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TAX SHELTER TRANSPARENCY ACT

JUNE 28, 2002.—Ordered to be printed

Mr. BAUCUS, from the Committee on Finance, submitted the following

REPORT

[To accompany S. 2498]

The Committee on Finance, to which was referred the bill (S. 2498) to amend the Internal Revenue Code of 1986 to require adequate disclosure of transactions which have a potential for tax avoidance or evasion and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

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I. LEGISLATIVE BACKGROUND

The Senate Committee on Finance began a mark up of an original bill, S. 2498 (the "Tax Shelter Transparency Act") on June 13, 2002. On June 18, 2002, the Senate Committee on Finance resumed the mark up and approved the Committee amendment by a voice vote on that date.

The Committee held a hearing on March 21, 2002, regarding the proliferation of tax shelters.

II. PROVISIONS RELATING TO THE TAX SHELTER TRANSPARENCY ACT

A. Penalty for Failure To Disclose Reportable Transactions

(Sec. 101 of the bill and new sec. 6707A of the Code)

PRESENT LAW

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[1]

There are two categories of reportable transactions. The first category includes any transaction that is the same as (or substantially similar to)[2] a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction"). A taxpayer must disclose any listed transaction that is expected to reduce the taxpayer's Federal income tax liability by more than $1 million in any single taxable year or more than $2 million in any combination of years.[3]

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[1] Temp. Treas. Reg. sec. 1.6011–4T; Prop. Treas. Reg. sec. 1.6011–4. Effective June 14, 2002, the regulations were modified to require non-corporate taxpayers (i.e., individuals, trusts, partnerships, and S corporations) to disclose their participation in reportable transactions that have been specified by the Treasury Department as "listed" transactions. See T.D. 9000, 67 Fed. Reg. 41,324 (June 18, 2002). Disclosure of other reportable transactions under the regulations continues to be limited to corporate taxpayers.

[2] The recently-modified regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax benefits and that is either factually similar or based on the same or similar tax strategy. Also, the term must be broadly construed in favor of disclosure. See T.D. 9000, 67 Fed. Reg. 41,324 (June 18, 2002).

[3] Temp. Treas. Reg. sec. 1.6011–4T(b)(2) and (b)(4)(i).

The second category of reportable transactions includes transactions that are expected to reduce a taxpayer's Federal income tax liability by more than $5 million in any single year or $10 million in any combination of years and that have at least two of the following characteristics: (1) the taxpayer has participated in the transaction under conditions of confidentiality; (2) the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained; (3) the promoters of the transaction have received or are expected to receive fees or other consideration with an aggregate value in excess of $100,000, and such fees are contingent on the taxpayer's participation; (4) the transaction results in a reported book/tax difference in excess of $5 million in any taxable year; or (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 (such as a tax-exempt entity or foreign person), and the taxpayer knows or has reason to know that such difference has permitted the transaction to be structured to provide the taxpayer with a more favorable Federal income tax treatment.[4]

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure may jeopardize the taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[5]

REASONS FOR CHANGE

The Committee is aware that individuals and corporations are increasingly using sophisticated transactions to avoid or evade Federal income tax.[6] Such a phenomenon could pose a serious threat to the efficacy of the tax system because of both the potential loss of revenue and the potential threat to the integrity of the self-assessment system.

The Committee over two years ago began working on legislation to address this significant compliance problem. In addition, the Treasury Department, using the tools available, issued regulations requiring disclosure of certain transactions and requiring organizers and promoters of tax-engineered transactions to maintain customer lists and make these lists available to the IRS. Nevertheless, the Committee believed that additional legislation was needed to provide the Treasury Department with additional tools to assist its efforts to curtail abusive transactions. In that regard, the Committee issued for public comment three separate staff discussion drafts designed to address the tax shelter problem. The most recent draft (released in August 2001) focused on a regime that emphasized disclosure of tax shelter transactions.

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[4] Temp. Treas. Reg. sec. 1.6011–4T(b)(3)(i)(A)–(E). In certain circumstances, a taxpayer can avoid disclosure with respect to the second category of reportable transactions. See Temp. Treas. Reg. sec. 1.6011–4T(b)(3)(ii)(A)–(E).

