate tax shelter activities,

(2) increasing and modifying the penalty relating to the substantial understatement of income tax,

(3) codifying the economic substance doctrine, and

(4) providing consequences to all the parties to the transaction (e.g., promoters, advisors, and tax-indifferent, accommodating parties).

Increasing disclosure

Greater disclosure of corporate tax shelters would aid the IRS in identifying corporate tax shelters and would therefore lead to better enforcement by the IRS. Also, greater disclosure likely would discourage corporations from entering into questionable transactions. The probability of discovery by the IRS should enter into a corporation's cost/benefit analysis of whether to enter into a corporate tax shelter.

In order to be effective, disclosure must be both timely and sufficient. In order to facilitate examination of a particular taxpayer's return with respect to a questionable transaction, the transaction should be prominently disclosed on the return. Moreover, because corporate tax returns may not be examined for a number of years after they are filed, an "early warning" system should be required to alert the IRS to tax shelter "products" that may be promoted to, or entered into by, a number of taxpayers. Disclosure should be limited to the factual and legal essence of the transaction to avoid being overly burdensome to taxpayers.

Disclosure would be required if a transaction has certain of the objective characteristics identified above that are common in many corporate tax shelters. The Treasury Department believes that two forms of disclosure are necessary. Disclosure would be made on a short form separately filed with the National Office of the IRS.[19] Corporations entering into transactions requiring disclosure would file the form by the due date of the tax return for the taxable year for which the transaction is entered into and would include the form in all tax returns to which the transaction applies. The form would require the taxpayer to provide a description of the characteristics that apply to the transaction. The form should be signed by a corporate officer who has, or should have, knowledge of the factual underpinnings of the transaction for which disclosure is required. Such officer should be made personally liable for misstatements on the form, with appropriate penalties for fraud or gross negligence and the officer would be accorded appropriate due process rights.

Substantial understatement penalty

In order to serve as an adequate deterrent, the risk of penalty for corporations that participate in corporate tax shelters must be real. The penalty also must be sufficient to affect the cost/benefit analysis that a corporation considers when entering into a tax shelter transaction.

The Treasury Department believes that the substantial understatement penalty imposed on understatements of tax attributable to corporate tax shelters should be greater than the penalty generally imposed on other understatements. This view is shared by the staff of the Joint Committee on Taxation, the ABA, the NYSBA and others. Thus, to discourage the use of shelters, the Treasury Department would double the current-law substantial understatement penalty rate to 40 percent for corporate tax shelters. To encourage disclosure, the penalty rate would be reduced to 20 percent if the taxpayer files the appropriate disclosures.

[19] The requirements and format for disclosure in the Administration's FY 2001 Budget proposal is similar to the requirements and format in the temporary and proposed regulations issued under section 6011 on February 28, 2000.

In its FY 2000 Budget proposal, the Administration provided that the rate could not be further reduced below 20 percent or eliminated by a showing of reasonable cause (i.e., the penalty would be subject to a strict liability standard). Although one may rhetorically question whether there ever is any reasonable cause for entering into a corporate tax shelter transaction, many commentators have criticized the proposed elimination of the reasonable cause exception for corporate tax shelters. These commentators cited the potentially vague definitions of corporate tax shelter and tax avoidance transaction,[20] the allowance of a reasonable cause exception for other penalties, and basic fairness for opposing a "strict liability" penalty.

In light of the comments received, the Treasury Department modified its FY 2001 Budget proposal to provide that the substantial understatement penalty should be reduced or eliminated where the taxpayer properly discloses the transaction and the taxpayer has a reasonable belief that it has a strong chance of sustaining its tax position.

Codify the economic substance doctrine

As evidenced by the comments from the ABA, AICPA, NYSBA, and others, corporate tax shelters are proliferating under the existing legal regime. This proliferation results, in part, because discontinuities in objective statutory or regulatory rules can lead to inappropriate results that have been exploited through corporate tax shelters. Current statutory anti-abuse provisions are limited to particular situations and are thus inapplicable to most current corporate tax shelters. Further, application of existing judicial doctrines has been inconsistent over time, which encourages the most aggressive taxpayers to pick and choose among the most favorable court opinions.

The current piecemeal approach to addressing corporate tax shelters has proven untenable, as (1) policymakers do not have the knowledge, expertise and time to continually address these transactions; (2) adding more mechanical rules to the Code adds to complexity, unintended results, and potential fodder for new shelters; (3) the approach may reward taxpayers and promoters who rush to complete transactions before the anticipated prospective effective date of any reactive legislation; and (4) the approach results in further misuse and neglect of common law tax doctrines. Thus, the Treasury Department believes that a codification of the economic substance doctrine is necessary in order to curb the growth of corporate tax shelters. While increased disclosure and changes to the penalty regime are necessary to escalate issues and change the cost/benefit analysis of entering into corporate tax shelters, these remedies are not enough if taxpayers continue to believe that they will prevail on the underlying substantive issue.

The centerpiece of the substantive law proposal is the codification of the economic substance doctrine first found in seminal case law such as *Gregory v. Helvering*[21] and most recently utilized in ACM Partnership[22] and the cases in footnote one. The economic substance doctrine requires a comparison of the expected pre-tax profits and expected tax benefits. This test is incorporated in the first part of the Administration's proposed definition of "tax avoidance transaction." Under that test, a tax avoidance transaction would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. In addition, the economic substance doctrine would apply to financing transactions (that do not lend themselves to a pre-tax profit comparison) by comparing the tax benefits claimed by the issuing corporation to the economic profits derived by the person providing the financing.

A tax benefit would be defined to include a reduction, exclusion, avoidance or deferral of tax, or an increase in a refund. However, the definition of tax benefit subject to disallowance would not include those benefits that are clearly contemplated by the applicable Code provision (taking into account the Congressional purpose for such provision and the interaction of the provision with other provisions of the Code). Thus, tax benefits that would normally meet the definition, such as the low-income housing credit and deductions generated by standard leveraged leases, would not be subject to disallowance.

[20] These criticisms were addressed by the Treasury Department by modifying the definition of these terms.

[21] 293 U.S. 465 (1935).

[22] ACM Partnership v. Comm., 73 T.C.M. (CCH) 2189, aff'd in part, rev'd in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 119 S.Ct. 1251 (1999).

A similar approach to that discussed above can be found in H.R. 2255, the "Abusive Tax Shelter Shutdown Act of 1999," introduced by Messrs. Doggett, Stark, Hinchey and Tierney on June 17, 1999.

The Treasury Department continues to believe that it is necessary to codify the economic substance doctrine, thus requiring taxpayers to perform a careful analysis of the pre-tax effects of a potential transaction before they enter into it. The Treasury Department's proposed substantive provision is intended to be a coherent standard derived from the economic substance doctrine as enunciated in a body of case law to the exclusion of less developed, inconsistent decisions. Codification of the doctrine, while not creating a new doctrine, would create a consistent standard so that taxpayers may not choose between the conflicting decisions to support their position. Codification would isolate the doctrine from the facts of the cases so that taxpayers could not simply distinguish the cases based on the facts.

Consequences to other parties

Proposals to deter the use of corporate tax shelters should provide sanctions on other parties that participate in, and benefit from, a corporate tax shelter. These sanctions would reduce or eliminate the economic incentives for parties that facilitate sheltering transactions, thus discouraging those transactions. As the ABA stated in its recent testimony: "All essential parties to a tax-driven transaction should have an incentive to make certain that the transaction is within the law." With respect to corporate tax shelters, the "other parties" generally are promoters, advisors, and tax-indifferent parties that lend their tax-exempt status to the shelter transaction to absorb or deflect otherwise taxable income.

When Congress was concerned with the proliferation of individual tax shelters in the early 1980's, it enacted several penalty and disclosure provisions that applied to advisors and promoters. These provisions were tailored to the types of "cookie-cutter" tax shelter products then being developed. Similar provisions could be enacted that are tailored to corporate tax shelters.

Alternatively, with respect to promoters and advisors of corporate tax shelters, the Treasury Department proposes to affect directly their economic incentives by levying a penalty excise tax of 25 percent upon the fees derived by such persons from the corporate tax shelter transaction. Only persons who perform services in furtherance of the corporate tax shelter would be subject to the proposal, and appropriate due process procedures for such parties with respect to an assessment would be provided.

A tax-indifferent party often has a special tax status conferred upon it by operation of statute or treaty. To the extent such person is using this status in an inappropriate or unforeseen manner, the system should not condone such use. Imposing a tax on the income allocated to tax-indifferent parties could deter the inappropriate rental of their special tax status, limiting their participation in corporate tax shelters, and thus reducing other taxpayers' use of shelters that utilize this technique.

The Treasury Department proposes to require tax-indifferent parties to include in income (either as unrelated business taxable income or effectively connected income) income earned in a corporate tax shelter transaction. To the extent such parties are outside the U.S. tax jurisdiction, such liability would be joint and several with the U.S. corporate participant. The proposal would apply only to tax-indifferent parties that are trading on their special tax status and such parties would have appropriate due process rights.

G. IRS Administrative Actions

The IRS currently is undergoing a substantial restructuring in which it will be reorganized into divisions based on types of taxpayers. The newly established Office of Tax Shelter Analysis is part of the Large and Mid-Size Business Division located in Washington, D.C. The office is expected to serve as a clearinghouse for all information relating to tax shelter activity that comes to the attention of the IRS, including information relating to tax shelters affecting taxpayers other than those served by the Large and Mid-Size Business Division.

The Office of Tax Shelter Analysis will, among other things, review all disclosures by promoters and taxpayers under the new disclosure regulations for the purposes of identifying potentially improper tax shelter transactions, identifying taxpayers that have participated in such transactions, and better assessing the overall extent of tax shelter activity by corporate taxpayers. Where it is determined to be warranted, the Office of Tax Shelter Analysis will also coordinate the IRS's follow-up efforts relating to such disclosed transactions.

The Office of Tax Shelter Analysis, acting with the Office of Chief Counsel and Treasury's Office of Tax Policy, will evaluate the tax treatment of new forms of tax-structured transactions at the earliest possible time. This review process is nec-

essary not only to identify improper tax shelters, but also to protect taxpayers that engage in legitimate business transactions. The IRS wants to ensure that transactions are not labeled as improper tax shelters merely because they are novel or complex.

In addition to analyzing transactions that are reported to the IRS under the new disclosure rules, the Office of Tax Shelter Analysis will provide a centralized point for the review of tax shelter transactions that come to the attention of the IRS in other ways, including transactions examined by field personnel and those that are disclosed to the IRS by taxpayers, practitioners, and other members of the public. The Treasury Department will work closely with the IRS to create appropriate systems and procedures to centralize review and analysis, to ensure fair, consistent, and expeditious consideration of corporate tax shelter issues.

II. Penalties and Interest

A. General Discussion

As stated in its report, Treasury focused its penalty and interest report on the principal civil penalty provisions that affect large numbers of taxpayers and account for the majority of penalty assessments and abatements. In evaluating these penalties, Treasury was mindful that achieving a fair and effective system of compliance involves striking a balance that (1) fosters and maintains the high degree of voluntary compliance among the vast majority of taxpayers, (2) encourages taxpayers who are not compliant to expeditiously resolve noncompliance problems with the IRS, and (3) imposes an adequate system of sanctions that are fair to taxpayers whose noncompliance may be due to diverse causes that involve different degrees of culpability, but do not impose substantial additional complexity or burden. Achieving such a balance is inherently difficult because a system of sanctions that is calibrated to account for these differences may be complex, but a system that does not make adequate distinctions may be unfair. There is no perfect system of sanctions and striking the appropriate balance inherently involves tradeoffs among competing concerns.

The issue of penalties is one that often strikes an emotional chord, particularly with respect to penalties with their attendant normative overtones. At the same time, compliant taxpayers—the vast majority of taxpayers—deserve a tax system that recognizes their compliance. Although a penalty regime should not be overly harsh to noncompliant taxpayers whose noncompliance may not reflect deliberate flouting of the tax laws, it is equally true that the currently high compliance level should not be discouraged. Treasury's report and recommendations reflect an effort to strike a reasonable balance, understanding that there is no single solution and different approaches can be formulated to achieve the same goals.

Treasury also examined the respective roles of penalties and interest in our tax system, with a view toward maintaining an appropriate distinction between penalties as sanctions for noncompliant conduct and interest as a charge for the use or forbearance of money. Treasury recognizes that current law does not always make a clear or consistent distinction between interest and penalties, but believes that this distinction is important both with respect to taxpayer perception of the amounts they are required to pay and the underlying reasons for the imposition, the desired deterrent effects, and the corollary consequences of the characterization of the payment.

The distinction between penalties and interest has particular consequence for the statutory provisions that permit abatement of those impositions. Penalties generally can be abated for reasonable cause and other statutorily-prescribed reasons that reflect their function as a sanction, that is, as a deterrent to noncompliant conduct. By contrast, the grounds for abatement of interest traditionally have been more narrowly drawn because interest is a charge for the use or forbearance of money. To the extent that current-law penalties are converted to interest charges or interest becomes a more dominant mechanism for dealing with arrears in payment, important corollary consequences, such as interest deductibility or interest abatement provisions, must be considered.

In general, Treasury's position is that interest should remain principally a charge for the use or forbearance of money and should be set at a rate that approximates market rates. Although there are penalties in the Code that have attributes of an interest charge and whose legislative origins support that characterization, these penalties also function as sanctions. Treasury is particularly concerned that conversion of certain penalties to interest, even if supportable on analytical grounds, may involve a correlative blurring of the distinctions that have been drawn in the Code between penalty and interest abatement provisions. If that distinction is blurred, it may cause further confusion among taxpayers regarding the distinction between penalties and interest.

Treasury also is mindful of the ongoing IRS reorganization and implementation aspects of the new taxpayer right provisions of RRA98. Considerable guidance has been issued by Treasury in the past year relating to a number of these new provisions and the IRS is engaged in a major overhaul of its structure and systems as directed by Congress. Time is required for the impact of these new provisions to be evaluated and certain of the new provisions affect IRS programs, such as the offer-in-compromise program, that provide avenues other than abatement for relief from monetary impositions.

B. Specific Recommendations

In its report, Treasury made a number of specific legislative recommendations, which are described below.

Penalties for failure to file and failure to pay

Treasury recommends that the failure to file and failure to pay penalties be restructured to eliminate the frontloading of the failure to file penalty and to impose a higher failure to pay penalty than under current law. The frontloading of the failure to file penalty under current law in the first five months of a filing delinquency does not provide a continuing incentive to correct filing failures and imposes additional financial burden on taxpayers whose filing lapse may be coupled with payment difficulties so as to impede compliance. The filing obligation is of paramount importance to the tax system, but imposition of a severe penalty in the first five months of a filing delinquency appears incongruent with the availability of automatic extensions of time to file. Treasury proposes, accordingly, that the failure to file penalty be restructured to impose a lower penalty rate over a longer period of time, up to the current-law maximum amount. The current-law higher penalty for fraudulent failures to file, however, would be maintained. This proposal would maintain a failure to file penalty to encourage timely filing, but not impose as significant a financial burden as under current law for a filing lapse of short duration, while providing a continuing incentive for delinquent filers to correct a filing lapse of longer duration.

The failure to pay penalty should provide appropriate incentives to taxpayers to correct a payment delinquency and, if necessary, arrange for payment under various payment programs that the IRS makes available. A taxpayer who fails to make such arrangements in a timely manner should be subject to a higher penalty rate than that provided under current law. Treasury proposes, accordingly, that the failure to pay penalty be restructured to accomplish these purposes by imposing a penalty at the current rate of 0.5 percent per month for the first six months of a payment delinquency. The penalty rate would be raised to one percent per month for continuing payment delinquencies after the sixth month to provide an additional incentive to pay an outstanding tax liability. As under current law, the maximum penalty would be 25 percent. These penalty rates would be reduced if taxpayers make, and adhere to, arrangements with the IRS for payment. The failure to pay penalty would not be coordinated, as under current law, with the failure to file penalty to recognize that each form of delinquency is a separate act of noncompliance. More specifically, these recommendations would:

(1) Restructure the failure to file penalty to impose a penalty of 0.5 percent per month of the net amount due for the first six months of a delinquency in filing tax returns, which penalty rate will be increased to one percent per month thereafter, up to a maximum 25 percent. This restructured penalty would eliminate the current-law frontloading of the penalty into the first five months of a filing delinquency, providing a continuing incentive for delinquent filers to correct their filing delinquency over longer periods of time. The maximum penalty of 25 percent is the same as under current law. As under current law, fraudulent failures to file would be penalized at a higher penalty rate of 15 percent per month, up to a maximum of 75 percent.

(2) Restructure the failure to pay penalty to impose a penalty of 0.5 percent per month of the net amount due for the first six months of a payment delinquency, which rate would be increased to one percent per month thereafter, up to a maximum 25 percent. The penalty rate would be decreased from 0.5 percent to 0.25 percent per month if the taxpayer, within six months, enters into a payment arrangement with the IRS to which the taxpayer adheres. Likewise, the one-percent penalty rate would be reduced to 0.5 percent if the taxpayer, after the lapse of six months, enters into a payment arrangement with the IRS to which the taxpayer adheres.

