COMPARISON OF RECOMMENDATIONS RELATING TO CORPORATE TAX SHELTERS MADE BY THE DEPARTMENT OF TREASURY AND THE STAFF OF THE JOINT COMMITTEE ON TAXATION

Scheduled for a Public Hearing

Before the

SENATE COMMITTEE ON FINANCE

on March 8, 2000

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

March 7, 2000

JCX-25-00

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on March 8, 2000, regarding penalties and interest and corporate tax shelters. The Internal Revenue Service Restructuring and Reform Act of 1998 directed the Joint Committee on Taxation and the Department of the Treasury to undertake separate studies of the interest and penalty provisions of the Internal Revenue Code of 1986 (the "Code"), and make any legislative and administrative recommendations they deem appropriate to simplify penalty administration and reduce taxpayer burden. The staff of the Joint Committee on Taxation released its study[1] on July 22, 1999. The Department of the Treasury released its White Paper discussion of corporate tax shelters[2] and its report on penalty and interest provisions[3] in July 1999 and October 1999, respectively. On February 7, 2000, the Department of the Treasury released their explanation of the President's Fiscal Year 2001 Budget Proposals;[4] included among the President's budget proposals are five proposals having general application to corporate tax shelter arrangements.[5] On February 28, 2000, the Department of the Treasury released temporary and proposed regulations relating to (1) disclosure of tax shelters by corporate taxpayers, (2) registration of confidential corporate tax shelters by tax shelter promoters, and (3) the maintenance of lists of investors in potentially abusive tax

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[1] Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99), July 22, 1999.

[2] Department of the Treasury, *White Paper: The Problem of Corporate Tax Shelters (Discussion, Analysis and Legislative Proposals)*, July 1999 ("White Paper").

[3] Department of the Treasury, *Report to the Congress on Penalty and Interest Provisions of the Internal Revenue Code*, October 1999.

[4] See Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2001: Analytical Perspectives* (H. Doc. 106-162. Vol. III), pp. 54-86.

[5] See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals*, February 2000.

shelters.[6]

This document,[7] prepared by the staff of the Joint Committee on Taxation, provides a comparison of the legislative changes with respect to corporate tax shelters recommended[8] by the Joint Committee staff and the Department of the Treasury.

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[6] *See* Temp. Treas. Reg. secs. 1.6011-4T; 301.6111-2T; and 301.6112-1T. These regulations are reflected, as appropriate, in the "Present Law" column in the table below.

[7] This document may be cited as follows: Joint Committee on Taxation, *Comparison of Recommendations Relating to Corporate Tax Shelters Made by the Department of Treasury and the Staff of the Joint Committee on Taxation* (JCX-25-00), March 7, 2000.

[8] As used in the "Recommendation" columns of this document, "No recommendation" means that no specific recommendation was made with respect to that item.

PROVISION	PRESENT LAW	JCT STAFF RECOMMENDATIONS	TREASURY RECOMMENDATIONS
I. PROPOSALS RELATING TO CORPORATE TAXPAYERS			
A. Definition of a tax shelter	An accuracy-related penalty under section 6662 applies to an understatement of tax that is attributable to a tax shelter. A tax shelter is defined as a partnership, entity, plan, or arrangement a significant purpose of which is the avoidance or evasion of Federal income tax.	Specific recommendations with respect to the definition of a corporate tax shelter are described below.	Specific recommendations with respect to the definition of a corporate tax shelter are described below.
B. Definition of a corporate tax shelter	Present law does not contain a special definition of a corporate tax shelter. The definition of a tax shelter described above applies to all taxpayers.	<u>Corporate tax shelter</u> - A partnership, entity, plan, or arrangement (collectively referred to as an "arrangement") involving a corporate participant will be considered to have a significant purpose of Federal income tax avoidance or evasion under section 6662 if it satisfies one of five corporate tax shelter indicators. The mere purchase or sale of an asset will not	<u>Corporate tax shelter</u> - Any entity, plan, or arrangement in which a direct or indirect corporate participant attempts to obtain a "tax benefit" in a "tax avoidance transaction." It is unclear whether this recommendation would replace or be in addition to the present-law significant purpose definition.