[5] Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith.

[6] In this regard, the Committee has concerns with the outcomes and rationales used by courts in some recent decisions involving tax-motivated transactions. For a more detailed discussion of recent court decisions and other developments regarding tax shelters, see Joint Committee on Taxation, Background and Present Law Relating to Tax Shelters (JCX 19–02), March 19, 2002.

On March 21, 2002, the Committee heard testimony from Treasury Department and IRS officials that only 272 transactions by 99 different taxpayers were disclosed under the present law for the 2001 tax-filing season. In connection with the hearing, the Treasury Department announced a new initiative (the "Treasury shelter initiative") that is designed to provide the Treasury Department and the Internal Revenue Service ("IRS") with the tools necessary to respond to abusive tax avoidance transactions.[7] The Treasury shelter initiative emphasizes combating abusive transactions by requiring increased disclosure of such transactions by all parties involved. To facilitate such disclosure, the Treasury shelter initiative proposes clearer definitions to identify transactions that must be disclosed, and stiffer penalties for failure to disclose such transactions. The Treasury shelter initiative provides for

> [A] series of clear, mutually reinforcing rules for disclosure, registration, and list maintenance. These rules will be easier for taxpayers and their advisors to apply, and harder for those who seek to avoid disclosure to manipulate. * * * The Treasury Department's proposals, for example, will broaden and align the rules and regulations for disclosure, registration, and list keeping under Sections 6011, 6111, and 6112 of the Code. * * * The Treasury Department's enforcement initiative will create a single, clear definition of a transaction that must be disclosed and registered, and for which lists must be maintained.

The Committee believes that the course of action outlined in the Treasury shelter initiative will bolster ongoing efforts to combat abusive tax avoidance transactions, and that encouraging greater disclosure of transactions with a potential for tax avoidance is beneficial to the tax system. Moreover, the Committee believes that a penalty for failing to make the required disclosures, when the imposition of such penalty is not dependent on the tax treatment of the underlying transaction ultimately being sustained, will provide an additional incentive for taxpayers to satisfy their reporting obligations under the new disclosure provisions.

EXPLANATION OF PROVISION

In general

The provision creates a new penalty for any person who fails to include with any return or statement any required information with respect to a reportable transaction. The new penalty applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any accuracy-related penalty that may be imposed.

Transactions to be disclosed

The provision does not define the terms "listed transaction"[8] or "reportable transaction," nor does the provision explain the type of

[7] See generally, "The Treasury Department's Enforcement Proposals for Abusive Tax Avoidance Transactions," released on March 20, 2002, reprinted electronically at 2002 TNT 55–28 (March 21, 2002).

[8] The provision states that, except as provided in regulations, a listed transaction means a reportable transaction, which is the same as, or similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011. The Committee anticipates that regulations under section 6011 will provide that a transaction is similar to a listed

information that must be disclosed in order to avoid the imposition of a penalty. Rather, the provision authorizes the Treasury Department to define a “listed transaction” and a “reportable transaction” under section 6011. As part of the Treasury shelter initiative, the Committee expects the Treasury Department to issue new regulations under section 6011 that will provide taxpayers with a set of objective standards to be applied in determining whether a taxpayer must disclose information regarding a particular transaction. The Committee anticipates that the new regulations will define a reportable transaction to include (but not be limited to) transactions with any of the following characteristics: (1) a significant loss, (2) a brief holding period, (3) a transaction that is marketed under conditions of confidentiality, (4) a transaction that is subject to indemnification agreements, or (5) a certain amount of book-tax difference.[9]