Treasury also recommends that consideration be given to charging a fee, in the nature of a service charge, for late filing of "refund due" or "zero balance" returns. Presently, the failure to file penalty is imposed if a balance is due with the return

but is not imposed if tax is not owed as a result, for example, of overwithholding. The importance of the filing obligation and the IRS administrative costs associated with nonfiling may warrant imposition of a fee for late-filed returns to encourage timely filing even if no balance is due with the return, at least after the IRS has contacted the nonfiling taxpayer.

Consideration also can be given to permitting the IRS to utilize a fixed interest rate for installment agreements to avoid the incurrence by a taxpayer who has made the required installment payments of a balloon payment at the end of the agreement.

Penalties for failure to pay estimated tax

Treasury recommends that the current-law addition to tax for failure to pay estimated tax remain treated as a penalty. Treasury recognizes that the current sanction has attributes of interest and of a penalty. The ancillary effects, however, of converting the sanction to an interest charge do not warrant such a change. Conversion to an interest charge may mean that existing statutory waiver provisions are inappropriate. Conversion to interest also would permit corporations to deduct the payment of such sanction.

In recognition, however, of the potentially cumbersome nature of complying with the estimated tax payment requirements, the following simplifying changes are recommended for consideration:

(1) Individuals should not be subject to estimated tax penalties if the balance due with their returns is less than $1,000. Thus, estimated tax payments should be included in the calculation of the $1,000 threshold, but Treasury recommends this change under a simplified averaging method that would preclude taxpayers from satisfying the threshold by concentrating estimated tax payments in later installments.

(2) A reasonable cause waiver from penalty should be permitted for individuals who are first-time estimated taxpayers, provided the balance due on the tax return is below a threshold amount and is paid with a timely filed return.

(3) Penalty waiver should be provided for individual estimated tax penalties below a de minimis amount, in the range of $10 to $20.

Penalty for failure to deposit

Treasury recommends that few immediate changes be made to the deposit rules or penalties at this time to provide a sufficient period of time for changes to the deposit rules enacted by RRA98 to take effect. However, the penalty for failure to use the correct deposit method should be reduced. The current-law 10-percent penalty is too severe for this type of error.

Treasury also recommends that, in cases where depositors miss a deposit deadline by only one banking day, consideration be given to a reduction in the current penalty rate of two percent to a lower amount, but above an interest charge for a one-day delay.

Accuracy-related and preparer penalties

The minimum accuracy standards, for disclosed and nondisclosed tax return positions, should be modified to impose the same standards on taxpayers and tax return preparers. A significant proportion of taxpayers rely on paid preparers. Such professionals have dual responsibilities to their client/taxpayers and to the integrity of the tax system and should be expected to be knowledgeable and diligent in applying the Federal tax laws.

The minimum accuracy standards should be raised to require a "realistic possibility of success on the merits" for a disclosed tax return position and "substantial authority" for an undisclosed return position. The standards for tax shelter items of noncorporate taxpayers should be higher. In the case of disclosed positions, substantial authority and a reasonable and good faith belief that the position had a "more likely than not" chance of success should be required. For undisclosed positions, substantial authority should be accompanied by a reasonable and good faith belief based upon a higher standard of accuracy than the "more likely than not" chance of success standard. The proposed changes in the accuracy standards would reduce the number of accuracy standards, impose minimum standards that are higher than current law litigating standards to discourage aggressive tax reporting, and eliminate divergence between the standards applicable to taxpayers and tax preparers.

Treasury further recommends consideration of better harmonization of the substantial understatement and negligence penalties. In many cases, the standards applicable to the substantial understatement penalty may subsume the negligence standards. It may be appropriate to consider whether the negligence penalty should relate only to understatements that do not satisfy the "substantiality" requirement.

In determining the amount of the preparer penalty, consideration should be given to a fee-based or other approach to more closely correlate the preparer penalty to the amount of the underlying understatement of tax, rather than the current-law flat dollar penalty amount.

Finally, Treasury also recommends enactment of the Administration's Budget proposals that would address penalties applicable to corporate tax shelters and the determination of "substantiality" for large corporate underpayments.

Penalty for filing a frivolous return

The current-law penalty for filing a frivolous tax return should be raised from $500 to $1,500, but the IRS should abate the penalty for a first-time occurrence if a nonfrivolous return is filed within a reasonable period of time. This penalty amount was last raised in 1982 and significant numbers of such penalties are assessed. This approach will help bring taxpayers who file frivolous returns into better compliance.

Failures to file certain information returns with respect to employee benefit plans

Several penalties currently apply to a qualified retirement plan's failure to file IRS Form 5500. These penalties should be consolidated into a single penalty not in excess of a monetary amount per day and not to exceed a monetary cap per return. This penalty would be waived upon a showing of reasonable cause. Welfare and fringe benefit plans should be subject to a similar single penalty.

Penalty and Interest Abatement

Interest abatement

Abatement of interest in situations where taxpayers have reasonably relied on erroneous written advice of IRS personnel should be available. Treasury does not recommend further legislative expansion of the provisions permitting abatement of interest. A distinction exists between the imposition of interest as a charge for the use of money and penalties as sanctions for noncompliance. Because of this distinction, abatement of interest should be allowed in more limited circumstances than for penalties and generally restricted to circumstances where the IRS may be at fault or where serious circumstances outside the taxpayer's control result in payment delays. Current law provisions permitting abatement in circumstances of unreasonable IRS error or delay and in certain other prescribed circumstances provide sufficient scope for interest abatement at this time. In addition, taxpayers have recourse to other mechanisms for mitigation of interest and penalties, such as the offer-in-compromise program, which are in the early stages of implementing changes after enactment by RRA98.

Consideration of any modification of the current law monetary limitation on mandatory interest abatement in cases of erroneous refunds should be coupled with consideration of whether the IRS has adequate means under current law to recover erroneous refunds. Procedural impediments exist with regard to the recovery of erroneous refunds by assessment in all cases and litigation is required in some circumstances.

Penalty abatement

Other than as described above, Treasury recommends that the IRS implement administrative improvements to ensure greater consistency in the application of penalty abatement criteria and enhanced quality review of penalty abatement decisions.

Interest Provisions

The underpayment interest rate (other than the "hot interest" rate) should be a uniform rate determined by appropriate market rates of interest. Treasury recognizes that no single rate is the appropriate market rate for all taxpayers but concludes that, for reasons of fairness and administrability, a single rate generally should apply to underpayments of tax. The appropriate rate should be in the range of the Applicable Federal Rate (AFR) plus two to five percentage points to reflect an average market rate for unsecured loans.

The existing rate differentials between the underpayment and overpayment rates for corporate underpayments and overpayments, including the "hot interest" rate on large corporate underpayments, should be retained. Because of the recent enactment of global interest netting rules, it is premature to eliminate existing rate differentials.

Treasury does not support an exclusion from income for overpayment interest paid to individuals. The legislative policy precluding deductions of consumer interest does not warrant such a change.

Conclusion:

Mr. Chairman, the proliferation of corporate tax shelters presents an unacceptable and growing level of tax avoidance behavior by wasting economic resources, reducing tax receipts, and threatening the integrity of the tax system. This morning we have laid out the rationale for our suggested approach for combating this problem, and discussed why we believe that existing law does not provide sufficient tools to combat this behavior. We look forward to working with you and the members of the Committee to address this important problem, as we have in the past to curb specific abuses.

Treasury strongly supports a penalty and interest regime that fosters and maintains the current high level of compliance, provides appropriate costs and sanctions for noncompliance, and provides a reasonable and administrable degree of latitude for individual taxpayer circumstances and errors.

The proposals made in Treasury's report strike an appropriate balance among these objectives. Consideration of any legislative change in the current penalty and interest regime must take into account: (1) behavioral impact of significant change cannot be predicted with precision, and (2) the ability of the IRS to administer the new rules in a timely and equitable manner.

RESPONSES TO QUESTIONS FROM SENATOR MACK

Question: Has Treasury any knowledge of the benefit side of the corporate shelter cost/benefit equation?

Answer: The taxpayer's private benefit comes largely in the form of reduced tax payments. Revenue estimates for specific proposed and enacted anti-shelter provisions give some idea of the tax savings available from particular tax shelters. As one example, Treasury estimates that 1998 legislation prohibiting the "liquidating REIT" transaction saved the fisc $38.7 billion in taxes over ten years. Some papers dealing with the cost/benefit calculation that underlies the decision to take aggressive tax positions are cited in the answer to the next question.

Question: Are there any studies on the correlation between the level of corporate tax shelter activity and the level of corporate income tax rates?

Answer: I am aware of no studies that specifically relate corporate tax rates to the level of corporate tax shelter activity. Nonetheless, the proposition that the benefit of tax shelter activity rises as the tax rate rises is widely accepted. In addition, some studies have emphasized that high tax rates may encourage tax shelters or tax evasion by increasing the benefits of such activities, but the relationship can be more complicated than suggested by casual intuition. For example, an increase in the tax rate would increase the benefit from evasion, but it may also increase the expected marginal cost. That would happen if penalties or the probability of detection rose with increases in the dollar amount of tax saving from evasion. The increase in expected marginal cost would reduce the incentive to evade, making ambiguous the tax rate's overall effect on evasion. Increases in the tax rate also reduce the taxpayer's after-tax income. This can make the taxpayer less willing to accept risk, and therefore less willing to engage in tax evasion.

Three papers relevant to the general issue of tax evasion are: Feinstein, Jonathan S., "An Econometric Analysis of Income Tax Evasion and its Detection," *Rand Journal of Economics,* 22 No. 1 (Spring, 1991): 14–35; Joulfaian, David, "Corporate Income Tax Evasion and Managerial Preferences," *Review of Economics and Statistics* (forthcoming); Samwick, Andrew A., "Tax Shelters and Passive Losses After the Tax Reform Act of 1986," *Empirical Foundations of Household Taxation,* edited by Martin Feldstein and James Poterba, Chicago: University of Chicago Press, 1996.

Question: The corporate income tax rates in the U.S. seem to be over 12% higher than the OECD average. Do the OECD member nations with lower corporate tax rates than the U.S.—such as the Scandinavian countries, Ireland, Korea, the U.K.—have lower levels of suspected tax shelter activities than those with higher tax rates—including Germany, Japan, Canada, France and Turkey?

Answer: I am aware of no systematic study of corporate tax shelter activities in OECD countries. A number of country-specific features, including cultural attitudes, the details of the tax code, and the level of enforcement would make any cross-country study very difficult to do well. In addition, as discussed in the previous question, the relationship between tax evasion and tax rates is ambiguous when costs also depend on the tax rate and when taxpayers are risk averse.

Question: It would be my guess that effective corporate tax rates, calculated by comparing corporate taxes with corporate income, tend toward some global mean no matter the statutory rates. Are you aware of any international studies comparing the height and progressivity of statutory corporate income tax rates with the effective corporate tax rates of respective nations?

Answer: You are correct to suggest that the tax base is as important as the tax rate in determining the burden of taxation. A number of studies calculate and compare effective (i.e., average) tax rates across countries. Two such studies are Mendoza, Enrique G., Assaf Razin, and Linda L. Tesar, "Effective Tax Rates In Macroeconomics: Cross-Country Estimates of Tax Rates on Factor Incomes and Consumption," *Journal of Monetary Economics,* 34 (1994): 297–323; and Volkerink, Bjorn and Jakob de Haan, "Tax Ratios: A Critical Survey," Faculty of Economics, University of Groningen, The Netherlands, Unpublished Manuscript, September 1999.

These studies do not directly address the issue you raise, whether statutory corporate tax rates or effective corporate tax rates are distributed over a wider range of values. Neither do they address the effect of tax shelter activities. The studies show, however, that effective corporate tax rates vary widely from one country to another. For example, for 1996 Volkerink and Haan calculate an effective corporate tax rate of: 75.23% for Australia, 28.98% for Belgium, 27.72% for Canada, 17.49% for Denmark, 29.21% for Finland, 36.03% for France, 58.71% for Italy, 45.86% for Japan, 28.10% for The Netherlands, 27.31% for Norway, 63.64% for Sweden, 28.81% for Switzerland, 63.38% for the United Kingdom, and 39.12% for the United States.

For information on the statutory tax rates in OECD countries, see Organization of Economic Cooperation and Development, *OECD Tax Data Base (1999),* Paris: Organization for Economic Cooperation and Development, 1999.

COMMUNICATIONS

STATEMENT OF THE CERIDIAN CORP.

[SUBMITTED BY JAMES R. BURKLE, VICE PRESIDENT, CORPORATE TAX]

Mr. Chairman, thank you for the opportunity to provide comments on the penalty provisions of the Internal Revenue Code (IRC) and on the recommendations for improvement made by the Joint Committee on Taxation (JCT) and the US Treasury.

Ceridian Corporation, headquartered in Minneapolis, Minnesota, is a leading information services company that provides outsourced payroll processing, tax filing services, and integrated human resource management systems to predominantly large and mid-sized businesses. Ceridian's Tax Service is a high volume automated bulk filer serving approximately 60,000 employers. Ceridian collects and deposits $98 billion in employment taxes annually, files in excess of 800,000 quarterly tax returns with the IRS and 6,000 other tax agencies, and processes more than 2.6 billion electronic payroll tax transactions on behalf of clients. Ceridian has over 20 years of tax filing experience.

Ceridian's payroll and tax filing service, including the depositing of employment taxes, is comprised of many processes and procedures, all of which are designed to insure the accurate and timely filing and depositing of all federal and state tax liabilities, and are continually updated in order to fulfill the ever-changing needs of our client base and meet reporting requirements. The timely depositing of tax liabilities to the Internal Revenue Service (IRS) on behalf of clients ranks as Ceridian's highest priority.

Mr. Chairman, in your opening statement at the March 8, 2000, hearing you said, "Throughout the extensive IRS investigation and oversight hearings this committee began more than two years ago, it's become clear that one of the issues in need of serious attention is that of interest and penalties." We agree. Ceridian was pleased to submit a statement to the JCT and US Treasury when they invited comments from interested parties for their studies on tax penalty administration. As stated in those comments, we believe that the current administration of the tax penalty system is inadequate and unfairly treats taxpayers that are and want to be compliant with the system. The IRS penalty handbook in Part XX of the Internal Revenue Manual states that "penalties are used to enhance voluntary compliance." (IRM (20)121). But the system has failed to uphold this basic tenet by administering penalties arbitrarily, and by putting the burden on the taxpayer to prove good faith compliance. The penalty system for employers needs improvement in the following three areas:

1. Current administration of the penalty system fails to distinguish between employers that want to comply and those that are deliberately non-compliant.
2. The penalty provisions of the IRC are not uniformly applied. While the IRS national office may advocate one policy and set of goals, the IRS field offices generally do not follow that stated policy, resulting in delays and inconsistent policies based on local rulings.
3. The size of the penalty is often not proportionate to the offense.

1. A fair and effective penalty system should take into account tax deposit history

The Code's penalty and interest provisions are intended to deter noncompliance and prevent tax avoidance and fraud. But today the provisions are applied without regard to the taxpayer or type of error. Taxpayers that fail to make deposits out of willful neglect, have a truly egregious compliance history and demonstrate a pattern of noncompliance, should be penalized severely. But the system fails to distinguish between taxpayers that won't comply, and taxpayers that want to comply or have economic difficulty doing so.

Taxpayers that make every effort to comply can be severely penalized for inadvertent, human errors or tax system problems. For example, as a result of human error, Ceridian transmitted a client's payroll using an incorrect client ID number, resulting in tax deposits being misapplied. Ceridian corrected the error and immediately implemented procedures to ensure that a similar error does not recur. But Ceridian did not have visibility of the error until after the deposit was made and penalty and interest already were assessed. Despite a history of compliance and having reasonable cause for the late deposit, the taxpayer and Ceridian had to go through extraordinary efforts to prove good faith compliance. Penalties are automatically assessed regardless of the type of error, putting the burden on the taxpayer to prove good faith compliance.

A particular concern of bulk filers and large employers is that penalties are unnecessarily punitive on taxpayers that process a large number of transactions annually and incur one or two errors as opposed to taxpayers with very few transactions that incur the same number of errors. The result is that taxpayers with high compliance rates are penalized as severely as those with high error rates. An important indication of a taxpayer's willingness or unwillingness to comply—the taxpayer's record of compliance—is not taken into consideration by the IRS when assessing penalties.

The seemingly unfair treatment of taxpayers that have a history of demonstrated compliant behavior directly undermines what is the stated goal of a voluntary tax system, encouraging taxpayer compliance.

Recommendation: In a voluntary tax system, the taxpayer's prior actions and conduct should weigh heavily in determining the assessment of any penalty and interest. Otherwise, human or technical error is penalized to the same degree as willful noncompliance. The type of reporting should also be taken into account. A bulk filer with a client base in the thousands has voluntary compliance as its implied, if not stated goal. An assessment of a Failure to Deposit Penalty for such an entity because of human error, for example, does little to encourage voluntary compliance and much to prove the system's arbitrariness. An analysis of past behavior is the best, and at times, the only way to gauge the "intent" of the taxpayer and identify the members of the non-compliant group. Targeting taxpayers that are willfully noncompliant would improve administrative efficiencies and establish "the fairness of the tax system by justly penalizing the non-compliant taxpayer," as stated in the IRM XX-Penalty Handbook.