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		constitute an arrangement for these purposes. <u>Corporate tax shelter indicators</u> - (1) The present value of the reasonably expected pre-tax profit from the arrangement is insignificant relative to the present value of the reasonably expected net tax benefits. (2) The arrangement involves a tax-indifferent participant, and (a) results in taxable income materially in excess of economic income to the tax-indifferent participant, (b) 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 (c) results in a noneconomic increase, creation, multiplication, or shifting of basis for the benefit of the	<u>Tax benefit</u> - Includes any reduction, exclusion, avoidance, or deferral of tax, or an increase in a refund, but would not include a tax benefit clearly contemplated by the applicable provision. <u>Tax avoidance transaction</u> - (1) Any transaction in which the present value of the reasonably expected pre-tax profit of the transaction is insignificant relative to the present value of the reasonably expected net tax benefits; and (2) In the case of financing transactions, any transaction in which the present value of the tax benefits of the taxpayer to whom the financing is provided is significantly in excess of the present value of the pre-tax profit or return of the person providing the financing.

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		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 arrangement involves significant reasonably expected net tax benefits and a tax indemnity or similar agreement. (4) The arrangement involves significant reasonably expected net tax benefits and a reasonably expected "permanent difference" for U.S. financial reporting purposes under generally accepted accounting principles. (5) The arrangement involves significant reasonably expected net tax benefits and the corporate participant incurs little (if any) additional economic risk.	

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C. Codification of the common-law economic substance doctrine in a substantive rule	The economic substance doctrine has been developed in common law through numerous court cases. This doctrine has been invoked to deny claimed tax benefits if the transaction giving rise to those benefits lacked economic substance independent of tax considerations.	No recommendation.	Codifies and clarifies the economic substance doctrine by disallowing any tax benefit derived in a tax avoidance transaction (defined above). Applies to any trade or business or activity engaged in for profit or for the production of income, including those that engage in business in non-corporate forms. Does not apply to any claimed loss or deduction economically been incurred by a taxpayer before entering into the transaction.
D. Amount of penalty under section 6662	Imposes a 20-percent penalty on the portion of any underpayment attributable to (1) negligence or (2) any substantial understatement of income tax.	Increases the penalty rate 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.	Increases the penalty rate to 40 percent for any understatement that is attributable to a corporate tax shelter.

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		Reduces the 40-percent rate to 20 percent if certain disclosures are made and the tax treatment is supported by substantial authority.	Reduces the 40-percent rate to 20 percent if certain disclosures are made.
	Penalty does not apply if the taxpayer establishes reasonable cause for the underpayment and the taxpayer acted in good faith. Reasonable cause may be established with a more-likely-than-not opinion of a third-party.	Penalty does apply if the corporate taxpayer (1) satisfies disclosure requirements (including corporate officer certification), (2) reasonably believes that there is at least a 75-percent likelihood of sustaining the position on its merits, and (3) has a material nontax business purpose. Repeals the present-law reasonable cause exception.	Penalty does not apply if the taxpayer discloses the transaction and satisfies a strengthened reasonable cause standard (i.e., the taxpayer shows that it had a strong chance of sustaining its tax position and acted in good faith).
E. Definition of substantial understatement under section 6662	A substantial understatement exists if the correct income tax liability for a taxable year exceeds the liability reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations).	Modifies the penalty with respect to a corporate tax shelter to eliminate the requirement that the understatement be substantial. Imposes the penalty on the understatement attributable to each corporate tax shelter (without regard to whether there was an overall underpayment of tax for the	No recommendation specific to corporate tax shelters, but another proposal treats any corporate understatement in excess of $10 million as substantial, regardless of whether it exceeds 10 percent of the tax liability.