Disclosure requirements

The Committee further expects that the new regulations will specify the manner in which a taxpayer must disclose reportable transactions. The Committee anticipates that the information required to be disclosed with respect to reportable transactions will be sufficiently detailed so as to provide the Treasury Department and IRS the ability to analyze all aspects of the transaction and determine an appropriate course of action (if any). To accomplish this objective, a taxpayer may be required to disclose the following information with respect to a reportable transaction: (1) a detailed description of all facts relevant to the expected tax treatment of the reportable transaction (such as the structure of the transaction and the principal elements of the transaction), (2) a description and schedule of the expected tax benefits for all tax years resulting from the reportable transaction (including any anticipated transactions as part of the overall strategy), (3) if applicable, the names and addresses of any party who promoted, solicited, or recommended the taxpayer’s participation in the transaction and who had a financial interest (including the receipt of fees) in the taxpayer’s decision to participate, and (4) other information that the Secretary may prescribe (e.g., the involvement of any accommodation party or any tax-indifferent party, the receipt of a tax opinion with respect to the transaction, the amount of any fees paid to any promoter or advisor in connection with the transaction, any anticipated subsequent transactions or exit strategies).

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transaction if such transaction is expected to obtain the same or similar types of tax benefits and that is either factually similar or based on the same or similar tax strategy. The Secretary will have discretion to modify this definition as appropriate (as well as the definitions of reportable and listed transactions).

[9] The Treasury shelter initiative stated that a reportable transaction would be defined as any transaction with any of the following characteristics: (1) any transaction specifically identified by the IRS in published guidance as a tax avoidance transaction without regard to the size of the tax savings (i.e., a “listed transaction”), (2) certain loss transactions under section 165 in excess of $10 million for corporations, partnerships, and S corporations ($2 million for trusts and individuals), (3) any transaction resulting in a tax credit in excess of $250,000 if the taxpayer held the underlying asset for less than 45 days, (4) any book-tax difference of at least $10 million, subject to certain exceptions, and (5) any transaction marketed under conditions of confidentiality, if the transaction is expected to result in a reduction in taxable income of at least $250,000 ($500,000 in the case of a corporation).

The Committee intends that, in accordance with section 6065 (relating to verification of returns), the form the Secretary prescribes for taxpayer disclosure of reportable transactions will include a written declaration that the information is being provided under penalties of perjury. Moreover, the Committee intends that the verification under penalties of perjury also will apply to any large entity that discloses that it did not enter into any reportable transactions during the tax year covered by such declaration.

Penalty rate

The penalty for failing to disclose a reportable transaction is $50,000. The amount is increased to $100,000 if the failure is with respect to a listed transaction. For large entities and high net worth individuals, the penalty amount is doubled (i.e., $100,000 for a reportable transaction and $200,000 for a listed transaction). The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded or abated only in exceptional circumstances.[10] All or part of the penalty may be rescinded only if: (1) the taxpayer on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the Commissioner personally or the head of the Office of Tax Shelter Analysis; this authority to rescind cannot otherwise be delegated by the Commissioner. Thus, the penalty cannot be rescinded by a revenue agent, an appeals officer, or other IRS personnel. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no taxpayer right to appeal a refusal to rescind a penalty.

The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

A "large entity" is defined as any entity with gross receipts in excess of $10 million in the year of the transaction or in the preceding year. A "high net worth individual" is defined as any individual whose net worth exceeds $2 million, based on the fair market value of the individual's assets and liabilities immediately before entering into the transaction.

A public entity that is required to pay a penalty for failing to disclose a listed transaction (or is subject to an accuracy-related penalty for a nondisclosed listed transaction or a nondisclosed reportable transaction with a significant tax avoidance purpose[11]) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission ("SEC") for such period as the Secretary shall specify. The provision applies without regard to whether the

[10] The Committee recognizes that the Secretary's present-law authority to postpone certain tax-related deadlines because of Presidentially-declared disasters (sec. 7508A) will also encompass the authority to postpone the reporting deadlines established by the provision.

[11] This category of transactions is described in greater detail below in connection with the provision modifying the accuracy-related penalty to tax shelters.

taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and treats any failure to disclose a transaction in such reports as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

As described above in connection with present law, current regulations under section 6011 require the disclosure of certain reportable transactions. Until such regulations are modified to reflect the new categories of reportable transactions, the penalty will apply to taxpayers who fail to timely disclose any reportable transaction under the definitions contained in the current regulations.