2. Penalty provisions should be applied uniformly to encourage greater compliance

The Joint Committee on Taxation acknowledged in their study that penalty assessment and abatement is not uniform across the IRS. The IRS national office's policies for encouraging voluntary compliance by the taxpayer often are not the policies of the IRS field offices. Uniform application of penalty and interest provisions across all levels of the IRS (including IRS service centers and district offices) as is intended in the Code and under the IRM XX-Penalty Handbook, would produce more efficient and effective administration of the tax system. It also would improve the perception of fairness in the tax system and encourage greater compliance. The reality is that the penalty provisions are not being uniformly implemented or administered.

For example, past experiences of large employers and bulk filers have been that each IRS service center would interpret the facts in similar penalty abatement requests differently, resulting in abatement in one case and upholding the assessment in another. The unintended result is service center "shopping" by large employers and bulk filers. Also, as a bulk filer, it has not been unusual for penalty and interest abatements issued by the service center with jurisdiction over the client taxpayer to be rescinded by another service center. The tax system is undermined when the national office's stated policies and goals are not followed by IRS offices in the field that have direct contact with taxpayers. If the penalty and interest provisions were applied uniformly, the administration of the tax system would be more effective and fair as intended by the IRS.

Recommendation: The issue of uniformity is important to the integrity of the tax system. The JCT recommends that the IRS improve its supervisory review of penalty imposition and abatement and establish oversight committees for specific penalties—similar to the Transfer Pricing Penalty Oversight Committee. Ceridian agrees that supervisory review emphasizing consistent policies between the national and field offices could achieve more effective administration of penalties and abatement.

Ceridian also recommends establishing a single point of contact within the IRS to oversee penalty issues for the large number of employers represented by bulk filers. The JCT and US Treasury recognize that the IRS' case-by-case procedure for

handling penalties is not efficient for bulk filers and their clients, or the IRS, when one software change can cause penalties to be imposed on hundreds or thousands of taxpayers across every state. The US Treasury recommends working with bulk filers to develop a "proxy" penalty that would alleviate the problem of dealing with many taxpayers individually on the same inadvertent error. The JCT recommends that the IRS work with bulk filers "to expedite resolution of problems where a single error or mishap may impact multiple taxpayers." Ceridian suggests that resolution of these problems can be expedited by designating a national point of contact for bulk filers.

"One point of contact" already is being implemented for taxpayers under IRS' reorganization of its 33 district offices and 10 service centers into 4 operating divisions. Each division will have responsibility for specific taxpayer groups from pre-filing to post-filing. Many bulk filers, however, will have clients in more than one division with no identified point of contact for specific issues pertaining to these taxpayers. A single, national point of contact would simplify the tax payment and filing process and reduce the compliance burden on both the taxpayer and the IRS.

3. The size of the penalty should be proportionate to the offense

The perceived fairness of the tax system is diminished by the amount of penalty and interest that can be assessed because of one inadvertent, human mistake or technical error. The tax system not only puts the burden squarely on the taxpayer to prove good faith compliance, but it could cost the taxpayer excessive penalties.

A good example is the Failure to Deposit penalty for failing to use the correct deposit method, especially with regard to the Electronic Federal Tax Payment System (EFTPS). Employers are automatically penalized 10 percent per tax deposit if payments are not made through EFTPS—even if tax liabilities are paid on time and the taxpayer has an otherwise unblemished deposit record. The amount of the penalty often is many times greater than the actual loss of revenue to the IRS and is disproportionate to the offense. The IRS and Congress have taken action to waive the 10 percent penalty for some employers, but the waiver does not address the unnecessary severity of the penalty.

It also does not address the issue that a taxpayer should never be penalized in instances where their payments are on deposit with the IRS or its depository on or before the tax due date. The fact that payment has been deposited should be taken into account before assessing penalties. The imposition of a penalty in such an instance is wholly inappropriate and not proportionate to the error.

Recommendation: Ceridian agrees with the US Treasury's recommendation to reduce the 10 percent deposit penalty to 2 percent because the severity of this penalty often exceeds the taxpayer error. However, reducing the penalty amount does not address the issue of fairness. An honest mistake by a taxpayer with a history of compliance would still be penalized to the same degree as a willfully non-compliant taxpayer. A taxpayer's compliance record should be taken into account in administering penalties. Ceridian also agrees with the JCT's recommendation to revise deposit regulations so that taxpayers whose deposit schedules change are notified by the IRS of the change in status before it takes effect. Employers may not realize that their deposit schedule has changed until they receive a penalty notice months later and start incurring penalties.

CONCLUSION

The JCT and US Treasury studies were important undertakings that should prompt needed change. The vast majority of taxpayers want to comply and should be assisted and encouraged to do so. As Commissioner Rossotti has stated numerous times, the IRS is working to encourage compliance by providing clearer communications, marketing the benefits of electronic payment and offering improved taxpayer service and education.

This is a tremendous step in the right direction. But the current administration of tax penalties does little to instill confidence in the tax system and fails to effectively target and reduce severe noncompliance. The penalty system has become arbitrary where taxpayers in different parts of the country may receive different treatment in similar situations. The arbitrariness extends to the actual amount of the penalty where excessive penalties can be automatically assessed without regard to the reason for the error or the taxpayer's deposit history. Resources should be focused more effectively. Uniform goals across all levels of the IRS and targeting efforts toward deterring noncompliance among willfully non-compliant taxpayers will produce a more efficient and equitable system.

Thank you, again, for the opportunity to comment on the penalty provisions of the Internal Revenue Code and the studies completed by the JCT and the US Treasury.

STATEMENT OF THE COALITION FOR THE FAIR TAXATION OF BUSINESS TRANSACTIONS [1]

The Coalition for the Fair Taxation of Business Transactions (the "Coalition") is composed of U.S. companies representing a broad cross-section of industries. The Coalition is opposed to the broad-based "corporate tax shelter" provisions in the Administration's budget because of their detrimental impact on legitimate business transactions. The Coalition is particularly concerned with the broad delegation of authority provided to IRS agents under these proposals, which would reverse some of the reforms of the IRS Restructuring Act, passed in 1998.

Pursuant to section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998, the Department of Treasury, on October 25, 1999, issued a report [2] on the penalty and interest provisions of the Code. The Joint Committee on Taxation ("JCT"), on July 22, 1999, released a study [3] of present-law penalty and interest provisions. Both studies include recommendations regarding penalty and interest provisions in the Code. The Coalition will focus its comments only on those recommendations we believe will have an impact on corporate taxpayers.

On February 28, 2000, the Department of Treasury issued three sets of regulations [4] imposing new requirements on promoters and taxpayers for certain so-called corporate tax shelter activities. These regulations require promoters to register certain confidential corporate tax shelters, require certain corporate taxpayers to file tax shelter disclosure statements both to the National Office of the IRS as well as with their Federal corporate tax return, and require promoters to maintain lists of investors in potentially abusive tax shelters.

As with the Administration's legislative proposals dealing with corporate tax shelters, these regulations would impact many legitimate business transactions because they apply to an extremely broad category of transactions. Despite the regulation's attempt to provide exceptions for transactions performed in the ordinary course of business, as drafted, these exceptions would not apply to many legitimate business transactions. As a result, these regulations will impose a significant additional compliance burden on corporate taxpayers that are not engaged in corporate tax shelter activity.

These regulations have been issued with an immediate effective date, rather than following general administrative procedures of issuance in proposed form and allowing for comments to be received from taxpayers before the regulations are finalized and become effective. Because these regulations raise many of the same concerns that taxpayers raised with the Administration's legislative proposals, we do not think they should be effective until taxpayers have had an opportunity to comment on them.

I. ACCURACY-RELATED PENALTY

The American scheme of income taxation is based on the fundamental premise of "self-assessment" by taxpayers of their tax liability.[5] It is clear that the existing tax system could not function properly if the majority of taxpayers did not report the correct amount of tax without the government's prior determination of the tax liability.

To encourage taxpayers to comply with this self-assessment system of taxation, the Internal Revenue Code ("Code") contains provisions to punish taxpayers and return preparers that fail to comply with minimum tax return reporting standards.[6] For taxpayers, return positions must meet the "reasonable basis" standard to avoid penalties. For return preparers, the minimum standards to avoid penalties for undisclosed return positions are the "realistic possibility of success on the merits" standard and the "not frivolous" standard for disclosed positions.

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[1] This testimony was prepared by Arthur Andersen on behalf of the Coalition for Fair Taxation of Business Transactions.

[2] Department of the Treasury, Report to Congress on Penalty and Interest Provisions of the Internal Revenue Code, October 1999.

[3] 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) (JCS-3-99), July 22, 1999.

[4] TD 8875 and REG-103736-00; TD 8876 and REG-110311-98; and TD 8877 and REG-103735-00.

[5] Commissioner v. Lane Wells Co., 321 U.S. 219 (1944).

[6] See I.R.C. §§6662 and 6694.

JCT and Treasury each recommend raising the minimum standards that must be met in order for taxpayers and return preparers to avoid the impositions of penalties. We believe these recommendations would raise the minimum standards to unjustifiable levels. It is unrealistic to expect taxpayers to file "perfect" returns, on which every item is unquestionably correct. Federal tax law is complex, ambiguous and constantly evolving. The determination of a taxpayer's correct amount of tax is often not clear-cut. The recommendations to raise the minimum accuracy standards to avoid the accuracy-related penalty and return preparer penalties are too harsh and are not justified.

A. Joint Committee and Treasury Proposals

JCT recommends that for both taxpayers and return preparers the minimum standard for each undisclosed position on a tax return is that the taxpayer or preparer must reasonably believe that the tax treatment is "more likely than not" the correct tax treatment. This standard requires a greater than 50 percent likelihood that an undisclosed position would be sustained if challenged. For adequately disclosed positions, JCT recommends the minimum standard be substantial authority.

Treasury recommends that for both taxpayers and return preparers the minimum accuracy standard for undisclosed positions be the substantial authority standard. For positions disclosed in a tax return, Treasury recommends that the minimum accuracy standard be the realistic possibility of success on the merit standards.

B. Analysis

As justification for raising the minimum reporting standard for undisclosed positions on a tax return to a "more likely than not standard," JCT argues that a tax return is signed under penalties of perjury, which implies a high standard of diligence in determining the positions taken on a return. JCT believes this requires a minimum reporting standard that an undisclosed return position satisfy a "more likely than not" reporting standard.

The accuracy-related penalties are designed to reinforce a taxpayer's self-assessment obligation. The current accuracy-related penalty and reporting standards, which require substantial authority for an undisclosed return position and reasonable basis for a disclosed return position, already provide a powerful incentive for corporate taxpayers to closely review and analyze positions taken on their tax returns.

A basic premise of our tax system is that a taxpayer is entitled to contest a dispute with the Internal Revenue Service in the United States Tax Court prior to payment of the tax liability in dispute. This ability is critical in certain situations where IRS agents aggressively assert a position that cannot be justified based on a careful analysis of the tax law in the area.[7] Taxpayers are not required to possess certainty of the correctness of a position in order to advance that position on the return. Given the complexity of the tax system, it is unreasonable to expect every position on every return to be unquestionably correct. A standard that requires a taxpayer to possess a "more likely than not" certainty of the position advanced on the return effectively prevents a taxpayer from advancing a position and litigating it in the prepayment forum of the Tax Court because of the probable imposition of a penalty if the taxpayer does not prevail. Accordingly, the reporting standards recommended by JCT and Treasury would, as a practical matter, require a taxpayer to self-assess a tax liability according to the government's position on a tax issue, pay the tax, and pursue relief by filing a refund suit.

The recommendation of JCT is further flawed because the more likely than not standard applies to both the substantial understatement penalty and the negligence penalty. The effect of the JCT proposal is to create one accuracy-related penalty that requires a stricter reporting standard than the substantial understatement, while no longer requiring the existence of a substantial understatement of tax for the penalty to apply. As a result of this proposed reporting standard, any mistake, whether intentional or inadvertent, results in the automatic imposition of an accuracy-related penalty. Treasury's recommendation is subject to the same criticism. By raising the minimum reporting standard, the substantial understatement penalty subsumes the negligence penalty and reverses the long-standing policy of requiring a higher reporting standard for taxpayers with substantial understatements.

[7] For example, since the Supreme Court decision in Indopco, Inc. v. Commissioner, 503 U.S. 79 (1992) (requiring expenditures that give rise to more than incidental future benefits to be capitalized rather than expensed) IRS agents aggressively try to require taxpayers to capitalize expenditures with taxpayers ultimately prevailing in court. See RJR Nabisco v. Commissioner, T.C. Memo 1998–252.

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For return positions disclosed by taxpayers, JCT recommends that the minimum standard for the disclosed return position be substantial authority. This minimum standard applies to the negligence penalty and the substantial understatement penalty. Treasury recommends the minimum reporting standard to avoid these penalties for disclosed positions be the realistic possibility of success on the merits standard. Raising the minimum reporting standard for disclosed return positions is unjustified for three reasons. First, the recommended standards eliminate the long-standing policy of distinguishing between any understatement of tax and a substantial understatement of tax. Second, the recommended standards are so high that they are likely to have the effect of taxpayers disclosing less. This is because if uncertain of a position, a taxpayer may be more likely to take the chance the Internal Revenue Service will not audit the return rather than disclose the position on the tax return. Third, under each of the recommendations, the substantial understatement subsumes the negligence penalty.

II. ESTIMATED TAX PENALTY

If a corporation fails to make timely estimated tax payments, then a penalty is imposed under section 6655. The penalty imposed under section 6655 is determined by applying the underpayment interest rate to the amount of the underpayment for the period of the underpayment. Although Treasury recognizes that this sanction has attributes of interest and of a penalty, it recommends that the current-law sanction remain a penalty.

We believe this sanction is more appropriately treated as an interest charge rather than a penalty. As JCT recognized in its penalty study, the conversion of the corporate estimated tax penalty (and individual estimated tax penalty) into interest charges more closely conforms the title and descriptions of these provisions to their effect. These penalties are computed as an interest charge, therefore, conforming their titles to the substance of their function will improve taxpayers' perceptions of the fairness of the tax systems. Because these sanctions are essentially a time value of money computation, which is not punitive in nature but rather compensatory, calling them penalties makes the offense of underpaying estimated taxes seem greater than it is and wrongfully denies an appropriate deduction to business entities.

For the reasons stated above, we recommend following the JCT recommendation to convert the existing penalty for failure to pay estimated tax into an interest provision.

III. INTEREST

Under current law, there is an interest rate differential between the interest the government pays on large corporate overpayments of tax and what it charges on large corporate underpayments of tax. Treasury recommends in its penalty study to retain this interest rate differential. JCT recommends that this interest rate differential be repealed. We agree with the JCT recommendation for the reasons set forth in their study.

JCT recommends providing one interest rate for both individuals and corporations applicable to both underpayments and overpayments. Accordingly, JCT recommends eliminating the so-called "hot interest" provision that applies a higher rate of interest to certain corporate underpayments, as well as the special rule that applies a lower interest rate to certain corporate overpayments. This proposal also limits the need for interest netting for corporations, a very complex burden for both taxpayers and the Service.

As recognized by JCT, the recommended changes to the interest rate provisions would complete the policy begun by the IRS Reform Act of providing equivalent effective interest rates on underpayments and overpayments. The recommended changes to the interest rate provision would, on a prospective basis, provide a better mechanism for achieving the equivalent effective interest rate goal than the net zero interest rate approach of present law. This is because the proposed changes would, at least on a prospective basis, automatically achieve the desired result. On the other hand, the implementation of the net zero interest rate under present law requires taxpayers to identify the appropriate periods to which the net zero rate should apply and to recalculate interest for those periods. The recommended changes would make the benefits of equivalent effective interest rates available to all taxpayers on a prospective basis, not only to those taxpayers capable of preparing complex net zero rate calculations.

WRITTEN TESTIMONY SUBMITTED ON BEHALF OF THE COALITION OF SERVICE INDUSTRIES[1] TO THE COMMITTEE ON FINANCE U.S. SENATE FOR THE HEARING CONDUCTED ON FEBRUARY 8, 2000

REGARDING A PROPOSAL IN PRESIDENT CLINTON'S FISCAL YEAR 2001 BUDGET TO INCREASE PENALTIES FOR FAILURE TO FILE CORRECT INFORMATION RETURNS

The Coalition of Service Industries, which represents a broad range of financial institutions, including both large and small institutions, strongly opposes the Administration's proposal to increase penalties for failure to file correct information returns.

The proposed penalties are unwarranted and place an undue burden on already compliant taxpayers. It seems clear that most, if not all, of the revenue estimated to be raised from this proposal would stem from the imposition of higher penalties due to inadvertent errors rather than from enhanced compliance. The financial services community devotes an extraordinary amount of resources to comply with current information reporting and withholding rules and is not compensated by the U.S. government for these resources. The proposed penalties are particularly inappropriate in that (i) there is no evidence of significant current non-compliance and (ii) the proposed penalties would be imposed upon financial institutions while such institutions were acting as integral parts of the U.S. government's system of withholding taxes and obtaining taxpayer information.