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		taxable year).	
F. Disclosure by corporate taxpayers			
1. Transactions required to be disclosed	A corporate taxpayer must disclose: (1) Any transaction that is the same as, or substantially similar to, a transaction identified by the IRS in published guidance as being a tax avoidance transaction (a"listed" transaction) and which is expected to reduce Federal income tax liability by more than $1 million in any single year or by more than $2 million for any combination of years, or (2) Any transaction having at least two of six characteristics ("filters") and which is expected to reduce Federal income tax liability by more than $5 million in any single year or $10 million for any combination of years.	<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 must be disclosed within 30 days of entering into the arrangement. <u>Tax-return disclosure</u> - Arrangements that are described by a tax shelter indicator are required to be disclosed on corporate taxpayer's tax returns. <u>Corporate tax shelter indicators</u> (same as described in connection with the definition of a corporate tax shelter) - (1) The present value of the reasonably expected pre-tax profit from the arrangement is insignificant relative to the present value of the reasonably	Same as present law (proposed and temporary regulations issued in February 2000 include disclosure requirements that are similar to those contained in the President's budget proposals).

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	<u>Filters</u>: (1) The transaction is offered under conditions of confidentiality. (2) The transaction involves contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained. (3) Aggregate contingent promoter fees for such transactions exceed $100,000. (4) The transaction involves a book/tax difference in excess of $5 million in any year. (5) The transaction involves a person that the taxpayer knows or has reason to know is in a Federal income tax position that differs from that of the taxpayer (e.g., a tax-exempt entity or foreign person), and the taxpayer	expected net tax benefits. (2) The arrangement involves a tax-indifferent participant, and the arrangement (a) results in taxable income materially in excess of economic income to the tax-indifferent participant, (b) 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 (c) 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 arrangement involves	

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	knows or has reason to know that such difference has permitted the transaction to be structured to provide the taxpayer with more favorable Federal income tax treatment than it could have obtained without the participation of such person. (6) The expected U.S. tax and foreign tax characterizations of any significant aspect of the transaction differ.	significant reasonably expected net tax benefits and a tax indemnity or similar agreement. (4) The arrangement involves significant reasonably expected net tax benefits and reasonably expected "permanent difference" for U.S. financial reporting purposes under generally accepted accounting principles. (5) The arrangement involves significant reasonably expected net tax benefits and the corporate participant incurs little (if any) additional economic risk.	
2. Exceptions from disclosure	Disclosure is not required for transactions otherwise subject to disclosure (i.e., exhibiting at least 2 of the 6 filters described above) if: (1) The taxpayer participated in the transaction in the ordinary course of the taxpayer's trade or business in a form consistent	(1) Disclosure is not required for arrangements that are properly reported on certain forms (e.g., Form 1120-FSC for foreign sales corporations; Form 1120-DISC for domestic international sales corporations; Form 8586 for the low income housing credit; Form 1120, schedule K, line 12 for tax-exempt interest;	Authorizes the Treasury Secretary to provide exceptions from disclosure.

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	with customary commercial practice and would have entered into the transaction on substantially the same terms irrespective of the expected Federal income tax benefits. (2) The taxpayer participated in the transaction in the ordinary course of its business in a form consistent with customary commercial practice and the taxpayer reasonably determines that there is a long-standing and generally accepted understanding that the expected Federal income tax benefits from the transaction are allowable. (3) The taxpayer reasonably determines that there is no reasonable basis under Federal tax law for denial of any significant portion of the expected tax benefits. (4) The transaction is identified in published guidance as	and Form 8860 for the qualified zone academy bond credit), but only to the extent provided by the Treasury Secretary in regulations. (2) Solely for purposes of the 30-day disclosure, disclosure is not required for leasing transactions that satisfy the guidelines in Rev. Proc. 75-21 and the case law thereunder.	