EFFECTIVE DATE

The provision is effective for returns and statements the due date for which is after the date of enactment.

B. MODIFICATIONS TO THE ACCURACY-RELATED PENALTIES FOR LISTED TRANSACTIONS AND REPORTABLE TRANSACTIONS HAVING A SIGNIFICANT TAX AVOIDANCE PURPOSE

(Sec. 102 of the bill and new sec. 6662A and secs. 6662 and 6664 of the Code)

PRESENT LAW

The accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[12] The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[13]

Special rules apply with respect to tax shelters.[14] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The understatement penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment

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[12] Sec. 6662.
[13] Sec. 6662(d)(2)(B).
[14] Sec. 6662(d)(2)(C).

and that the taxpayer acted in good faith.[15] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] * * * unambiguously concludes that there is a greater than 50–percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[16]

REASONS FOR CHANGE

The Committee understands that taxpayers are being advised not to disclose tax avoidance transactions on the grounds that any accuracy-related penalty that could result from an underpayment of tax on such a transaction can be avoided.[17] Because the Treasury shelter initiative emphasizes combating abusive tax avoidance transactions by requiring increased disclosure of such transactions by all parties involved, the Committee believes that taxpayers should be subject to a strict liability penalty on an understatement of tax that is attributable to non-disclosed listed transactions or non-disclosed reportable transactions that have a significant purpose of tax avoidance. Furthermore, in order to deter taxpayers from entering into tax avoidance transactions, the Committee believes that a more meaningful (but less stringent) accuracy-related penalty should apply to such transactions even when disclosed.

EXPLANATION OF PROVISION

In general

The provision modifies the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose (hereinafter referred to as a "reportable avoidance transaction").[18] The penalty rate and the taxpayer defenses available to avoid the penalty vary depending on the category of the transaction (i.e., listed or reportable avoidance transaction) and whether the transaction was adequately disclosed.

In general, a 20–percent accuracy-related penalty is imposed on any understatement attributable to a listed transaction or a reportable avoidance transaction. The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the "strengthened reasonable cause exception"), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

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[15] Sec. 6664(c).

[16] Treas. Reg. sec. 1.6662–4(g)(4)(i)(B); Treas. Reg. sec. 1.6664–4(c).

[17] See "The Treasury Department's Enforcement Proposals for Abusive Tax Avoidance Transactions," at 12 (released on March 20, 2002), reprinted electronically at 2002 TNT 55–28 (March 21, 2002).

[18] The terms "reportable transaction" and "listed transaction" have the same meanings as previously described in connection with the penalty for failing to disclose a reportable transaction.

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a no-fault penalty applies), and the taxpayer is subject to an increased penalty rate. If the understatement is attributable to an undisclosed listed transaction, the penalty rate is increased to 30 percent of the understatement. For understatements attributable to an undisclosed reportable avoidance transaction, the penalty rate is 25 percent of the understatement.

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this provision, the amount of the understatement is determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return),[19] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

Except as provided in regulations, the taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of when the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.

Strengthened reasonable cause exception

A penalty is not imposed under the provision with respect to any portion of an understatement if it is shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011,[20] (2) there is or was substantial authority for such treatment, and (3) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.

A taxpayer may (but is not required to) rely on an opinion of a tax advisor in establishing its reasonable belief with respect to the tax treatment of the item. However, a taxpayer may not rely on an opinion of a tax advisor for this purpose if the opinion (1) is pro-

[19] For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to section 1211) be allowed for such year, shall be treated as an increase in taxable income.

[20] See the previous discussion regarding the penalty for failing to disclose a reportable transaction.

vided by a "disqualified tax advisor," or (2) is a "disqualified opinion."

Disqualified tax advisor

A disqualified tax advisor is any material advisor[21] who (1) participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267 or 707) to any person who so participates, (2) is compensated by another material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, or (4) as determined under regulations prescribed by the Secretary, has a continuing financial interest with respect to the transaction.[22]

Organization, management, promotion or sale of a transaction

The Committee intends that a material advisor be considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of the transaction with any federal, state or local government body.[23] Participation in the "management" of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the "promotion or sale" of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

Disqualified opinion

An opinion may not be relied upon if the opinion (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events), (2) unreasonably relies upon representations, statements, finding or agreements of the taxpayer or any other per-

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[21] The term "material advisor" (defined below in connection with the new information filing requirements for material advisors) means any person who provides any material aid, assistance, or advice with respect to organizing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons ($250,000 in any other case).