The Proposal

As included in the President's fiscal year 2001 budget, the proposal generally would increase the penalty for failure to file correct information returns on or before August 1 following the prescribed filing date from $50 for each return to the greater of $50 or 5 percent of the amount required to be reported[2]. The increased penalties would not apply if the aggregate amount that is timely and correctly reported for a calendar year is at least 97 percent of the aggregate amount required to be

[1] The Coalition of Service Industries (CSI) was established in 1982 to create greater awareness of the major role services industries play in our national economy; promote the expansion of business opportunities abroad for US service companies; and encourage US leadership in attaining a fair and competitive global marketplace. CSI represents a broad array of US service industries including the financial, telecommunications, professional, travel, transportation, information and information technology sectors.
[2] A similar proposal was included in President Clinton's fiscal year 1998, 1999 and 2000 budgets.

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reported for the calendar year. If the safe harbor applies, the present-law penalty of $50 for each return would continue to apply.

Current Penalties are Sufficient

We believe the current penalty regime already provides ample incentives for filers to comply with information reporting requirements. In addition to penalties for inadvertent errors or omissions[3], severe sanctions are imposed for intentional reporting failures. In general, the current penalty structure is as follows:

- The combined standard penalty for failing to file correct information returns and payee statements is $100 per failure, with a penalty cap of $350,000 per year.

- Significantly higher penalties—generally 20 percent of the amount required to be reported (for information returns and payee statements), with no penalty caps—may be assessed in cases of intentional disregard.[4]

- Payors also may face liabilities for failure to apply 31 percent backup withholding when, for example, a payee has not provided its taxpayer identification number (TIN).

There is no evidence that the financial services community has failed to comply with the current information reporting rules and, as noted above, there are ample incentives for compliance already in place.[5] It seems, therefore, that most of the revenue raised by the proposal would result from higher penalty assessments for inadvertent errors, rather than from increased compliance with information reporting requirements. Thus, as a matter of tax compliance, there appears to be no justifiable policy reason to substantially increase these penalties.

Penalties Should Not Be Imposed to Raise Revenue

Any reliance on a penalty provision to raise revenue would represent a significant change in Congress' current policy on penalties. A 1989 IRS Task Force on Civil Penalties concluded that penalties "should exist for the purpose of encouraging voluntary compliance and not for other purposes, such as raising of revenue."[6] Congress endorsed the IRS Task Force's conclusions by specifically enumerating them in the Conference Report to the Omnibus Budget Reconciliation Act

[3] It is important to note that many of these errors occur as a result of incorrect information provided by the return recipients such as incorrect taxpayer identification numbers (TINs).
[4] The standard penalty for failing to file correct information returns is $50 per failure, subject to a $250,000 cap. Where a failure is due to intentional disregard, the penalty is the greater of $100 or 10 percent of the amount required to be reported, with no cap on the amount of the penalty.
[5] Also note that, in addition to the domestic and foreign information reporting and penalty regimes that are currently in place, for payments to foreign persons, an expanded reporting regime with the concomitant penalties is effective for payments made after December 31, 1999. See TD 8734, published in the Federal Register on October 14, 1997. The payor community is being required to dedicate extensive manpower and monetary resources to put these new requirements into practice. Accordingly, these already compliant and overburdened taxpayers should not have to contend with new punitive and unnecessary penalties.
[6] Statement of former IRS Commissioner Gibbs before the House Subcommittee on Oversight (February 21, 1989, page 5).

of 1989.[7] There is no justification for Congress to abandon its present policy on penalties, which is based on fairness, particularly in light of the high compliance rate among information return filers.

Safe Harbor Not Sufficient

Under the proposal, utilization of a 97 percent substantial compliance "safe harbor" is not sufficient to ensure that the higher proposed penalties apply only to relatively few filers. Although some information reporting rules are straightforward (e.g., interest paid on deposits), the requirements for certain new financial products, as well as new information reporting requirements,[8] are often unclear, and inadvertent reporting errors for complex transactions may occur. Any reporting "errors" resulting from such ambiguities could easily lead to a filer not satisfying the 97 percent safe harbor.

Application of Penalty Cap to Each Payor Entity Inequitable

We view the proposal as unduly harsh and unnecessary. The current-law $250,000 penalty cap for information returns is intended to protect the filing community from excessive penalties. However, while the $250,000 cap would continue to apply under the proposal, a filer would reach the penalty cap much faster than under current law. For institutions that file information returns for many different payor entities, the protection offered by the proposed penalty cap is substantially limited, as the $250,000 cap applies separately to each payor.

In situations involving affiliated companies, multiple nominees and families of mutual funds, the protection afforded by the penalty cap is largely illusory because it applies separately to each legal entity. At the very least, any further consideration of the proposal should apply the penalty cap provisions on an aggregate basis. The following examples illustrate why aggregation in the application of the penalty cap provisions is critical.

EXAMPLE I – Paying Agents

A bank may act as paying agent for numerous issuers of stocks and bonds. In this capacity, a bank may file information returns as the issuers' agent but the issuers, and not the bank, generally are identified as the payors. Banks may use a limited number of information reporting systems (frequently just one overall system) to generate information returns on behalf of various issuers. If an error in programming the information reporting system causes erroneous amounts to be reported, potentially all of the information returns subsequently generated by that system could be affected. Thus, a single error could, under the proposal, subject each issuer for whom the bank filed information returns, to information reporting penalties because the penalties would be assessed on a taxpayer-by-taxpayer basis. In this instance, the penalty would be imposed on each issuer. However, the bank as paying agent may be required to indemnify the issuers for resulting penalties.

[7] OBRA 1989 Conference Report at page 661.
[8] For example, Form 1099-C, discharge of indebtedness reporting, or Form 1042-S, reporting for bank deposit interest paid to certain Canadian residents.

Recommendation: For the purposes of applying the penalty cap, the paying agent (not the issuer) should be treated as the payor.

EXAMPLE II – Retirement Plans

ABC Corporation, which services retirement plans, approaches the February 28th deadline for filing with the Internal Revenue Service the appropriate information returns (i.e., Forms 1099-R). ABC Corporation services 500 retirement plans and each plan must file over 1,000 Forms 1099-R. A systems operator, unaware of the penalties for filing late Forms 1099, attempts to contact the internal Corporate Tax Department to inform them that an extension of time to file is necessary to complete the preparation and filing of the magnetic media for the retirement plans. The systems operator is unable to reach the Corporate Tax Department by the February 28th filing deadline and files the information returns the following week. This failure, under the proposal, could lead to substantial late filing penalties for each retirement plan that ABC Corporation services (in this example, up to $75,000 for each plan)[9].

Recommendation: Retirement plan servicers (not each retirement plan) should be treated as the payor for purposes of applying the penalty cap.

EXAMPLE III – Related Companies

A bank or broker dealer generally is a member of an affiliated group of companies, which offer different products and services. Each company that is a member of the group is treated as a separate payor for information reporting and penalty purposes. Information returns for all or most of the members of the group may be generated from a single information reporting system. One error (e.g., a systems programming error) could cause information returns generated from the system to contain errors on all subsequent information returns generated by the system. Under the proposal, the penalty cap would apply to each affiliated company for which the system(s) produces information returns.

Recommendation: Each affiliated group[10] should be treated as a single payor for purposes of applying the penalty cap.

While these examples highlight the need to apply the type of penalty proposed by the Treasury on an aggregated basis, they also illustrate the indiscriminate and unnecessary nature of the proposal.

CONCLUSION

The Coalition of Service Industries represents the preparers of a significant portion of the information returns that would be impacted by the proposal to increase penalties for failure to file correct information returns. In light of the current reporting burdens imposed on our industries and the significant level of industry compliance, we believe it is highly inappropriate to raise penalties. Congress has considered and rejected this proposal on three previous occasions, and we hope it will continue to reject this unwarranted penalty increase. Thank you for your consideration of our views.

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[9] If the corrected returns were filed after August 1, the penalties would be capped at $250,000 per plan.
[10] A definition of "affiliated group" which may be used for this purpose may be found in Section 267(f) or, alternatively, Section 1563(a).

STATEMENT OF GIL HYATT

OVERVIEW

Even though Congress reformed the IRS with the Internal Revenue Service Restructuring and Reform Act of 1998, State taxing agencies guilty of similar types of abuses that provoked Congressional reform of the IRS have nevertheless resisted such reform measures. Many States use the same type of abusive tactics for which their federal counterpart—the IRS—was reprimanded by Congress. The State taxing agencies, however, have gone even further than the IRS ever dared to go by exacting revenue from non-residents using tax assessments that are significantly increased by ill-supported penalties. In making this assessment, State taxing agencies use Federal tax return information without regard for its confidentiality. The Joint Committee on Taxation recently addressed the problems of breaches of confidentiality of Federal tax returns and return information by State tax agencies.[1]

States are particularly abusive towards former residents who have moved to another State. Moving to another State is a common occurrence in the U.S., where citizens have the constitutional right to travel to and establish residency in any State in the United States. In 1996, Congress passed legislation that prevents States from taxing the pensions of retirees living in other States. This Congressional legislation illustrates the need for federal intervention in order to prevent States from overreaching in their pursuit of interstate tax revenue. Unfortunately, this action by Congress only focused on one small avenue in which States pursue non-residents for additional taxes. Another tactic is to assess a tax on citizens leaving the State by contesting when the former resident moved out of the State. Years after a citizen has relocated to another State, the State taxing agency will open a "residency audit" to exact as much tax revenue from a former resident as possible.

States train auditors to over-inflate their proposed tax assessments by invoking penalties (regardless of any evidentiary basis for such penalties) and then maneuver the taxpayer into settling, at which time the alleged penalties are negotiated away giving the State what it wants and leaving the taxpayer feeling relieved for not having to pay for or deal with the embarrassment of penalties. The training manual for penalties has on its cover a full-page Skull-and-Crossbones symbol (see attachment) illustrating a cavalier and almost sadistic attitude of piracy that the State takes towards penalties. In training seminars, the use of a fraud penalty is illustrated with a poker chip (i.e. a bargaining chip) and the auditors are taught that by using a penalty as a "poker chip," it can intimidate and coerce the taxpayer into acquiescing to its demands while making the taxpayer feel fortunate that the FTB does not pursue the embarrassing penalty.

Furthermore, if the taxpayer does not negotiate even under the threat of penalties, the State may threaten the taxpayer with public disclosure of private information submitted to the State in confidence, including the disclosure of Federal tax returns and return information which violates the terms under which the State is allowed to receive Federal tax information.

Many of these same tactics and abuses were the subject of recent Congressional hearings by the Senate Committee on Finance. The Senate Finance Committee reviewed numerous cases of misuse of penalties, as well as intimidation and coercion tactics by Federal revenue agents. While their review resulted in changes in law at the Federal level, many, if not more, egregious actions continue to take place at the State level.

If the notion of an out-of-control, abusive governmental agency seems unfathomable, then one need look no further than the recent scandal that has erupted in the Rampart division of the Los Angeles Police Division. Stories of police officers within the Rampart division of Los Angeles committing perjury and fabricating evidence seemed unbelievable until a former officer of the division began disclosing the division's "dirty little" secrets.

The foundation of the State's scheme involving penalties and interest results in an audit that either totally ignores or disregards or distorts exculpatory evidence, creates sham evidence "out of thin air,"[2] and uses falsified evidence to support the audit determination.

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[1] See Joint Committee on Taxation "Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions as required by Section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998," January 28, 2000.

[2] The court in Wertin v. FTB, 68 Cal. App. 4th 961, 80 Cal Rptr. 2d 644 (1998) condemned the FTB for assessing taxes "out of thin air" and sanctioned the agency severely.

DISTORTION OF THE RECORD TO JUSTIFY IMPOSING FRAUD PENALTIES

The fraud penalty imposed by the State is based upon the Internal Revenue Code §6663. It is based upon both any direct evidence of fraud and so-called "badges of fraud," which include: 1) implausible or inconsistent explanations of behavior, 2) concealment of assets, and 3) Failure to cooperate with tax authorities.

State auditors make allegations of hiding of assets, dealing in cash, refusal to cooperate, and other "badges" of fraud without any evidentiary basis in the record. The auditor maintain that the holding of fraud is "based upon all of the facts and circumstances" but may never have stated what facts in particular led to the holding of fraud. Such generalized statements do not surmount the standard of "clear and convincing evidence" that the State is required to meet in order to impose fraud penalties. The statements usually address innocuous events that have innocent explanations but are distorted to appear to be fraudulent behavior. Examples are provided below.

Unsupported accusations that are on their face absurd and made by those with hatred for the taxpayer are given sacred qualities. For example, statements by a bitter ex-wife that she had heard that the taxpayer had helped yet another person do something improper is stated as conclusive direct evidence of fraud. Innocent events, such as cashing a check for petty cash or transferring utilities to the purchaser of the taxpayer's former house, or short delays in changing addresses after a move are taken to be direct evidence of fraud.

A trust created for privacy and for estate planning purposes, which is a method recommended by many professionals and used by many private or wealthy persons, is miscast as a concealment of assets.

States have adopted a mission statement promising that its agency will collect taxes fairly and which directs the State and its employees to "treat everyone with fairness, honesty, courtesy, and respect." Apparently, the demands on States to generate tax revenue have forced them to be anything but fair, or honest, or courteous, or respectful. Unfortunately, the State is all too often unfair, dishonest, discourteous, and disrespectful to the point where it has been accused of fraud and extortion.

THE SETTLEMENT BUREAU PROVIDES THE "COUP DE GRAS"

The State then suggests that the taxpayer settle in order to avoid the public exposure of the taxpayer's private records and finances, the records generated by the auditors during its investigation, and the auditor's alleged fraud holding. The State designs its "audit investigation" to cause the taxpayer great emotional distress and concern for his financial, business, and personal life, so that, when the State suggests a settlement, the taxpayer will be relieved to go along with it in order to end the personal hell and torment and allow his life to return to normal (if ever possible after this ordeal). George Archer, after winning a long battle against the FTB over his Nevada residency, expressed the sentiment of many non-California resident taxpayers best when he asked, "Why has the Franchise Tax Board made my life a living hell for the last six years?"[3] A State's pattern of using auditors trained to follow one-sided rules, generate self-serving evaluations, and apply alleged fraud penalties must not be allowed to continue.

THE STATE'S ABUSIVE CONDUCT PARALLELS THE LAPD'S RAMPART CORRUPTION SCANDAL

State auditors justify their conduct by believing that they are doing their patriotic duty to help the State collect taxes from tax cheats. As the State sees it, penalties are just a tool to help make its job easier: "By properly using the full force of the penalties written into the tax laws we may better be able to get the taxpayers to be more cooperative."[4] In actuality, however, the State is just another example of a government agency gone amok, where the individuals within the agency became so accustomed to their power and invincibility that they abuse it.

Another current example of an agency that let its zeal for pursuing "bad guys" lead to citizen-abuse is the Los Angeles Police Department's Rampart Division. This has erupted into a scandal that has engulfed and continuing to engulf the entire city: "The scandal centers on allegations that Rampart Division gang suppression CRASH officers routinely manufactured evidence and committed perjury to frame

[3] "BOE Rules FTB Bogeyed Golfer Archer's Case," CalTaxLetter, Vol. 12, No. 32, September 6, 1999.

[4] "Penalties" section of FTB training Manual prepared by Larry Moy, Los Angeles District Office, August 31, 1993.

people for crimes they did not commit."[5] Already "39 people have had their convictions reversed on grounds that crooked Rampart cops set them up."[6] The scandal erupted last September when a former Rampart police office told of misconduct by his fellow Rampart officers. The misconduct included dealing drugs, framing people for crimes they did not commit, lying in sworn affidavits or in court, and engaging in "dirty" shootings and beatings. The City Attorneys office estimates the financial liability of the City to be "125 million, and others guesses have ranges as high as $1 billion."[7]

Similarly, allegations of corruption and abuse are coming out against the State. One former auditor has detailed an out-of-control taxing agency with a culture of dehumanizing taxpayers and turning the tax collecting process into an "us versus them" battle. Auditors manufactured incriminating evidence, suppressed or destroyed exculpatory evidence, and committed perjury in order to "accomplish its patriotic duty." And the State rewarded them well for their bad deeds with promotions and awards.

The Rampart CRASH unit even had its own Skull-and-Crossbones insignia to boost morale within the unit—very similar to the Skull-and-Crossbones symbol of swashbuckling piracy that is on the front of one State's Penalties training material.

The Skull-and-Crossbones pirate symbol of the State taxing agency and of the LAPD Rampart Division is reminiscent of the famous 1798 American rallying cry against the French "pirates": "Millions for defense, but not one cent for tribute.[8] American citizens need to once again rise up against oppressive taxing agencies such as the State and proclaim "not one cent for tribute." See the letters from California Congressman Brad Sherman and the cover of the FTB training manual on Penalties attached hereto.