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	excepted from disclosure.		
3. Content of disclosure	The disclosure is required to include: the name of transaction, whether it has been registered by a promoter, a description of the principal elements giving rise to tax benefits, a description of the tax benefits, identification of each tax year affected (and the amount of tax benefits).	The disclosure is required to include: a summary of relevant facts and assumptions, the expected net tax benefits, identification of each tax shelter indicator that describes the arrangement, legal analysis and rationale for the tax treatment, the business purpose, and the existence of any contingent fees.	Same as present law.
4. Timing of disclosure	The disclosure is required no later than the due date of tax return (with extensions).	One disclosure required within 30 days of entering into the arrangement and a second disclosure required by the due date of the tax return (with extensions).	The disclosure is required no later than the original due date of tax return (without extensions).
5. Certification of disclosure	No special certification required.	A corporate officer must certify (under penalties of perjury) the adequacy of the disclosure.	A corporate officer must certify (under penalties of perjury) the adequacy of the disclosure. Such officer would be personally liable for misstatements on the disclosure form.
6. Penalty for nondisclosure	No provision. However, a failure to disclose adequately a reportable transaction is a factor	No recommendation. However, a failure to disclose adequately a reportable transaction will	Penalty of $100,000 imposed per failure to disclose regardless of whether the arrangement is a tax

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	in determining whether any understatement attributable to the transaction is due to reasonable cause, and that the taxpayer acted in good faith.	preclude reduction of the section 6662 penalty rate below 40 percent.	avoidance transaction. In addition, failure to disclose adequately a tax avoidance transaction will preclude reduction of the section 6662 penalty rate below 40 percent.
7. Special disclosure to shareholders	No provision.	Requires a corporate participant to disclose to its shareholders the payment (including the amount and transaction details) of an understatement penalty of at least $1 million that was attributable to a corporate tax shelter.	No recommendation.

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II. PROPOSALS THAT AFFECT OTHER PARTIES INVOLVED IN CORPORATE TAX SHELTERS			
A. Impose tax on tax-indifferent parties that participate in corporate tax shelters	No provision. However, one of the filters (described above) relates to the involvement of certain tax-indifferent parties.	No recommendation. However, one of the corporate tax shelter indicators (described above) relates to the involvement of certain tax-indifferent parties.	Any income allocable to a tax-indifferent party (trading on its tax exemption) with respect to a corporate tax shelter would be taxable to such party without regard to any statutory, regulatory, or treaty exclusion or exception. The other corporate participants in the corporate tax shelter would be jointly and severally liable for such tax (in addition to any tax resulting from the denial of tax benefits to the corporate participants under the codification of the economic substance doctrine).
B. Aiding and abetting penalty	Section 6701 imposes a penalty on any person who (1) aids, assists, procures, or advises with respect to the preparation or presentation of any portion of a return, affidavit, claim, or other	Expands 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	No recommendation with respect to aiding and abetting. The proposal includes, however, a new penalty excise tax of 25 percent on fees received in connection with the purchase

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	document, (2) knows (or has reason to believe) that the document will be used in connection with any material matter arising under the internal revenue laws, and (3) knows that the document would result in an understatement of another person's tax liability. Aiding or abetting requires "direct involvement" in the preparation or presentation of a tax return or other tax-related document.	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.	and implementation of a corporate tax shelter (as defined above) and the rendering of certain tax advice related to a corporate tax shelter. The 25-percent penalty excise tax applies only to persons who perform services in furtherance of a corporate tax shelter. Appropriate due process rights to contest the excise tax would be provided.
	The penalty for aiding and abetting with respect to an individual's tax liability is $1,000; the penalty is $10,000 with respect to a corporation's tax liability.	Increases penalty from $10,000 to the greater of $100,000 or one-half of the fees related to the transaction.	No recommendation.
		Requires the publication of the names of any person penalized	No recommendation.