[22] This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

[23] An advisor should not be treated as participating in the organization of a transaction if the advisor's only involvement with respect to the organization of the transaction is the rendering of an opinion regarding the tax consequences of such transaction. However, such an advisor may be a "disqualified tax advisor" with respect to the transaction if the advisor participates in the management, promotion or sale of the transaction (or if the material advisor is compensated by another material advisor, has a fee arrangement that is contingent on the tax benefits of the transaction, or as determined by the Secretary, has a continuing financial interest with respect to the transaction).

son, (3) does not identify and consider all relevant facts, or (4) fails to meet any other requirement prescribed by the Secretary.

Coordination with other penalties

Any understatement to which a penalty is imposed under this provision is not subject to the accuracy-related penalty under section 6662. However, such understatement is included for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1).

The penalty imposed under this provision shall not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

EFFECTIVE DATE

The provision is effective for taxable years ending after the date of enactment.

C. Modifications to the Substantial Understatement Penalty

(Sec. 103 of the bill and sec. 6662 of the Code)

PRESENT LAW

Definition of substantial understatement

An accuracy-related penalty equal to 20 percent applies to any substantial understatement of tax. A "substantial understatement" exists if the correct income tax liability for a taxable year exceeds that 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).[24]

Reduction of understatement for certain positions

For purposes of determining whether a substantial understatement penalty applies, the amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[25]

The Secretary is required to publish annually in the Federal Register a list of positions for which the Secretary believes there is not substantial authority and which affect a significant number of taxpayers.[26]

REASONS FOR CHANGE

The Committee believes that the present-law definition of substantial understatement allows large corporate taxpayers to avoid the accuracy-related penalty on questionable transactions of a significant size. The Committee believes that an understatement of more than $10 million is substantial in and of itself, regardless of the proportion it represents of the taxpayer's total tax liability.

[24] Sec. 6662(a) and (d)(1)(A).
[25] Sec. 6662(d)(2)(B).
[26] Sec. 6662(d)(2)(D).

The Committee believes that a higher compliance standard should be imposed on any taxpayer in order to reduce the amount of an understatement resulting from a transaction that the taxpayer did not adequately disclose. The Committee further believes that a taxpayer should not take a position on a tax return that could give rise to a substantial understatement penalty that the taxpayer does not believe is more likely than not the correct tax treatment unless this information is disclosed to the IRS.

EXPLANATION OF PROVISION

Definition of substantial understatement

The provision modifies the definition of "substantial" for corporate taxpayers. Under the provision, a corporate taxpayer has a substantial understatement if the amount of the understatement for the taxable year exceeds the lesser of (1) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or (2) $10 million.

Reduction of understatement for certain positions

The provision elevates the standard that a taxpayer must satisfy in order to reduce the amount of an understatement for undisclosed items. With respect to the treatment of an item whose facts are not adequately disclosed, a resulting understatement is reduced only if the taxpayer had a reasonable belief that the tax treatment was more likely than not the proper treatment. The provision also authorizes (but does not require) the Secretary to publish a list of positions for which it believes there is not substantial authority or there is no reasonable belief that the tax treatment is more likely than not the proper treatment (without regard to whether such positions affect a significant number of taxpayers). The list shall be published in the Federal Register or the Internal Revenue Bulletin.

EFFECTIVE DATE

The provision is effective for taxable years beginning after date of enactment.

D. TAX SHELTER EXCEPTION TO CONFIDENTIALITY PRIVILEGES RELATING TO TAXPAYER COMMUNICATIONS

(Sec. 104 of the bill and sec. 7525 of the Code)

PRESENT LAW

In general, a common law privilege of confidentiality exists for communications between an attorney and client with respect to the legal advice the attorney gives the client. The Code provides that, with respect to tax advice, the same common law protections of confidentiality that apply to a communication between a taxpayer and an attorney also apply to a communication between a taxpayer and a federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. This rule is inapplicable to communications regarding corporate tax shelters.