[5] Michael D. Harris, "DA's Believe Scandal Affects Trials' Results," Los Angeles Daily Journal, Wednesday, March 16, 2000 at 1.

[6] Id.

[7] Joel Fox, "We Will Have to Pay the Piper—but How?" Los Angeles Time, Sunday, March 12, 2000 at op-ed page, M5.

[8] Robert Goodloe Harper, a toast at banquet for John Marshall, June 18, 1798, as quoted in John Bartlett, Bartlett's Familiar Quotations, Fifteenth Edition (Little Brown and Company, Inc.: 1980) at 416.

The Rampart CRASH division has been described as a "secret fraternity of anti-gang officers and supervisors [who] committed crimes and celebrated shootings by awarding plaques to officers who wounded or killed people."[9] Similarly, the State auditors were rewarded for their trumped-up assessments.

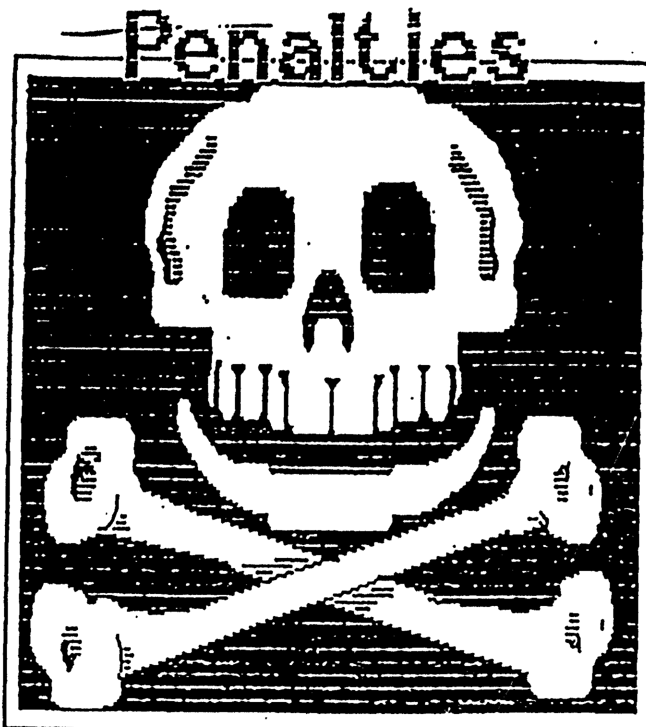
The State calling its initial assessment letter only a "proposed" assessment and not a bill is a perfect example of form over substance. What the agency doesn't acknowledge is that this "proposed" assessment, if not challenged by the taxpayer within 60 days, becomes an actual assessment. Thus, an outrageous assessment that has no basis in fact is just as enforceable against the taxpayer if the taxpayer does not play into the State's settlement game. What the State also doesn't want to acknowledge is that interest begins to accrue on this "proposed" assessment at 10% compounded daily from the day the tax was claimed to be due regardless of its factual basis or lack thereof.

CONCLUSION

Penalties do have a valid place within the realm of income tax administration. However, any taxing agency, federal or state, that fabricates allegations of fraud and other abuses in order to apply penalties against a taxpayer so that those penalties can be used as bargaining chips to give up during settlement negotiations crosses the line of fair and just tax administration. Penalties were not meant to be used as tools of piracy to intimidate and coerce a taxpayer into acquiescing to its demands. As an area involving interstate commerce, Congress has an obligation to prevent state taxing agencies from exerting this kind of coercive power on non-residents who are simply attempting to exercise their constitutional right to travel and move among the states.

[9] Scott Glover and Matt Lait, "Police in Secret Group Broke Law Routinely, Transcripts Say," Los Angeles Times, February 10, 2000, at 1.

ATTACHMENT 1



Prepared by:
Larry Moy
Los Angeles District Office
August 31, 1993

ATTACHMENT 2

CONGRESSMAN BRAD SHERMAN

24TH DISTRICT, CALIFORNIA

SERVING THE SAN FERNANDO AND CONEJO VALLEYS,
LAS VIRGENES AND MALIBU

COMMITTEE ON BANKING
AND FINANCIAL SERVICES

COMMITTEE ON
INTERNATIONAL RELATION

February 7, 2000

Jerry Goldberg
Executive Director
Franchise Tax Board
P.O. Box 942840
Sacramento, CA 94240-0040

Dear Mr. Goldberg:

Its been a while since we have had a chance to talk and exchange letters here in Washington. From time to time I run across people who do not love the Franchise Tax Board as much as you do. Sometimes the FTB has a "result oriented" image as opposed to simply trying to get the fairest possible resolution of a tax matter. While I know you strive to avoid any basis for this image, the image itself is certainly not helpful to California's continuing efforts to recruit business.

I have enclosed what I am told is the front cover of a FTB training manual. Its dated August 31, 1993. I am told that this same cover or approach may still be in use.

I think you will agree that the picture on the cover is simply not an appropriate way to set the tone for FTB staff.

Very truly yours,

Brad Sherman

Brad Sherman

cc: Kathleen Connell, B. Timothy Gage, Dean Andal, Marcy Joe Mandal, Aleesa Islas, Jim Speed, Johan Klehs, Claude Parrish, John Chiang

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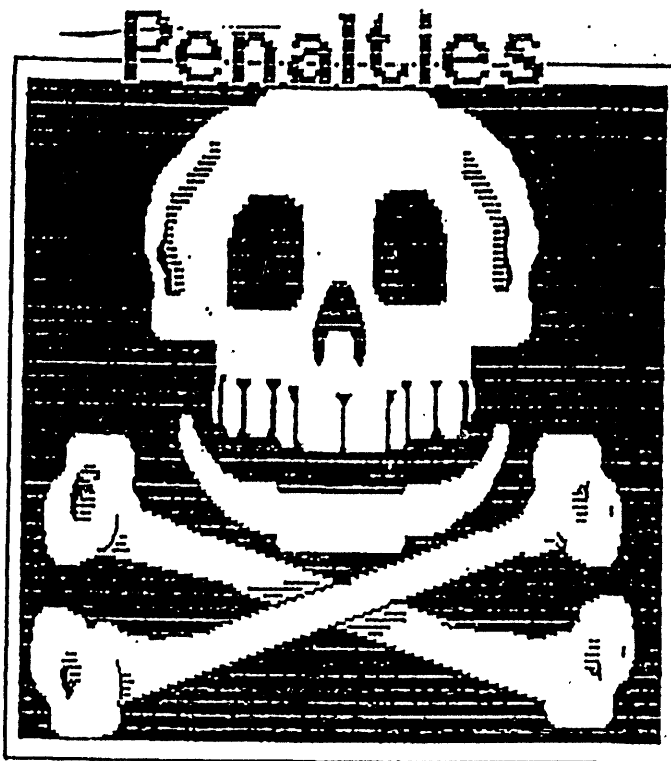

Prepared by:
Larry Moy
Los Angeles District Office
August 31, 1993

ATTACHMENT 3

CONGRESSMAN BRAD SHERMAN

24TH DISTRICT, CALIFORNIA

SERVING THE SAN FERNANDO AND CONEJO VALLEYS, LAS VIRGENES AND MALIBU

COMMITTEE ON BANKING AND FINANCIAL SERVICES

COMMITTEE ON INTERNATIONAL RELATIONS

February 7, 2000

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c/o Aleesa Islas
Constituent Affairs Representative
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Dear Friends:

As you know, information provided by the Internal Revenue Service is critically important to the Franchise Tax Board and the Board of Equalization.

On January 28, 2000, the staff of the Joint Committee on Taxation released a report entitled

Study of Present - Law TaxPayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998.

Complete copies of this 3 volume study are available by simply contacting my office.

I want to refer you to pages 168 through 173 of volume I (a copy of which is enclosed). This discusses efforts by state governments to safeguard the confidentiality provided to them by the IRS.

As you know, I continue my dedication to effective tax administration that requires the exchange of information between the IRS and relevant state tax authorities. The more that can be done to ensure that federal information is kept strictly confidential, the easier it will be to convince Congress to continue to allow and facilitate these exchange of information agreements.

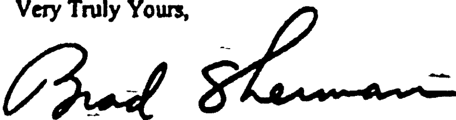
If you want to delve into this issue further, I refer you to the letter dated January 12, 2000, which appears on page 221 of volume III of the study (a copy of which is enclosed). It addresses the issue of states keeping the information they receive from federal tax authorities confidential. It particularly focuses on the Franchise Tax Board.

In setting policy, it is important to remember how dependent state authorities are on federal tax information, and the reluctance most members of Congress have in taking heat to collect revenue that Congress doesn't get to spend. I am sure you are familiar with the failure of Congress to overturn the Quill case, and the successful attempt by the electronic commerce industry to shape the debate on the taxation of the Internet to often include taxation of tangible personal properties sold through the Internet.

Accordingly, it is very important that California do everything possible to maintain proper confidentiality of information obtained through the IRS, and avoid pressure in Washington to reduce the flow of this information. Not only does the continuing battle with direct mail and Internet sales indicate a reason for care in this area, but also you should remember that, here in Washington , Nevada has as many senators as California. Moreover, tax fighters tend to have more friends than tax collectors.

I look forward to doing whatever is possible to have a working efficient exchange of information. I also trust that you will do everything possible to avoid instances that would make that effort difficult.

Very Truly Yours,



Brad Sherman

STATEMENT OF KATHLEEN M. NILLES, ESQ.

I am a tax lawyer practicing in Washington, D.C. I have been involved in federal tax law for 15 years. Following law school, I worked for five years as a tax associate in private practice. Then I served as tax counsel to the Committee on Ways and Means, U.S. House of Representatives. As Ways and Means Tax Counsel, I was responsible for advising the Committee on tax compliance issues, including IRS penalties and interest.

Since leaving Government service in early 1995, I have represented a variety of clients as a tax partner in the law firm of Gardner, Carton & Douglas. I currently represent the Partnership Defense Fund Trust, an organization formed to defend the interests of individual investors in the partnerships described below.

In connection with the Finance Committee's review of the penalty and interest provisions in the Internal Revenue Code, I would like to bring to the Committee's attention a situation which has drastically affected the lives of thousands of taxpayers throughout the country. It is the kind of situation that this Committee attempted to address in the Internal Revenue Service ("IRS") Restructuring and Reform Act of 1998. To date, however, the IRS has failed to incorporate Congressional intent—both in its published guidance and in its actual administration of the tax law. Thus, I would urge Congress to consider whether stronger legislative measures are needed.

THE SITUATION OF THE INDIVIDUAL TAXPAYERS WHO INVESTED IN HOYT PARTNERSHIPS

From 1977 through 1997, approximately 3,000 individuals and couples throughout the United States were induced to invest in one or more of over 100 separate partnerships set up by Walter J. Hoyt, a nationally recognized cattle breeder. Twenty years later, many of these investors are confronting a fate much worse than the mere loss of their original investment in these now bankrupt partnerships. Pursuant to a complex fraud in which the partnerships' promoter inappropriately allocated a limited number of cattle among several partnerships resulting in excess deductions, many Hoyt investors have received tax, penalty and interest assessments totaling twenty to fifty times their original investment. As a result of factors beyond their control, these individual investors—who are largely middle-class wage earners—now face IRS liabilities of $200,000 to $500,000. The enormity of these liabilities has caused great emotional distress and threatened many investors' financial and retirement security.

The Hoyt partnerships, although fraught with fraudulent misrepresentations and bookkeeping irregularities, were not a typical tax shelter. Mr. Hoyt and his family were nationally recognized cattle breeders. In the years 1984 to 1994, the cattle operations owned between 4,000 and 10,000 head of cattle. The cattle were kept on ten to twelve separate ranches owned by Hoyt partnerships with a combined acreage totaling over 500,000 acres, as well as on other leased land. The Hoyt investors could not have individually discovered the fraud. Indeed, it took IRS auditors and federal prosecutors years to develop sufficient evidence to verify their longstanding suspicions.

An IRS employee, with substantial experience on this case, recognized that the investors were "unwitting victims" of Walter J. Hoyt's fraud. Appeals Officer William McDevitt filed a statement in 1997 in which he described the taxpayers as "unwitting victims," "unsophisticated in tax matters," and "confused by the" Tax Court's 1989 decision in *Bales v. Commissioner.*[1]

The *Bales* case held that the partnerships were bona fide businesses and seemed to confirm most of Hoyt's assertions and theories.[2]

For several years after the IRS Criminal Investigation Division first began to investigate the Hoyt operations, Walter J. Hoyt was allowed to continue to conduct business as usual, to promote more partnerships, and to retain his role as the Tax Matters Partner ("TMP") for the approximately 118 separate partnerships he formed and promoted. In addition to failing to remove him as TMP, the IRS failed to take any of the following possible actions against him:

The IRS failed to file an injunction against Mr. Hoyt as a tax return preparer. See IRC § 7407.

The IRS failed to file an injunction against Mr. Hoyt as a promoter of an abusive tax shelter. See IRC § 7408.

The IRS failed to disbar Mr. Hoyt from practice before the IRS as an "Enrolled Agent."[3]

Notwithstanding the *Bales* decision in October 1989, the IRS continued auditing the Hoyt partnerships, disallowing all claimed deductions and making adjustments consistent with the position that the partnerships constituted abusive tax shelters. In 1993, the IRS and Mr. Hoyt as TMP settled the 1981 through 1986 partnership tax years. The settlements meant that essentially all claimed deductions and losses allocated to the investors from the partnership returns would be disallowed, while substantial income to the Hoyt family was minimized.

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[1] Statement of Appeals Officer William McDevitt, Appeals Supporting Statement (Dec. 23, 1997).

[2] In *Bales v. Commissioner,* T.C. Memo 1989–568, the Tax Court found that a Hoyt cattle partnership was not an abusive tax shelter; however, the Court also held that certain deductions for expenses in excess of the partners' actual investment should be disallowed.

[3] From the late 1970s until 1997, Mr. Hoyt used his continued Enrolled Agent status as proof that he was a legitimate tax advisor. The IRS finally removed Mr. Hoyt's Enrolled Agent status in 1997 and as TMP in 1999.

The individual partners first received notice of their 1981 through 1986 personal tax liabilities from the settlement (via Form 4549 computational adjustment notices) beginning in 1998. However, the National Taxpayer Advocate and the IRS Chief Operating Officer issued a Stay of Collection on February 2, 1999. The 1987 through 1996 tax years remain unresolved, with the selected dockets for the 1987 through 1992 tax years having been tried and awaiting an opinion of the Tax Court.

RECENT CONGRESSIONAL FOCUS ON THE HOYT PARTNERSHIPS

W. Val Oveson, testifying as the IRS National Taxpayer Advocate at the recent Oversight Subcommittee hearing on penalty and interest reform, described the Hoyt situation (and others similar to it) as follows:

One of the problems taxpayers are bringing to the Taxpayer Advocate Service with increasing frequency involves TEFRA partnerships determined to be tax shelters. Taxpayers, as early as the 1970s and up through the 1990s, invested in a number of partnerships whose major, if not only, purpose was to shelter income from tax liability.[4]

For a number of reasons, audits of shelter cases can be quite extensive and Tax Court proceedings fairly lengthy. Thus, for taxpayers who do not settle these cases, but await the results of litigation, final resolution can leave them with liabilities dating back 10 years or more with penalty and interest accruals to match.

The enormity of these liabilities has caused taxpayers to seek assistance from a number of sources, including their Congressional representatives and various functional areas within the Service, including my office, to abate all or part of the accumulated liabilities or to suspend collection action. Some taxpayers have filed for bankruptcy protection. More than most, shelter cases can reflect the burden associated with the past and current penalty and interest structures. Very few taxpayers are prepared to pay or can pay penalty and interest accumulations that may date back to the 1970s.

Some say that these taxpayers should have known that the results of their investments were too good to be true. Nevertheless, I believe we should not focus on blame at this point. We need to work to get these taxpayers back into full compliance, possibly through installment agreements or the expanded offer-in-compromise criteria. I believe that tax shelters are an abuse of our system and the investors should be penalized. I also concede that the investors owe interest for the time they had the use of the government's money. I question, however, whether it is the function of the government and our penalty and interest regimes to punish these taxpayers to the point that they become insolvent and unable to pay even a fraction of these liabilities.

Statement of W. Val Oveson, National Taxpayer Advocate, Internal Revenue Service, before the Subcommittee on Oversight, Committee on Ways and Means (January 27, 2000) (emphasis added).

Oversight Subcommittee Chairman Amo Houghton highlighted the Hoyt investors' situation in his Opening Statement at that same hearing to illustrate the heavy burden of compounded interest on tax liabilities that take years to resolve:

I doubt that there is anyone on this panel who hasn't heard more than one heartbreaking story from constituents who find themselves facing crushing back taxes, penalties and interest payments because they were unable to comply with a tax code they have no hope of understanding. Albert Einstein once said that compounded interest is the most powerful force in the universe. Taxpayers whose interest payments far exceed their underlying taxes can well appreciate the truth of his words.

