Joint Committee on Taxation
March 7, 2000
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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-income individuals, and other interested parties, and met with representatives of major taxpayer groups and professional organizations to discuss their comments.

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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.

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 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.

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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.

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 personal interest includes interest paid on underpayments of Federal income tax, regardless of the source of the income generating the tax liability.[7]

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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.

[7] Treas. Reg. sec. 1.163-9T(b)(2).

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.

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

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[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.

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.

Undisclosed tax return positions

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, 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.

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[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.

[11] *Commissioner v. Lane Wells Co.*, 321 U.S. 219, 223 (1944).

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 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.

[12] Treas. Reg. sec. 1.6662-4(d)(2).

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.

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

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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).

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 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.

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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.

[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.

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.

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

[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.

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.

<u>Penalty for failure to file annual information returns for charitable remainder trusts</u>

> **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.

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 returns 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:

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[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.

(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:

(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

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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.

[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).

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 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 <u>fell</u> 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

[25] Budget of the United States Government: Fiscal year 2001.

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 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

[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).

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.

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

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[28] 113 T.C. No. 21 (Oct. 19, 1999).

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

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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.

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.

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.

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[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.

[31] *See* IRS Announcement 2000-12 (Feb. 28, 2000).

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]

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

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[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."

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

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 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.

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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).

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 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

[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.

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 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.

Recommendations that affect other parties involved in corporate tax shelters

(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.