REASONS FOR CHANGE

The Committee believes that the rule currently applicable to corporate tax shelters should be applied to all tax shelters, regardless of whether or not the participant is a corporation.

EXPLANATION OF PROVISION

The bill modifies the rule relating to corporate tax shelters by making it applicable to all tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt entities, or any other entity. Accordingly, communications with respect to tax shelters are not subject to the confidentiality provision of the Code that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner.

EFFECTIVE DATE

The provision is effective with respect to communications made on or after the date of enactment.

E. Disclosure of Reportable Transactions by Material Advisors

(Secs. 201 and 202 of the bill and secs. 6111 and 6707 of the Code)

PRESENT LAW

Registration of tax shelter arrangements

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.[27] A "tax shelter" means any investment with respect to which the tax shelter ratio[28] for any investor as of the close of any of the first five years ending after the investment is offered for sale may be greater than two to one and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State securities agency, or (3) a substantial investment (greater than $250,000 and at least five investors).[29]

Other promoted arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of Federal income tax by a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the promoter may receive fees in excess of $100,000 in the aggregate.[30]

A transaction has a "significant purpose of avoiding or evading Federal income tax" if the transaction: (1) is the same as or substantially similar to a "listed transaction,"[31] or (2) is structured to produce tax benefits that constitute an important part of the in-

[27] Sec. 6111(a).

[28] The tax shelter ratio is, with respect to any year, the ratio that the aggregate amount of the deductions and 350 percent of the credits, which are represented to be potentially allowable to any investor, bears to the investment base (money plus basis of assets contributed) as of the close of the tax year.

[29] Sec. 6111(c).

[30] Sec. 6111(d).

[31] Temp. Treas. Reg. sec. 301.6111–2T(b)(2).

tended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.[32] Certain exceptions are provided with respect to the second category of transactions.[33]

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows, or has reason to know that a party other than the potential participant claims that the transaction (or any aspect of it) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use.[34]

Failure to register tax shelter

The penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or $500.[35] However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

Section 6707 also imposes (1) a $100 penalty on the promoter for each failure to furnish the investor with the required tax shelter identification number, and (2) a $250 penalty on the investor for each failure to include the tax shelter identification number on a return.

REASONS FOR CHANGE

The Committee has been advised that the current promoter registration rules have not proven particularly helpful, because the rules are not appropriate for the kinds of abusive transactions now prevalent, and because the limitations regarding confidential corporate arrangements have proven easy to circumvent.

The Committee believes that providing a single, clear definition regarding the types of transactions that must be disclosed by taxpayers and material advisors (as outlined in the Treasury shelter initiative), coupled with more meaningful penalties for failing to disclose such transactions, are necessary tools if the effort to curb the use of abusive tax avoidance transactions is to be effective.[36]

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[32] Temp. Treas. Reg. sec. 301.6111–2T(b)(3).

[33] Temp. Treas. Reg. sec. 301.6111–2T(b)(4).

[34] The regulations provide that the determination of whether an arrangement is offered under conditions of confidentiality is based on all the facts and circumstances surrounding the offer. If an offeree's disclosure of the structure or tax aspects of the transaction are limited in any way by an express or implied understanding or agreement with or for the benefit of a tax shelter promoter, an offer is considered made under conditions of confidentiality, whether or not such understanding or agreement is legally binding. Treas. Reg. sec. 301.6111–2T(c)(1).

[35] Sec. 6707.

[36] The Treasury Department's enforcement proposals for abusive tax avoidance transactions are described in greater detail above in connection with the penalty for failing to disclose reportable transactions (new sec. 6707A).

EXPLANATION OF PROVISION

Disclosure of reportable transactions by material advisors

The provision repeals the present law rules with respect to registration of tax shelters. Instead, the provision requires each material advisor with respect to any reportable transaction[37] to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe). The return must be filed on such date as specified by the Secretary.

