Joint Committee on Taxation
November 10, 1999
JCX-82-99

TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION BEFORE THE COMMITTEE ON WAYS AND MEANS

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 before the House Committee on Ways and Means concerning corporate tax shelters.[1]

My testimony today focuses on recommendations made by the Joint Committee staff with respect to corporate tax shelters, which are contained in Part VIII of the study prepared by the Joint Committee staff regarding the present-law penalty and interest provisions.[2] Two attachments supplement my testimony. The first attachment provides data on Federal income tax receipts and corporate income.[3] The second receipt attachment is our staff's further analysis of the issues presented by corporate tax shelter proposals and recommendations.[4]

I. BACKGROUND

Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 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 ("Code") and to make any legislative or administrative recommendations to the House Committee on

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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 Before the House Committee on Ways and Means* (JCX-82-99), November 10, 1999.

[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 ("Joint Committee staff study").

[3] Joint Committee on Taxation, *NIPA and Federal Income Tax Receipts Data* (JCX-83-99), November 10, 1999.

[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.

Ways and Means and the Senate Committee on Finance that are deemed appropriate to simplify penalty and interest administration or reduce taxpayer burden. The Joint Committee staff study makes a number of recommendations with respect to non-corporate tax shelter penalties and interest that will be the subject of a separate hearing by the Subcommittee of Oversight of the House Committee on Ways and Means.

The Joint Committee staff recommendations regarding corporate tax shelters were the product of an extensive review and analysis of the present-law system of penalties and interest in the Code. The Joint Committee staff study focused on sanctions in the Code 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 returns or reports.

The penalty provisions reviewed by the Joint Committee staff relating to tax shelters include the following:

(1) The accuracy-related penalty imposes a 20 percent penalty on any substantial understatement of income tax that, among other things, is attributable to corporate tax shelters.[5]

(2) Income tax return preparers may be liable for a penalty with respect to an understatement of a taxpayer's liabilities.[6]

(3) Penalties may be imposed on those who aid and abet a taxpayer with respect to a return that results in an understatement of tax liability.[7]

(4) Penalties may be imposed on those who promote abusive tax shelters.[8]

(5) Registration requirements apply with respect to tax shelters[9] and penalties are imposed for failing to comply with the registration requirements.[10]

The Joint Committee staff concluded after reviewing the above provisions that a

[5] Code section 6662.

[6] Code sections 6694 and 6695.

[7] Code section 6701.

[8] Code section 6700.

[9] Code sections 6111 and 6112.

[10] Code sections 6707 and 6708.

comprehensive study of the present-law penalty provisions of the Code relating to tax shelters was appropriate.

II. METHODOLOGY

The Joint Committee staff conducted a comprehensive review of the penalty and interest rules applicable to corporate tax shelters and evaluated their effectiveness in dealing with modern-day 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[11] and their interaction with the penalty and interest rules,

(2) The various common-law doctrines used by the courts to evaluate and potentially disallow tax benefits claimed in tax shelter transactions[12] 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 which are intended to have certain deterrent and punitive aspects.[13]

The Joint Committee staff spent considerable time analyzing a variety of recent transactions that have given rise to recent Congressional 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 put forward with regard to corporate tax shelters, including:

(1) The Administration's proposals that were included in the FY 2000 Budget, as supplemented by the Treasury White Paper on corporate tax shelters,

(2) H.R. 2255, The Abusive Tax Shelter Shutdown Act of 1999, introduced on June 17, 1999 by Congressman Doggett and others,

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[11] Code sections 269, 446, 482 and 7701(l).

[12] 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.

[13] <u>See</u> 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.

(3) Comments and recommendations submitted by various groups to this Committee and the Senate Committee on Finance, 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.

III. 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.

A. The Corporate Tax Shelter Problem

The Joint Committee staff believes that there is a corporate tax shelter problem -- more corporations are entering into arrangements 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 this year 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, as one might expect, but the importance of this evidence should not be discounted. The parties involved in developing, marketing, or implementing a tax shelter generally benefit by keeping its existence confidential. For example, some firms intentionally limit the sale of a corporate tax shelter that involves tens of millions of dollars in tax savings 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 disclosed the arrangement to a government official.

Recent data would suggest that corporate tax receipts are not keeping pace with a growing economy. Data just released shows that for fiscal year 1999, corporate income tax receipts actually <u>fell</u> by approximately $4 billion, representing a decline of approximately two percent, from the prior fiscal year.[14] The last year in which there was a decline in corporate tax receipts

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[14] Monthly Treasury Statement regarding Budget Results for Fiscal Year 1999, Department of the Treasury (October 27, 1999).

was in fiscal year 1990, a period in which the economy was softening and entering the brief recession which began in the last half of 1990.

Commentators and interested parties have relied on macroeconomic data to reach differing opinions regarding whether there is a corporate tax shelter problem. The Joint Committee staff believes that the data are not sufficiently refined to provide a reliable measure of the 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. Other factors include year-to-year changes in corporate economic losses and the increased use of non-corporate entities.

The Joint Committee staff believes that direct measurement of corporate tax shelter activity through macroeconomic data is not possible. Instead of focusing on macroeconomic data, a more instructive approach is 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 two years, the courts have disallowed tax benefits in several high-profile corporate tax shelter cases. For example, in ACM Partnership v. Commissioner,[15] 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 which 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.[16] 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 may be at least 15 other cases which 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 $60 million in taxes.