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		and an automatic referral of the person to the IRS Director of Practice.	
C. Injunctive action against promoters	Under section 7408, the Secretary may bring a civil action in district court to enjoin a person from further engaging in conduct subject to penalty under section 6700 (the penalty for promoting abusive tax shelters) or section 6701 (the penalty for aiding and abetting the understatement of tax liability. The court may grant injunctive relief if it finds (1) that the person has engaged in conduct subject to the penalty, and (2) that injunctive relief is appropriate to prevent recurrence of such conduct. Case law has indicated that traditional equity factors such as irreparable injury and likelihood of success on the merits need not be considered, provided that the government has satisfied the statutory requirements.	Clarifies that traditional equity factors such as irreparable injury and likelihood of success on the merits need not be considered once the government has satisfied the statutory requirements.	No recommendation.

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D. Promoter registration			
1. Transactions required to be registered	Registration required for an entity, plan, or arrangement: (1) a significant purpose of which is the avoidance or evasion of Federal income tax, (2) is offered under conditions of confidentiality, and (3) the promoters of which receive aggregate fees in excess of $100,000. An entity, plan, or arrangement has a significant purpose of avoiding or evading Federal income tax if: (1) it is the same as, or substantially similar to, a transaction identified by the IRS as being a tax avoidance transaction (i.e., a "listed" transaction); (2) (a) the present value of the reasonably expected pre-tax profits is insignificant relative to the present value of the expected net tax benefits, or (b) in the case of transactions that in substance are the borrowing of money or	Modifies the present-law rules to (1) eliminate the confidentiality requirement, (2) increase the fee threshold from $100,000 to $1 million, and (3) expand the registration requirement to cover any corporate tax shelter that is reasonably expected to be presented to more than one potential participant.	No recommendation.

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	acquisition of financial capital, the present value of the income tax deductions of the taxpayer to whom the loan or financial capital is provided significantly exceeds the present value of the pre-tax return of the lender or provider of the financial capital; or (3) the arrangement is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.		

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2. Exceptions from registration	Registration not required if - (1) the transaction is identified by the IRS in published guidance as excepted from registration; (2) if not identified as a tax avoidance transaction in published guidance (i.e., is not a "listed" transaction) and the promoter reasonably determines that there is no reasonable basis under Federal tax law for denial of any significant portion of the expected Federal income tax benefits from the transaction; or (3) with respect to the third category of transactions (i.e., transaction in which tax benefits constitute an "important part" of the intended results), the promoter reasonably determines that the potential participant is expected to participate in the transaction in the ordinary course of its business in a form consistent with customary commercial practice, and that there is a long-standing and	No recommendation.	No recommendation.

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	generally accepted understanding that the expected Federal income tax benefits from the transaction are allowable under the Code.		
3. Timing of registration	Registration required no later than the day on which the tax shelter is first offered to potential users.	Requires registration of corporate tax shelters no later than the earlier of: (1) the earliest day on which there is a reasonable belief that the promoter intends to present the promotional or marketing materials to more than one potential corporate participant, or (2) the day on which the presentation to the second potential participant occurs.	No recommendation.
4. Penalty for nonregistration	Penalty for nonregistration equals the greater of $10,000 or 50 percent (75 percent if intentional) of the fees payable to any promoter with respect to offerings prior to the date of late registration.	No recommendation.	No recommendation.

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E. Regulation of professional conduct of practice	Treasury Department regulations govern the practice of attorneys, certified public accountants, enrolled agents, and other persons representing clients before the IRS (“Circular 230"). The IRS Office of Director of Practice is responsible for the enforcement of Circular 230.	Includes the explicit statutory authorization for Circular 230 in the Code and authorizes the imposition of monetary sanctions. With respect to corporate tax shelters, directs the Treasury Department to amend Circular 230 to conform to the above recommendations by revising definitions and standards of practice and providing more meaningful enforcement measures.	No recommendation. The Treasury Department recently announced, however, that an updated version of Circular 230 will be issued later in 2000.