The information return will include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. It is expected that the Secretary may seek from the material advisor the same type of information that the Secretary may request from a taxpayer in connection with a reportable transaction.[38]

A "material advisor" means any person (1) who provides material aid, assistance, or advice with respect to organizing, promoting, selling, implementing, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income in excess of $250,000 ($50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons) for such advice or assistance.

The Secretary may prescribe regulations which provide (1) that only one material advisor has to file an information return in cases in which two or more material advisors would otherwise be required to file information returns with respect to a particular reportable transaction, (2) exemptions from the requirements of this section, and (3) other rules as may be necessary or appropriate to carry out the purposes of this section.

Penalty for failing to furnish information regarding reportable transactions

The provision repeals the present law penalty for failure to register tax shelters. Instead, the provision imposes a penalty on any material advisor who fails to file an information return with respect to any reportable transaction, or who files a false or incomplete information return with the Secretary with respect to a reportable transaction.[39] The amount of the penalty is $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50 percent of the gross income of such person with respect to aid, assistance, or advice which is provided with respect to the reportable transaction before the date the information return that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a reportable transaction increases the penalty to 75 percent of such gross income.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded

[37] The terms "reportable transaction" and "listed transaction" have the same meaning as previously described in connection with the taxpayer-related provisions.

[38] See the previous discussion regarding the disclosure requirements under new section 6707A.

[39] The terms "reportable transaction" and "listed transaction" have the same meaning as previously described in connection with the taxpayer-related provisions.

or abated only in exceptional circumstances.[40] All or part of the penalty may be rescinded only if: (1) the material advisor on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the Commissioner personally or the head of the Office of Tax Shelter Analysis; this authority to rescind cannot otherwise be delegated by the Commissioner. Thus, the penalty cannot be rescinded by a revenue agent, an appeals officer, or other IRS personnel. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

EFFECTIVE DATE

The provision requiring disclosure of reportable transactions by material advisors applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

The provision imposing a penalty for failing to disclose reportable transactions applies to returns the due date for which is after the date of enactment.

F. INVESTOR LISTS AND APPLICABLE PENALTIES

(Secs. 201 and 203 of the bill and secs. 6112 and 6708 of the Code)

PRESENT LAW

Investor lists

A promoter must maintain (for a period of seven years) a list identifying each person who was sold an interest in any tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions).[41] Regulations under section 6112 provide that, in addition to the name, tax shelter identification number and other identifying information the promoter must include detailed information about the tax shelter (including details of the shelter and the expected tax benefits, as well as copies of any additional written material given to any participant or advisor).[42] A limited exception is provided for certain shelters if the total fees are less than $25,000 or if the expected reduction in tax liabilities for any single year is less than $1 million for corporations or

[40] The Committee recognizes that the Secretary's present-law authority to postpone certain tax-related deadlines because of Presidentially-declared disasters (sec. 7508A) will also encompass the authority to postpone the reporting deadlines established by the provision.
[41] Sec. 6112.
[42] See Temp. Treas. Reg. sec. 301.6112–1T Q&A 17.

$250,000 for non-corporate taxpayers.[43] The Secretary is required to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.[44]

Penalties for failing to maintain investor lists

Under section 6708, the penalty for failing to maintain the list required under section 6112 is $50 for each name omitted from the list (with a maximum penalty of $100,000 per year).

REASONS FOR CHANGE

The Committee has been advised that the present-law penalties for failure to maintain customer lists are not meaningful and that promoters often have refused to provide requested information to the IRS. The Committee believes that requiring material advisors to maintain a list of advisees with respect to each reportable transaction, coupled with more meaningful penalties for failing to maintain an investor list, are important tools in the ongoing efforts to curb the use of abusive tax avoidance transactions. Furthermore, these provisions are consistent with the course of action outlined in the Treasury shelter initiative.[45]

EXPLANATION OF PROVISION

Investor lists

Each material advisor[46] that is required to file an information return with respect to a reportable transaction[47] is required to maintain a list that (1) identifies each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the provision authorizes (but does not require) the Secretary to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.