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[15] 157 F.3d 231 (3d Cir. 1998), aff'g 73 T.C.M. (CCH) 2189 (1997).

[16] 113 T.C. No. 17 (September 21, 1999).

A third recent corporate tax shelter case is Winn-Dixie Stores, Inc. v. Commissioner.[17] 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 may be as many as 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 approach 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 over $7 billion in unpaid corporate taxes (approximately $1 billion from ACM and similar cases, approximately $60 million from Compaq and similar cases, and approximately $6 billion from Winn-Dixie and similar cases). 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 are such that the IRS often may opt for a negotiated settlement. Only a fraction of tax shelter activity actually results in a judicial determination. In addition, as the 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 to be representative of the full magnitude of the problem, and (2) cannot be considered as 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 in some respects a secondary issue. 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 potentially 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

[17] 113 T.C. No. 21 (October 19, 1999).

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.

B. 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.[16] 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.[17] The most effective means of realigning the cost-benefit calculus is to clarify and enhance the present-law penalty regime.

C. 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

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[16] 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.

[17] 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.

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.

D. Alternative Responses

Maintaining the status quo

Some argue 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. The Joint Committee staff believes the present-law penalty structure contains a number of structural weaknesses that significantly undermine its effectiveness. Some of the weaknesses 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 definition of a corporate tax shelter 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. However, there appears to be much uncertainty, both in the Treasury Department and in the business community, as to what constitutes a "significant purpose" and no guidance has been issued by the Treasury Department. At the same time, the lack of statutory guidance could subject any regulatory guidance to criticism for exercising too much discretion and exceeding statutory authority in resolving these issues.

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[18] is widely disputed. Some tax professionals believe an opinion from a tax advisor is all that is necessary. Others believe that if the test 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

[18] Treas. Reg. sec. 1.6664-4(e).

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 in recent years there has been a flurry of legislative activity aimed at specific corporate tax shelters, 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 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 American Bar Association Tax Section recently suggested changes to the standards of practice before the IRS, known as Circular 230, which imposes some standards on tax shelter opinions. These suggestions are a good first step. However, the ABA Tax Section's suggestions are predicated on the present-law "more likely than not" standard, which the Joint Committee staff believes should be raised.[19] The Joint

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[19] Joint Committee staff study includes a recommendation that would eliminate the substantial understatement penalty attributable to corporate tax shelters only if the corporate participant is "highly confident" (i.e., reasonably believes that there is at least 75-percent chance that the tax treatment would be sustained on the merits). In addition, the Joint Committee staff recommends raising the minimum standards for tax return positions for both taxpayers and tax

Committee staff study includes recommendations on how the current rules under Circular 230 should be revised to regulate the conduct of practitioners as it relates to corporate tax shelters. Unfortunately, the IRS Director of Practice recently stated that, although the IRS could be proposing changes to Circular 230 next spring, these proposals are unlikely to tackle any "controversial issues" such as modifications to tax shelters.[20] Such a noncommittal response illustrates that Congress should provide the IRS with strong guidance on how to address the tax shelter issue.

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, 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 lacked 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 concluded that 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. Neither the ACM case nor the Winn-Dixie case makes reference to penalties.[21] 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 at the same time does not impede legitimate business transactions from going forward. 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

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[20] See Barton Massey, "Circular 230 Changes Unlikely to Address Shelters or Practice of Law," 1999 TNT 206-5, (Doc 1999-34521), October 26, 1999.

[21] The imposition of penalties may be a continuing issue in the ACM case.

shelter arrangements, referred to as "tax shelter indicators,"[22] 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. Thus, it is not enough that the arrangement appears to be a tax shelter; there must be a determination that the tax treatment was improper and 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.

E. 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.

IV. SPECIFIC RECOMMENDATIONS

Consistent with its analysis and conclusions, the Joint Committee staff recommends the following with respect to corporate tax shelters.

Recommendations that affect corporations which participate in corporate tax shelters

A. 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 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

[22] 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 indicator") should be considered to have a significant purpose of avoiding or evading Federal income tax for purposes of an understatement penalty.

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 an not permitted under present law. The indicators are:

(1) The reasonably expected pre-tax profit from the arrangement is insignificant relative to the reasonably expected net tax benefits.

(2) 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.

(3) 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.

(4) 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.

(5) 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.

B. 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.

C. Modify the penalty so that, with respect to a corporate tax shelter, there would be no requirement that the understatement be substantial.

D. 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.

E. 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.

F. 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.

G. 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.

Recommendations that affect other parties involved in corporate tax shelters

A. 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.

B. 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.

C. 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.

D. 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.

E. Include the explicit statutory authorization for Circular 230 in Title 26 of the United States Code and authorize the imposition of monetary sanctions.

F. 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).

<u>Disclosure and registration obligations</u>

A. Corporate taxpayer disclosure

(1) <u>30-day disclosure</u>.--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.

(2) <u>Tax-return disclosure</u>.--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.

B. Tax shelter registration

(1) 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.

(2) 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.

V. CONCLUSION

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. The Joint Committee staff's analysis and specific recommendations are discussed in more detail in the Joint Committee staff study.

I thank the Committee for the opportunity to present the Joint Committee staff recommendations on corporate tax shelters, and I would be happy to answer any questions the Committee may have at this time and in the future.