Just yesterday my staff met with representatives of a group of investors who were defrauded by an enrolled agent. His promotional materials targeted working people, promising them "quality investments for folks that dream about owning a piece of the country."

* * * * *

Today, nearly all of the investors face back taxes, penalties and interest—going back in some cases to the 1970s—because their deductions were disallowed. One of the investors, Ed Van Scoten, says the IRS is trying to collect about half a million dollars from him. "Who are they trying to kid?," he asks. "They could never get $500,000 from me if I worked five lifetimes."

[4] Note: Although Mr. Oveson's statement generally describes the situation of the Hoyt investors, the Hoyt partnerships do not fit the definition of a tax shelter (i.e., an organization whose major or exclusive purpose is to shelter income).

In some cases individual investors first received notice from the IRS of their 1981–1986 tax liability beginning in early 1998. The interest clock was running all this time.

The unscrupulous will always prey on the unsuspecting, but something is seriously wrong with a penalties and interest regime that adds to the problems faced by the victims of this sort of scam.

Statement of Congressman Amo Houghton (R–NY), before the Oversight Subcommittee of the Committee on Ways and Means (January 27, 2000).

CONGRESSIONAL MANDATE TO EXPAND OFFER IN COMPROMISE CRITERIA

Section 7122 of the Internal Revenue Code authorizes the IRS to settle tax cases with taxpayers under appropriate circumstances for less than the full amount of tax, penalties and interest owed. In the IRS Restructuring and Reform Act ("RRA") of 1998, Congress amended Section 7122 and directed the Secretary to prescribe guidelines to determine when an offer-in-compromise should be accepted. See Code § 7122(c) as added by Section 3462 of the RRA. The legislative history of this amendment clearly indicates what members of the tax-writing committees wanted the IRS to address:

The Conference Report of the 1998 RRA directs that "the IRS [in formulating these rules] take into account factors such as equity, hardship, and public policy where a compromise of an individual taxpayer's income tax liability would promote effective tax administration." H. Conf. Rep. No. 599, 105th Cong., 2d Sess. 289 (1998) (emphasis added).

The legislative history also specifies that the IRS should utilize this new authority "to resolve longstanding cases by forgoing penalties and interest which have accumulated as a result of delay in determining the taxpayer's liability." Id.

Consideration of factors such as equity and public policy represents a significant expansion of the traditional grounds for settling tax cases. Formerly, offers-in-compromise were limited to two situations: (1) doubt as to liability and (2) doubt as to collectibility.

IRS PROPOSED REGULATIONS ON EXPANDED OFFER IN COMPROMISE TESTS

On July 21, 1999, the IRS issued proposed regulations which clearly do not incorporate the Congressional mandate of encouraging offers-in-compromise in longstanding cases in which penalties and interest have accumulated as a result of delay. Instead, the regulations continue the traditional focus on economic factors while giving short shrift to equity and public policy considerations. Specifically, the regulations provide that if there are no grounds for compromise based on doubt as to collectability or liability, a compromise may be entered into to promote effective tax administration when:

(i) collection of the liability will create economic hardship; or

(ii) regardless of a taxpayer's financial circumstances, exceptional circumstances exist such that collection of the full liability will be detrimental to voluntary compliance by taxpayers; and

(iii) compromise of the liability will not undermine compliance by taxpayers with the tax laws.

Temp. Reg. § 301.7122–1T(b)(4)(i) through (iii).

The regulations provide specific factors for determining when the first and third prongs are satisfied, but no specific factors are provided for determining when the second prong—"exceptional circumstances"—may be satisfied. Unfortunately, the temporary and proposed regulations only offer two examples of cases of "exceptional circumstances:"

(i) the first involves a taxpayer who suffered a serious illness and was unable to manage his financial affairs during such time; and

(ii) the second example involves a case where a taxpayer relied on incorrect advice from the IRS in an informal E-mail response concerning the rollover period for an IRA account.

Temp. Reg. § 301.7122–1T(b)(4)(iv)(E) (examples 1 and 2).

The regulations provide a third example that involves embezzlement of payroll withholding taxes. This example could be viewed as illustrating equitable considerations in the case of a victimized taxpayer. However, the example is classified as a financial hardship example because paying the accumulated taxes, penalties and interest would cause the taxpayer's business to fail. Temp. Reg. § 301.7122–1T(b)(4)(iv)(D) (example 4).

In practice, the IRS continues to view "exceptional circumstances" with the same narrowly focused lens as it always has. In the IRS view, the overriding factor is the

taxpayer's ability to pay (i.e., financial hardship). This exclusive focus on financial factors to the exclusion of equitable considerations is evidenced in a recent letter from the IRS Chief Counsel's Office to Representative John M. McHugh (R–NY) in response to his inquiry about how the IRS planned to deal with Hoyt investor partners facing large interest accumulations:

> Taxpayers may at any time enter into an offer in compromise with regard to their tax liability. We understand that, in many cases, taxpayers will be unable to pay their liability in full, and an offer in compromise based on doubt as to collectibility will be considered under the established procedures for such a request. There are no special rules for Hoyt Partnership investors. . . .

Letter of Deborah A. Butler, Assistant Chief Counsel (Field Service), Internal Revenue Service to The Honorable John M. McHugh (June 4, 1999). Thus, although Congress specified in the 1998 RRA that the IRS should consider equity and public policy and to resolve "longstanding cases" by foregoing penalties and interest, neither the Treasury Department nor the IRS has shown any inclination to provide for significant interest abatement based on equitable considerations or exceptional circumstances.[5]

CONCLUSION

Where innocent taxpayers are victimized by a tax shelter promoter and the process of adjudicating the tax liabilities takes as long as 20 years, equitable factors are strongly present. The broader issue raised by the fraud perpetrated on the Hoyt partnership investors is how such equitable considerations should be taken into account in determining whether a portion of a taxpayer's total liability (e.g., the interest) should be compromised or abated.

In 1998, Congress determined that interest abatement should be part of the new offer-in-compromise procedures in certain situations. As noted above, Congress directed the IRS to take into account factors like "equity" and "public policy." However, two years later, the IRS has yet to develop reasonable guidelines to facilitate offers in compromise that give proper attention to these factors.

If the IRS continues to exhibit resistance to Congressional intent, Congress may want to revisit the issue in a legislative context. The Joint Committee on Taxation staff has recommended that abatement of interest be utilized if a "gross injustice" would otherwise result if interest were to be charged. It is anticipated that such authority would be used infrequently. Although I believe that the IRS already has the authority to address situations of gross injustice under the expanded offer-in-compromise authority of RRA 1998, enactment of a new statutory remedy may be necessary.

STATEMENT OF THE TAX FAIRNESS COALITION[1]

[SUBMITTED BY THE WASHINGTON COUNSEL, P.C., ATTORNEYS-AT-LAW]

This statement is submitted on behalf of the Tax Fairness Coalition, whose members include companies that share the objective of a tax system that is fair, easy to understand and administer, and does not undermine the ability of American businesses to create jobs at home and compete in our global economy.

Both the Treasury Department ("Treasury") and the staff of the Joint Committee on Taxation (the "Joint Committee") have put forth legislative proposals concerning corporate tax shelters. Previously, we filed comments with both the House Committee on Ways and Means and the Senate Finance Committee regarding these proposals.[2] This statement focuses on the current environment in which the issue of

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[5] At the Ways and Means Oversight Subcommittee hearing on January 27, 2000, Treasury Tax Legislative Counsel Joseph Mikout testified: ". . . Treasury's position remains that it is appropriate that situations involving abatement of interest be narrowly drawn."

[1] This statement is presented by LaBrenda Garrett-Nelson, Gary Gasper, Nicholas Giordano and Mark Weinberger, members of Washington Counsel, P.C.

[2] This statement supplements the written comments, primarily on the Joint Committee proposal, submitted by the Tax Fairness Coalition for the record of the "Corporate Tax Shelter" hearing on November 10, 1999, before the House Ways and Means Committee, and separately to the staff of the Senate Committee on Finance (referred to herein as our "November 1999 Submission"). A copy of that statement is attached.

Treasury's most recent proposal, which was included in the Clinton Administration's budget request for fiscal year 2001 ("2001 Budget"), was foreshadowed by a "white paper" released by Treasury in July 1999. See Department of the Treasury, The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals (July 1999) (the "White Paper"). In addition, cer-

Continued

tax shelters is being considered and, in particular, the significance of newly issued Treasury regulations, recent Internal Revenue Service ("IRS") court victories, and other IRS initiatives addressing corporate tax shelters. The Tax Fairness Coalition is concerned that legislative proposals—on top of the recently announced efforts by Treasury and the IRS—may be premature, particularly in light of the potential impact of the increasing use by the government of its existing tools. These developments should not be viewed as simply after-the-fact enforcement, because they are likely to deter taxpayers from engaging in abusive transactions.

INTRODUCTION

To the extent that taxpayers are entering into transactions that are not sanctioned under the applicable law, those taxpayers extract a cost that is borne by all other taxpayers—both individuals and corporations, and may undermine the foundation of our voluntary tax system. The Tax Fairness Coalition is concerned, however, that the proposals advanced by Treasury and the Joint Committee would have the practical effect of discouraging legitimate tax planning and unnecessarily burden routine business transactions, to the extent that they:

- Provide IRS agents with new weapons to extract inappropriate concessions from taxpayers;
- Add additional layers of mind-numbing complexity to the Internal Revenue Code;
- and Force more and more taxpayers into refund litigation.

More specifically, we are concerned that Treasury's proposal to "codify the economic substance doctrine" would give the Executive Branch and IRS agents unfettered discretion to rewrite substantive tax rules, while at the same time raising the risk inherent in any codification of common law that the legislative approach will have the unintended effect of limiting the ability of the courts to apply a doctrine that they have used readily for the past seventy years. In addition, the Joint Committee's proposals would have the effect of creating a strict liability penalty regime and would penalize tax advisers and return preparers by imposing penalties that routinely exceed their net after-tax income when their advice turns out to be wrong.

We raise these concerns to highlight the difficulty of legislating in this area. The increasing complexity of today's Federal tax laws means that the development of measured initiatives will take time, as evidenced by: (1) Treasury's delay in issuing regulations to implement 1997 tax shelter legislation (discussed below); (2) the differences in opinion reflected by disparate provisions in the Treasury and the Joint Committee proposals;[3] and (3) the modifications that Treasury itself made to the original corporate tax shelter proposal included in the Administration's budget last year.[4]

We are not suggesting that there are no transactions that generate unanticipated and inappropriate tax consequences. To the contrary, these results are the inevitable outcome of a tax system that is too complex and burdensome. We also recog-

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tain penalty and interest proposals were discussed by Treasury in a study that was required by section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998, P.L. 105–206 (July 22, 1998) (the "1998 Act"). See United States Treasury Department, Report to Congress on Penalty and Interest Provisions of the Internal Revenue Code (October 1999) (the "Treasury Study"). The Joint Committee corporate tax shelter proposals were included in its study on penalty and interest provisions also required by the 1998 Act. See Staff of the Joint Committee on Taxation, 106th Cong., 1st Sess., 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) JCS–3–99 (July 22, 1999) (the "Joint Committee Study"). Rep. Doggett has introduced legislation incorporating some of the Treasury Department's proposals. See H.R. 2255, 106th Cong., 1st Sess. (1999).

[3] For example, the Joint Committee has not recommended any new substantive rules—such as codifying the economic substance doctrine developed by the courts. Also, there is a lack of consensus between Treasury and Joint Committee on whether certain factors or "filters" should be viewed as indicative of a tax avoidance transaction, including, for example: contingent advisor fees or fees in excess of a certain amount; any difference between the form of transaction and how it is reported; and the offering of a transaction to multiple taxpayers.

[4] Treasury did not re-propose three provisions that were included in last year's Budget but not endorsed in the Joint Tax Committee Study. The dropped provisions would disallow deductions for promoter and advisor fees, preclude taxpayers from taking tax positions inconsistent with the form of their transactions (although the taking of inconsistent positions could trigger a disclosure requirement if other identified factors are present), and impose a 25-percent excise tax on rescission agreements, unwind provisions, and insurance arrangements. As in last year's proposal, in the provision to modify certain specific transactions that "provide sheltering potential," Treasury recycled six of the ten proposals to modify specific transactions that were included in last year's Budget, and included four new or substantially modified provisions. Other reversals in approach are present, including the absence of the 30-day disclosure requirement that was in last year's Budget proposal.

nize the obvious—taxpayers and their advisors move quickly to take advantage of perceived tax planning opportunities. Nevertheless, wholesale new laws with vague and punitive components can do more harm than good. Consistent with the age-old axiom of "First, Do No Harm," the Congress should act judiciously in this area, particularly in light of the potential for increased burdens on legitimate transactions if far-reaching legislation is enacted.

Moreover, laws are only as good as their implementation. While the expanded authority proposed by Treasury and the Joint Committee would technically vest with the Secretary, it would be exercised by IRS agents all around the country. Such a delegation of authority, coupled with cascading penalties, would put an awful lot of power in the hands of IRS agents. As the Joint Committee's report on the President's revenue proposals for Fiscal Year 2000 recognized, such power can be abused by agents and used to threaten taxpayers to settle unrelated tax issues that arise in annual audits. Caution is also necessary because once such power is transferred to the Executive branch, it would likely be very difficult for the Congress to reclaim it. Any attempt by the Congress to reverse an action taken in this area would be scored as a revenue loser under current scoring conventions. Congressional prerogatives to disagree with the Executive Branch would, thus, be limited.

Any corporate tax shelter proposal must be examined in light of the existing resources available to the IRS to combat corporate tax shelters. The IRS has several existing and some new tools at its disposal to identify corporate tax shelters. Before enacting new proposals, existing rules and authorities should be carefully and thoroughly reviewed. If they do not work or are inadequate perhaps they should be repealed and replaced with new ones. Adding another layer of penalties and rules to overlay existing ones merely creates more complexity and potential pitfalls for taxpayers.

DISCUSSION

An appropriate framework for addressing corporate tax shelters requires an evaluation of the ability of Treasury and the IRS to identify imperfections in our tax system through the tools it already has at its disposal, and the ability of the government to address the problems that it does identify, either through the rulemaking process or through the courts. Only when Treasury and the IRS do not have the necessary tools to address the problems they identify should the Congress provide additional tools and delegations of authority to Treasury and the IRS. To the extent that the Congress determines that such additional tools or delegations are necessary, we agree with the premise set forth by both Treasury and the Joint Committee that such tools or delegations should not interfere with legitimate tax planning or impose needless complexity, and would also suggest that such tools should not result in arbitrary or hidden tax increases or violate basic notions of fairness and equity.

1. The Congress Should Allow Treasury and the IRS Time To Assess the Impact of New Regulatory Guidance Before Taking Legislative Action.

Much of the rhetoric relating to corporate tax shelters suggests that the government needs new tools because it is not aware of transactions and tax planning arrangements that it might deem inappropriate. That is why the Administration has proposed numerous specific provisions to attack transactions that it does not like, plus the general provisions that would entangle ordinary tax planning and legitimate business transactions, in case there are others that they have not yet found. Recently, however, Treasury and the IRS published three sets of temporary and proposed regulations affecting corporate tax shelters, along with other published guidance (including Notice 2000–15, listing transactions identified by the IRS as tax avoidance or "listed" transactions).[5] Please note that companies in the Tax Fairness Coalition are still in the process of analyzing the impact of this new regulatory guidance, including the extent to which these rules raise practical or technical issues that will need to be addressed during the regulatory process. Nevertheless, it is fair to assume that these new regulations can be expected to bring about changes in behavior and, as such, change the tax-shelter legislative landscape dramatically. Additionally, because many of the concepts proposed in the Administration's FY 2001 Budget plan are incorporated into this guidance, these regulations could serve as a "proving ground" for the untested theories underlying Treasury's legislative proposals.

[5] T.D. 8877, 65 FR 11205 (Mar. 2, 2000), T.D. 8876, 65 FR 11215 (Mar. 2, 2000), T.D. 8875, 65 FR 11211 (Mar. 2, 2000).

a. *Regulatory Guidance Issued in February 2000, Regarding Registration of "Confidential" Corporate Tax Shelters*[6]. In 1997 the Congress amended Section 6111(d) to expand the definition of a "tax shelter" for purposes of registering such transactions with the IRS.[7] When Treasury proposed the registration legislation, it explained that the provision would help get the IRS useful information about corporate deals at an early stage to help identify transactions to audit and then take appropriate action—presumably through enforcement, regulatory changes, and requests for legislation when necessary.[8] Despite the professed need for this legislation, regulations implementing the provision (the "Registration Regulations") did not become effective until just last month when Treasury promulgated the implementing regulations.[9]

Generally, the "Registration Regulations" provide rules that define a "significant purpose of tax avoidance or tax evasion" for purposes of the requirement under Section 6111(d) that confidential corporate tax shelters be registered with the IRS. Because registration is required to be made before interests in the transaction are first offered for sale, the provision should provide significant early warning to the government of new types of transactions.

b. *The New Regulatory Rules Were Made Effective Immediately.* The Registration Regulations apply to three categories of transactions: (1) listed transactions (such as those identified in Notice 2000–15); (2) those in which avoidance or evasion are considered a "significant purpose" (generally, measured by whether the present value of the participant's reasonably expected pre-tax profits is "insignificant" relative to the present value of net tax savings, as proposed in the Administration's budget); and (3) those structured to produce Federal income tax benefits that constitute an important part of the intended results of the transaction, where the tax shelter promoter reasonably expects the transaction to be presented to more than one participant.

c. *The Scope of the Registration Requirement Was Broadened by Virtue of an Expansive Definition of "Confidential."* In order for the Registration Regulations to apply, the tax shelter in question must be offered to any potential participant under "conditions of confidentiality." Under the new regulations, the determination whether the condition of "confidentiality" is satisfied is based on all facts and circumstances, including the prior conduct of the parties. If the offeree's disclosure is limited in any way by an implied understanding or agreement, the offer is considered made under the conditions of confidentiality (and therefore subject to registration), without regard to whether the agreement or understanding is legally binding. This also results if the promoter knows or has reason to know the transaction is protected from disclosure, such as where the transaction is claimed to be proprietary.

d. *Maintenance of Lists of Investors in Potentially Abusive Tax Shelters*[10]. Section 6112 provides that any person—including "promoters" and outside advisors—who organizes or sells any interest in a "potentially abusive tax shelter" must maintain a list identifying each person who was sold an interest in the shelter. The regulations requiring maintenance of investor lists were issued at the same time as the Registration Regulations. Significantly, the definition of a potentially abusive tax shelter tracks the definition of transactions subject to the Registration Regulations, but there are no requirements under Section 6112that the transaction be offered under conditions of confidentiality or that the promoter receive minimum fees in excess of $100,000. Thus, certain transactions that are not subject to registration under Section 6111 may be subject to the requirement to maintain a list of investors.

These lists should greatly assist the IRS in identifying taxpayers who participated in "potentially abusive tax shelters," in view of the requirements that a person maintaining a list must make it available for inspection upon request by the IRS, and must retain the information for seven years. Moreover, the information required

[6] Temp. Regs. Sec. 301.6111–2T.

[7] See Section 1028 of the Taxpayer Relief Act of 1997, P.L. 105–34 (Aug. 5, 1997) (the "1997 Act") (enacting Section 6111(d)). Unless otherwise indicated, all Section references are to Sections of the Internal Revenue Code of 1986, as amended (the "Code").

[8] See the U.S. Treasury Department's General Explanations of the Administration's Revenue Proposals, at 81 (February 1997). According to Treasury: Many corporate tax shelters are not registered with the IRS. Requiring registration of corporate tax shelters would result in the IRS receiving useful information at an early date regarding various forms of tax shelter transactions engaged in by corporate participants. This will allow the IRS to make better-informed judgments regarding the audit of corporate tax returns and to monitor whether legislation or administrative action is necessary regarding the type of transactions being registered.

[9] T.D. 8876, 65 FR 11215 (Mar. 2, 2000).

[10] Q&A Temp. Regs. Sec. 301.6112–1T.

to be retained includes "all of the factual elements necessary to support the tax benefits that are expected to be claimed."[11]

e. Yet to be Issued "Substantial Understatement Penalty" Regulations. Also in 1997, the Congress expanded the definition of the term "corporate tax shelter" for purposes of the substantial understatement penalty provisions of Section 6662. The increased exposure to the substantial understatement penalty, as a result of the 1997 changes, is untested, primarily because Treasury has yet to issue regulations or other guidance (although the statutory definition under Section 6662 is similar to the definition under the tax shelter registration rules of Section 6111(d)). It seems premature for Treasury to request that the Congress double the amount of the penalty imposed under Section 6662 before it even issues rules outlining the scope of the penalty.

Unlike the registration requirement in Section 6111, there is no requirement under Section 6662 that the arrangement involve a corporation, a confidentiality agreement or minimum promoter fees. As a result, it is worth noting that under current law a corporate taxpayer can fully disclose a position on a tax return and can have substantial authority for such position but still be subject to penalty if the transaction is considered a tax shelter. The only way to avoid a penalty is to establish reasonable cause under Section 6664(c), which Treasury has already circumscribed by regulation (so that, for example, a taxpayer's reasonable belief that it is more likely than not to prevail may not be sufficient).

2. The IRS Has Also Just Begun to Identify New Applications of Long-standing Authority

As part of an ongoing administrative initiative on corporate tax shelters, at the same time the Registration Regulations were issued, Treasury used its general, pre-existing authority to prescribe the contents of corporate tax returns to issue temporary and proposed regulations requiring extensive tax return disclosure of corporate tax shelter transactions (the "Disclosure Regulations").

a. New, Retroactive Reporting Requirement. The Disclosure Regulations require a corporate taxpayer to disclose "reportable" transactions by attaching a statement to its tax return and sending a copy to the IRS National Office in Washington, D.C.[12] This disclosure requirement applies retroactively to certain transactions entered into before the regulation was issued.[13] Also, even if a transaction is not required to be disclosed when it is entered into, it may have to be disclosed if the IRS subsequently identifies the transaction as a listed transaction.[14]

A failure to disclose under the new regulations does not result in any new or increased penalties. In the preamble to the Disclosure Regulations, however, Treasury noted that "a taxpayer's failure to satisfy the disclosure requirements of the temporary regulations may affect its exposure to penalties under sections 6662 ("accuracy-related penalties") and 6663 ("fraud") of the Code" because "the nondisclosure could indicate that the taxpayer has not acted in 'good faith' with respect to the underpayment," such that the section 6664(c) reasonable cause exception would not apply.

The "reportable transactions" subject to the Disclosure Regulations include the same transactions subject to the Registration Regulations but without the "confidentiality" and "aggregate fee" qualifiers. Thus, although similar to the types of transactions covered by the tax shelter Registration Regulations, the Disclosure Regulations cover a broader range of transactions, such that they will provide the IRS with disclosure of transactions that might not be disclosed otherwise. "Reportable transactions" include: (1) transactions identified by the IRS (including those transactions identified as "listed transactions" in Notice 2000–15); and (2) transactions that possess two out of six identified characteristics (which are substantially similar to the "filters" listed as part of the corporate tax shelter proposals in the Administration's 2001 Budget). The six characteristics contained in the regulations are:

- The taxpayer has participated in the transaction under conditions of confidentiality (as defined in the "registration regulations");
- The taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended benefits from the transaction will not be sustained, including, but not limited to, recission rights, the right to a full or partial refund of fees paid to any person, fees that are contingent on the taxpayer's realization of tax benefits from the transaction, insurance protection

[11] See the Preamble to Temp. Reg. Sec. 301.6112–1T.

[12] Temp. Regs. Sec. 1.6011–4T.

[13] See, Temp. Regs. Sec. 1.6011–4T(g) and Example from Temp. Regs. Sec. 1.6011–4T(c)(2), describing disclosures required for a transaction entered into in January of 1999.

[14] Temp. Regs. Sec. 1.6011–4T(b)(2).

with respect to the tax treatment of the transaction, or a tax indemnity or similar agreement (other than a customary indemnity provided by a principal to the transaction that did not participate in the promotion of the transaction to the taxpayer);

- The taxpayer's participation in the transaction was promoted, solicited, or recommended by one or more persons who have received or are expected to receive fees or other consideration with an aggregate value in excess of $100,000, and such person or persons' entitlement to such fees or other consideration was contingent on the taxpayer's participation in the transaction;
- The expected treatment of the transaction for Federal income tax purposes in any taxable year differs or is expected to differ by more than $5 million from the treatment of the transaction for purposes of determining book income as taken into account on the schedule M–1 (or comparable schedule) on the taxpayer's Federal corporate income tax return for the same period;
- The transaction involves the participation of a person that the taxpayer knows or has reason to know is in a Federal income tax position that differs from that of the taxpayer (such as a tax exempt entity or a foreign person), and the taxpayer knows or has reason to know that such difference in tax position has permitted the transaction to be structured on terms that are intended to provide the taxpayer with more favorable Federal income tax treatment than it could have obtained without the participation of such person (or another person in a similar tax position); and
- The expected characterization of any significant aspect of the transaction for Federal income tax purpose differs from the expected characterization of such aspect of the transaction for purposes of taxation of any party to the transaction in another country.

The Disclosure Regulation contain dollar thresholds (based on the "projected tax effect test") and exceptions (described as ordinary course transactions), although the exceptions are drafted in very vague and uncertain terms that will require additional interpretive guidance. For example, one exception applies if the "taxpayer reasonably determines that there is no reasonable basis under Federal tax law for denial of any significant portion of the expected Federal income tax benefits."[15] It is not at all clear how this formulation differs from another exception that applies where there is "a long-standing and generally accepted understanding that the expected Federal income tax benefits from the transaction are allowable"[16] (a standard that is equally vague and uncertain). It is also unclear how the "no reasonable basis" standard should be interpreted. For example, the Joint Committee Study seems to suggest that this standard requires that the IRS have at least a 20% chance of prevailing in litigation.[17]

b. New Document Retention Requirements. The Disclosure Regulations add document retention requirements (in addition to those required by Section 6001), including a requirement to maintain all marketing materials related to the transaction and all documents discussing, referring to, or demonstrating the tax benefits arising form the reportable transactions.

c. Announced Changes to IRS Rules Governing Standards of Practice. In addition to the recently released regulations, Treasury and the IRS are taking a number of other administrative measures to combat corporate tax shelters. For example, last month Treasury Secretary Summers announced that Treasury will propose amendments to Circular 230, which governs practice before Treasury and the IRS, within the next six months.[18] These amendments could include sanctions on firms that issue opinions on tax shelters, limits on contingent fee arrangements and heightened opinion standards.

d. New IRS Office for Centralized Review of Corporate Tax Shelters. Moreover, the IRS has established a new office to monitor the use of corporate tax shelters and to coordinate the government's response to such transactions. The new Office of Tax Shelter Analysis will provide a centralized review of corporate tax shelters, something that the IRS has never attempted to do.

e. Other, Pre-existing Requirements That The IRS Might Explore. Under current law, corporate taxpayers generally are required to reconcile their book and taxable income on the face of the corporate income tax return.[19] Thus, corporate taxpayers

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[15] Temp. Reg. Sec. 1.6011–4T(b)(3)(ii)(C).

[16] Temp. Reg. Sec. 1.6011–4T(b)(3)(ii)(B).

[17] See the table on page 152 of the Joint Committee Study, quantifying reasonable basis as at least a 20% likelihood of success if challenged.

[18] Treasury Secretary Lawrence H. Summers, Tackling the Growth of Corporate Tax Shelters, Remarks to the Federal Bar Association (Feb. 28, 2000).

[19] Internal Revenue Service Form 1120, Schedule M–1.

already are required to disclose (and must be prepared to explain and justify) the book/tax differences that Treasury and the Joint Committee view as a key indicator of potential corporate tax shelter transactions.[20] Moreover, the largest 1,700 corporate taxpayers are included in the coordinated examination program[21] and are subject to continuous audit by revenue agents who routinely work from offices at the taxpayer's headquarters and have the time and access to all of the information necessary to identify potential corporate tax shelters.[22]

3. The IRS Regularly Identifies Imperfections in Our Tax System And Successfully Uses Tools It Already Has at Its Disposal

As a practical matter, when the government does identify what it perceives as "abuses," the IRS has often been aggressive in challenging those transactions through examination and litigation, regulatory changes, and other administrative action.

a. Examination and Litigation. Significant cases that the government has won in recent years include:

- *Ford Motor Co. v. Commissioner,*[23]
- *Jacobs Engineering Group, Inc. v. United States,*[24]
- *ACM Partnership v. Commissioner,*[25]
- *ASA Investerings Partnership v. Commissioner,*[26]
- *United Parcel Service of America, Inc. v. Commissioner,*[27]
- *The Limited Inc. v. Commissioner,*[28]
- *Compaq Computer Corp. v. Commissioner,*[29]
- *IES Industries, Inc. v. United States,*[30]
- *Winn-Dixie v. Commissioner,*[31] and

[20] Both the White Paper and the Joint Committee Study suggest that the Schedule M–1 is not a useful audit tool, and that negotiations over audit plans allow taxpayers to hide corporate tax shelter issues. This is simply not the case. The IRS invariably uses the Schedule M–1 as a road-map for conducting its audits, and one of the first requests made by the IRS in almost any audit of a large corporation is a request for a detailed explanation of book/tax differences. Moreover, if Schedule M–1 disclosure is determined to be inadequate, the IRS has unilateral power to make whatever changes it thinks are required (as evidenced, for example, by the new Disclosure Regulation).

[21] GAO, "Tax Administration—Factors Affecting Results from Large Corporations," p. 1, GAO/GGD–97–62 (Apr. 1997).

[22] Despite the assertion made in the Joint Committee Study that "audits of large corporations typically follow an agreed-upon agenda of issues that is negotiated by the IRS and the corporate taxpayer," in practice we have found that the IRS determines which issues will be covered by an audi, and that the IRS will continue to raise new issues throughout the audit process. Thus, the notion that corporate taxpayers can "win the audit lottery" by negotiating the initial agenda for an audit does not reflect the reality of how the IRS conducts audits.

[23] 102 T.C. 87 (1994), aff'd 71 F.3d 209 (6th Cir. 1995) (Tax Court limited a current deduction for a settlement payment, stating that tax treatment claimed by the taxpayer would have enabled it to profit from its tort liability).

[24] 97–1 USTC 87,755 (CCH ¶50,340) (C.D. Cal. 1997), aff'd 99–1 USTC 87,786 (CCH ¶50,33) (9th Cir. 1999) (applying Section 956 to a transaction despite the fact that a literal reading of the regulations would not have subjected the taxpayer to that provision).

[25] 73 T.C.M. (CCH) 2189 (1997), aff'd 157 F.2d 231 (3d Cir. 1998) (not respecting a partnership's purchase and subsequent sale of notes, stating that the transaction lacked economic substance) cert. denied 119 S. Ct. 1251 (1999).

[26] 76 T.C.M. (CCH) 325 (1998), aff'd ——— F.3d ——— (D.C. Cir. 2000) (applying an intent test to determine that a foreign participant in a partnership was a lender, rather than a partner, for federal income tax purposes).

[27] T.C.M. No. 268 (1999) (treating an intragroup restructuring involving a related insurance company as a sham, stating that the restructuring was primarily motivated by tax considerations).

[28] 113 T.C. No. 13 (1999) (holding in favor of the IRS on grounds that the principal purpose for organizing a foreign subsidiary to purchase certificates of deposit from a domestic subsidiary, rather than using a domestic corporation, was to avoid the application of Section 956).

[29] 113 T.C. No. 17 (1999) (holding that the economic substance doctrine applied to deny foreign tax credits attributable to the purchase and resale of ADRs when the transaction was (i) designed to yield a specific result and eliminate all economic risks, (ii) the taxpayer had no reasonable possibility of a pre-tax profit and (iii) the taxpayer had no non-tax business purpose for the transaction).

[30] No. C97–206 (N.D. Iowa September 22, 1999) (order granting partial summary judgment in favor of IRS under facts similar to Compaq).

[31] 113 T.C. No. 21 (1999) (holding that a leveraged corporate-owned life insurance program lacked economic substance and business purpose when the court found that the only function of the program was to generate interest and fee deductions in order to offset income from other sources).

- *Saba Partnership v. Commissioner.*[32]

Of particular note is that in UPS and Compaq the IRS asserted, and the courts sustained, the imposition of meaningful penalties on the taxpayers. This suggests that the current law penalty provisions are being used, despite an assertion to the contrary in the Joint Committee Study. Moreover, IRS officials have recently stated that cases such as Compaq have emboldened the government to seek penalties more often.[33]

b. *Regulatory Changes.* Likewise, the Administration regularly addresses what it perceives as "abuses" through notices and regulations. In recent years, Treasury has promulgated a number of regulations and other rules intended to stop tax planning activities that Treasury has viewed as inappropriate.[34]

c. *Other Administrative Action.* On a number of occasions in recent years, Treasury has issued notices to target specific tax planning techniques, typically announcing its intention to issue regulations addressing such techniques that will be effective as of the date of the notice.[35] On several occasions, the regulatory guidance has been issued with retroactive effective dates, a practice that has a chilling effect on transactions that taxpayers believe the government might find "abusive."[36] More recently, The IRS issued Notice 2000–15, which notice has broad application because it lists transactions identified by the IRS as "tax avoidance transactions" that are subject to the requirements of all the new regulations (described above).

d. *Congressional Interaction.* When Treasury identifies a perceived "abusive" transaction, whether through rulemaking or by way of a specific legislative proposal, the Congress has not hesitated to act appropriately to curb abuses. For example, two years ago the Congress eliminated certain tax benefits involving the liquidation of a regulated investment company or real estate investment trust. In addition, last year the Congress enacted a provision to address certain transactions involving the transfer of property subject to multiple liabilities. Although the statute in each case was effective as of the date of announcement, the Congress made clear (as it does routinely in perceived abuse cases) that the IRS was free to attack pre-effective date transactions under prior law.

The events that unfolded over the past two years following the release of Notice 98–11,[37] and the Congress' repeated rejection of most of the Administration's proposed revenue raisers, highlight another issue that should be considered in light of the proposals to provide the IRS and Treasury with new ways to combat transactions that they view as inappropriate. We respectfully submit that the new arsenal of weapons recommended by Treasury and the Joint Committee would effectively allow the IRS and Treasury to accomplish what the Congress has effectively prevented in the legislative arena.

4. Criteria That Should Be Used in Evaluating Legislative Proposals to Address Corporate Tax Shelters

When and if the Congress determines that legislative action is required to address corporate tax shelters, such action should be commensurate with the problem. Moreover, the Congress should balance carefully the expected benefit of any legislative proposal with the likely adverse consequences of enacting such a proposal. In particular, we respectfully suggest that no legislative proposal should be enacted that would:

- Interfere with mainstream business transactions and ordinary tax planning activities;
- Impose needless complexity;

[32] T.C.M. No. 359 (1999) (applying economic substance test to disregard partnership transactions similar to those addressed in ACM Partnership and ASA Investorings Partnership).

[33] See Tax Notes Today (February 10, 2000) (citing IRS Assistant Chief Counsel, Cynthia Mattson).

[34] For an extensive list of similar guidance issued over the last two years, see the attached copy of our November 1999 Submission.

[35] Examples are listed in our November 1999 Submission.

[36] See Section 7805(b)(3) (authorizing Treasury to issue regulations retroactively when necessary to prevent abuse, but only with respect to statutory provisions enacted on or after July 30, 1996).

[37] In Notice 98–11, the IRS and Treasury announced their intention to propose regulations targeting certain transactions involving foreign hybrid entities. Less than three months after the issuance of Notice 98–11, temporary regulations implementing the notice were promulgated. As a result of a significant legislative backlash to those temporary regulations, which generally focused on whether the targeted transactions were in fact inappropriate and whether Treasury had the authority to issue the regulations, the IRS and Treasury issued Notice 98–35, in which they expressed their intent to revise the temporary regulations with a new effective date. Those regulations were proposed on July 9, 1999, with a proposed effective date of no earlier than 2000.

- Violate basic notions of fairness and equity; or
- Result in an arbitrary or hidden tax increase.

All of the tax policy makers in the current debate on corporate tax shelters—including the Chairman of the House Committee on Ways and Means,[38] the Chairman of the Senate Committee on Finance,[39] Treasury[40] and the JCT[41]—have expressed the view that legislation should not inhibit legitimate business transactions and tax planning activities.

a. *Evaluating Fairness and Equity*. One of the striking aspects of the various proposals to address corporate tax shelters is the apparent failure to consider standards of basic fairness and equity. These concepts are, of course, difficult to define in practice. However, we believe that the fairness and equity of the proposals under consideration can be addressed by considering questions such as the following:

- Do the proposals allow IRS revenue agents to override substantive tax law?
- Do the proposals create a structural bias that will cause taxpayers to systematically over-pay their taxes?
- Do the proposals give IRS revenue agents the authority to extract inappropriate concessions from taxpayers?
- Do the proposals permit the government to avoid accountability for the rules that it writes?
- Do the proposals impose standards on taxpayers and third parties that are far more onerous than the standards imposed on the government?

Unfortunately, when reviewing the legislative proposals made by Treasury and the Joint Committee, the answer to each of these questions is likely to be yes. As a result, those proposals do violate basic notions of fairness and equity.

b. *Hidden Tax Increases*. If the goal of corporate tax shelter legislation is to create incentives in our self-assessment system for taxpayers to file tax returns that reflect the actual amount of tax required to be paid under the law, then any such legislation should not be crafted as a tax increase in disguise. Some of the proposals made by Treasury and the Joint Committee would result in arbitrary or hidden tax increases because they:

- Create strong structural incentives for taxpayers to overpay their taxes;
- Give IRS revenue agents weapons that they can use to extract inappropriate concessions from taxpayers;
- Impose penalties on third parties that would likely be borne by corporate taxpayers; and
- Impose dead-weight costs in the form of substantial compliance and administrative burdens.

c. *Application of Criteria to Pending Proposals*. First, because of the difficulty in defining a corporate tax shelter, both the Treasury and Joint Committee proposals would inject a new level of uncertainty into the tax law. Secondly, as Joint Committee has pointed out in its analysis of Treasury's proposal, to the extent that proposed definitions rely on a list of factors that are "over-inclusive, tax benefits to which a taxpayer would be entitled under current law would automatically be disallowed."[42] Moreover, Treasury's proposal to "codify the economic substance doctrine" would give the Executive Branch and IRS agents unfettered discretion to rewrite substantive tax rules, in addition to raising the risk inherent in any codification of common law that the legislative approach will have the unintended effect of limiting the ability of the courts to apply the doctrine.

Additionally, in proposing a penalty system in which the only way that a taxpayer can be certain to avoid penalties is to pay tax and sue for a refund, Joint Committee would create a structural bias that will cause taxpayers to overpay their taxes. Finally, the penalty systems proposed by both Treasury and Joint Committee will give

[38] Tax Bill Will Include Extenders, Some Shelter Provisions, Archer Says, 1999 TNT 56–1 (March 23, 1999) (quoting Rep. Archer, Chairman of the House Committee on Ways and Means, to the effect that he "wants to proceed more cautiously and doesn't want to injure taxpayers who are trying to legally reduce their tax liabilities in the push to catch those who abuse the system").

[39] Finance Committee to Review Tax Code Penalties, Including Corporate Tax Shelter Proposals, News Release from Sen. Roth (July 13, 1999) ("Corporate tax shelters should be curtailed without affecting legitimate business transactions.")

[40] Hearing on the President's Fiscal Year 2000 Budget Before the House Committee on Ways and Means, 106th Cong., 1st Sess. (1999) (statement of Hon. Donald Lubick, Assistant Secretary (Tax Policy), U.S. Department of the Treasury) ("The Treasury Department does not intend to affect legitimate business transactions.")

[41] Joint Committee Study at 219 (stating that the tax system mut not impede taxpayers' ability to conduct business).

[42] Staff of the Joint Committee on Taxation, 106th Cong., 2d Sess., Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal, JCS–2–00 (March 6, 2000) page 294.

IRS revenue agents new weapons they can use to extract inappropriate concessions from taxpayers.

CONCLUSION

The IRS is aggressively pursuing enforcement efforts, including the assertion of penalties. The government is actively litigating and the courts are siding with the IRS in a number of well-publicized "tax shelter" cases. Treasury is issuing regulations (including retroactive rules) to address transactions that it finds troublesome.[43] The IRS and Treasury have just begun to implement the tax shelter registration legislation that was enacted in 1997. The audit cycles for returns filed after the enactment of the changes made in 1997 to the penalties with respect to corporate tax shelters will begin in the next several years. IRS agents are increasingly making use of recent IRS court victories to attack transactions on economic substance and similar grounds.[44] These developments are of relatively recent vintage, and will likely begin having an impact on taxpayer behavior. Under these dramatically changing circumstances, we do not believe that more legislation is necessary at this time.

Accordingly, we recommend that the Congress continue to assess the recently changed environment and review the IRS and Treasury's use of the tools already at their disposal to address the issue of "tax shelters." In addition, the Congress should instruct the Treasury Department to continue implementing the 1997 legislation, and to identify specific areas of the substantive tax law in which changes may be necessary. Moreover, we recommend that the Congress instruct the IRS to develop a system of obtaining statistically valid quantitative data to indicate where the IRS should focus its enforcement efforts and where there are defects in the tax system that require legislative action. In addition, to make certain that the IRS has the resources it needs to make use of the tools already available to it, Congress should continue to provide adequate funding to the IRS (as it already has for the current fiscal year).

STATEMENT OF WASHINGTON COUNSEL, P.C., ATTORNEYS-AT-LAW [1]

PENALTY PROVISIONS AFFECTING CHARITABLE REMAINDER TRUSTS

Charitable remainder trusts are trusts established for the purposes of paying a stream of income to individuals for life (or for a period of years) with the remainder interest going to a charitable organization or educational institution. Section 664(c) of the Internal Revenue Code ("the Code") provides rules with respect to the treatment of charitable remainder trusts ("CRTs"). Section 6652 of the Code provides rules with respect to the penalties that apply for failure to file certain information returns. This paper comments on the application of these two sections to CRTs and the extent to which current law produces inequitable results and discourages voluntary compliance.

I. Unrelated Business Taxable Income Under Section 664(c)

Under section 664(c) of the Code, CRTs are not subject to income tax unless they earn unrelated business taxable income ("UBTI"). In the event a CRT earns any UBTI, the entire income of the CRT is subject to taxation. This is a draconian rule that can be highly inequitable to the beneficiaries of the CRT. Unlike other exempt organizations that simply pay tax on the portion of their income that is UBTI, CRTs are taxed on all of their income if they earn any UBTI. This rule applies regardless of how minor the UBTI and whether it is earned unintentionally. Thus, for example, if a CRT earns $50,000 of annual income, the CRT is not subject to tax on any of its income. If the CRT were to inadvertently earn $1.00 of UBTI, however, the en-

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[43] Moreover, even when the Treasury Department is not certain whether a transaction is troublesome, it increasingly attaches broad anti-abuse rules to otherwise objective regulations. See, e.g., Treas. Reg. §1.367(e)-2(d) (establishing broad anti-abuse rule authorizing the IRS to require gain recognition on otherwise tax-free liquidations "when a principal purpose of the liquidation is the avoidance of U.S. tax").

[44] See, e.g., T.A.M. 199934002 (May 24, 1999) (applying ACM Partnership and similar authorities to conclude that the taxpayer's non-tax motives for securing its promises to pay employee benefits lacked sufficient economic substance to cause them to be respected for Federal tax purposes).

[1] This statement is submitted by Robert Rozen, Gary Gasper, and Mark Weinberger, members of Washington Counsel, P.C., a law firm based in the District of Columbia that represents a variety of clients on tax legislative and policy matters.

tire $50,001 of income would be subject to taxation. There is no indication in the legislative history that suggests why such a draconian cliff result is necessary.

Section 512 of the Code defines unrelated business taxable income. In the case of a CRT, the UBTI rules generally prevent the trust from earning income from active business operations. As defined in section 514 of the Code, unrelated business income also includes any debt-financed income. Although, on their face, these rules appear easy to apply, in practice, they are particularly problematic due to the absence of guidance regarding the classification of certain types of investment income. Thus, even for those CRTs that have no intention of engaging in an active trade or business, there is still the risk of incurring a de minimis amount of UBTI that would taint all of the CRTs earnings for the year. For example, for a long period of time before the IRS issued clarifying guidance, CRTs avoided short sales of equity securities because there had not been any definitive pronouncement that income from such investments did not generate UBTI. Although this short sale issue was clarified, other passive investments needlessly remain off limits because the law is not clear or because—in the case of pass-through investments—the CRT cannot obtain certainty that the pass-through entity will not generate even an insignificant amount of UBTI income that, in turn, would be passed-through and allocated to the CRT.

Because the penalty is so great if even a minor amount of UBTI is earned, complying CRTs must go to great lengths to avoid investments that have any potential for generating UBTI. Often the charitable beneficiary has the responsibility of managing the assets of the trust and, as a result of this onerous rule, must establish elaborate procedures to manage its CRT assets separately from its other assets. It is particularly problematic for a trustee to invest in a venture capital or private equity fund. The risk is that in spite of agreements to the contrary, the managing partner may earn what are considered advisory fees for its services to a start-up company. Or it may earn breakup fees in connection with a failed acquisition agreement. Both fees could be considered UBTI, which if earned, could be extremely costly to the CRT. Even the simple purchase of stock by a CRT creates potential dangers if for some reason there is a processing mistake during the settlement process that causes the purchase price not to be deposited in a timely manner. If the broker clears the trade pending the receipt of payment from the CRT, this margin may inadvertently create indebtedness that would result in UBTI pursuant to section 514 of the Code.

By imposing such a draconian sanction on the receipt of just one dollar of UBTI, current law forces the investment manager (which is generally either the charity itself or a separate trustee) to incur substantial costs to determine if it is permitted to make an investment that it may view as financially advantageous. Indeed, because the UBTI rules are often very complicated, CRTs are forced either to make less advantageous investments or have nearly all their potential investments approved by tax accountants and/or lawyers to ensure that the investments will not lead to UBTI. These unproductive, inefficient costs directly reduce the funds that would otherwise be paid to the charities that hold the remainder interests.

The question is, what public policy is served by imposing such burdens on CRTs? The answer is none.

Although section 664(c) is not per se a penalty provision in the Code, the severe consequences of its application means it operates more as a penalty provision than a tax. The enormous effective tax that it could impose on unrelated business taxable income makes this appropriately a part of any congressional effort to address problems with the penalty and interest provisions of the Code. In the words of the Joint Tax Committee press release inviting comment on its penalty and interest provisions study, section 664(c) "produces inequitable results" that impose "undue hardships for taxpayers" which "result in inefficient or ineffective tax administration." The tax policy against CRTs having UBTI is not in question. That policy can be preserved without imposing such drastic consequences on a CRT such that its trustees must go to such burdensome lengths to avoid realizing any UBTI.

These issues were also the subject of comments submitted to the Joint Committee on Taxation in connection with its July, 1999 study of the penalty and interest provisions. The Joint Committee determined that section 664(c) was not within the scope of its study which was generally limited to "sanctions in the Code that relate to the proper amount of tax liability"—as opposed to "provisions that address substantive Federal tax issues, including the adverse tax consequences that may result from the failure to meet requirements that are a condition of obtaining a particular

tax benefit."[2] The report does note, however, that "different conclusions as to whether a provision is a penalty might be drawn in different contexts." The limitations on the scope of the Joint Committee study should not prevent this issue from being addressed in Finance committee consideration, hearings, or potential legislation to improve the interest and penalty regime in the Code.

II. Failure to File Information Returns Under Section 6652

Under section 6652(c) of the Code, exempt organizations and certain trusts are subject to penalty for failure to file information returns. Section 6652(c)(1), which applies to exempt organizations required to file under section 6033, imposes a penalty of $20 a day, not to exceed the lesser of $10,000 or 5 percent of the gross receipts of the organization. In the case of exempt organizations with gross receipts over $1 million for any year, the penalty is $100 a day, not to exceed $50,000. This is a sizeable penalty that serves as an effective means of ensuring that exempt organizations comply with the filing requirements of the tax laws. However, in the case of trusts required to file under section 6034, including CRTs, the maximum penalty for a failure to file information returns is only $5,000 regardless of the annual income of the CRT. Because the penalty for failure to file is so small, relative to the size of some CRTs, reasonable concerns arise as to whether the penalty is sufficient to encourage voluntary compliance. There does not seem to be any public policy reason why exempt organizations should be subject to a failure to file penalty far greater than CRTs.

III. Recommendations on Ways to Reduce Inequities and Burdens of Taxpayers

Section 664(c). The Code should continue to discourage CRTs from earning UBTI but it should not impose excessive burdens that require CRTs to set up elaborate administrative systems to avoid the possibility of earning a small or de minimis amount of such income. One way to reduce the inequity and burden on CRTs would be to modify section 664(c) and impose a sliding scale approach to the tax provision rather than a cliff approach. Under this recommendation, until UBTI amounts to more than 5 percent of the income of CRT, the CRT should only be taxed on its UBTI, the same rule that applies generally to exempt organizations. If UBTI represents more than 5 percent but less than 25 percent of the CRT's income, the CRT should be subject to a tax that equals four times the tax that would be imposed on the UBTI only. If UBTI represents 25 percent or more of the CRT's gross income, the CRT should be subject to tax on all of its income. The effect of this proposal would be to phase-up to a penalty that would be the same as under current law if UBTI amounts to 25 percent or more of CRT income. This proposal would continue to strongly discourage the receipt of UBTI to a CRT but it would remove an excessive penalty that imposes an inequitable compliance burden on taxpayers seeking to avoid the receipt of UBTI. As amended, the law would continue to discourage the receipt of UBTI, but not impose an excessive penalty for the receipt of small or de minimis amounts of such income.

Section 6652(c). Our second recommendation would be amend the Code to treat CRTs like exempt organizations with respect to the penalty for failure to file an information return. CRTs should be subject to a potential penalty of $20 a day, not to exceed the lesser of 5 percent of annual gross receipts, or $10,000. CRTs with annual gross income in excess of $1 million should be subject to a penalty of $100 a day, not to exceed $50,000. This should increase compliance with the information return requirements applicable to CRTs, giving the IRS more information with which to audit their activities.

IV. Conclusion

Under current law, CRTs are subject to unreasonable rules that impose an excessive penalty on the receipt of any amount of UBTI. This causes many CRTs to go to burdensome lengths adopting stringent procedures to ensure even a minor amount of inadvertent UBTI is not earned. Meanwhile, an anomaly in the failure to file penalty provisions may encourage other CRTs to avoid the UBTI rules simply by not filing an information return. Both laws should be changed; first to impose more reasonable taxes and penalties on the UBTI of CRTs; and second to encourage all CRTs to file the information returns necessary to ensure a higher level of compliance with the law.

[2] 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, Volume I, (JCS 3-99) July 22, 2000, at page 14.

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