Penalty for failing to maintain investor lists

The provision modifies the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a material advisor who is required to maintain an investor list and who fails to make the list available upon request by the Secretary within 20 business days after the request will be subject to a $10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty

[43] See Temp. Treas. Reg. sec. 301–6112–1T Q&A 8.
[44] Sec. 6112(c)(2).
[45] The Treasury Department's enforcement proposals for abusive tax avoidance transactions are described in greater detail above in connection with the penalty for failing to disclose reportable transactions (new sec. 6707A).
[46] The term "material advisor" has the same meaning as when used in connection with the requirement to file an information return under section 6111.
[47] The term "reportable transaction" has the same meaning as previously described in connection with the taxpayer-related provisions.

can be waived if the failure to make the list available is due to reasonable cause.[48]

EFFECTIVE DATE

The provision requiring a material advisor to maintain an investor list applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

The provision imposing a penalty for failing to maintain investor lists applies to requests made after the date of enactment.

G. Actions To Enjoin Conduct With Respect to Tax Shelters

(Sec. 204 of the bill and sec. 7408 of the Code)

PRESENT LAW

The Code authorizes civil action to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.[49]

REASONS FOR CHANGE

The Committee understands that some promoters are blatantly ignoring the rules regarding registration and list maintenance regardless of the penalties. An injunction would place these promoters in a public proceeding under court order. Thus, the Committee believes that the types of tax shelter activities with respect to which an injunction may be sought should be expanded.

EXPLANATION OF PROVISION

The bill expands this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of tax shelters[50] and the keeping of lists of investors by material advisors.[51] Thus, under the provision, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction.

EFFECTIVE EATE

The provision is effective on the day after the date of enactment.

H. Understatement of Taxpayer's Liability by Income Tax Return Preparer

(Sec. 211 of the bill and sec. 6694 of the Code)

PRESENT LAW

An income tax return preparer who prepares a return with respect to which there is an understatement of tax that is due to a

[48] In no event will failure to maintain a list be considered reasonable cause for failing to make a list available to the Secretary.
[49] Sec. 7408.
[50] Sec. 6707, as amended by other provisions of this bill.
[51] Sec. 6708, as amended by other provisions of this bill.

position for which there was not a realistic possibility of being sustained on its merits and the position was not disclosed (or was frivolous) is liable for a penalty of $250, provided that the preparer knew or reasonably should have known of the position. An income tax return preparer who prepares a return and engages in specified willful or reckless conduct with respect to preparing such a return is liable for a penalty of $1,000.

REASONS FOR CHANGE

The Committee believes that the standards of conduct applicable to income tax return preparers should be the same as the standards applicable to taxpayers. Accordingly, the minimum standard for each undisclosed position on a tax return would be that the preparer must reasonably believe that the tax treatment is more likely than not the proper tax treatment. The Committee believes that this standard is appropriate because the tax return is signed under penalties of perjury, which implies a high standard of diligence in determining the facts and substantial accuracy in determining and applying the rules that govern those facts. The Committee believes that it is both appropriate and vital to the tax system that both taxpayers and their return preparers file tax returns that they reasonably believe are more likely than not correct. In addition, conforming the standards of conduct applicable to income tax return preparers to the standards applicable to taxpayers will simplify the law by reducing confusion inherent in different standards applying to the same behavior.

EXPLANATION OF PROVISION

The bill alters the standards of conduct that must be met to avoid imposition of the first penalty. The bill replaces the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. The bill also replaces the not frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position.

In addition, the bill increases the amount of these penalties. The penalty relating to not having a reasonable belief that the tax treatment was more likely than not the proper tax treatment is increased from $250 to $1,000. The penalty relating to willful or reckless conduct is increased from $1,000 to $5,000.

EFFECTIVE DATE

The provision is effective for documents prepared after the date of enactment.

I. PENALTY ON FAILURE TO REPORT INTERESTS IN FOREIGN FINANCIAL ACCOUNTS

(Sec. 212 of the bill and sec. 5321 of Title 31, United States Code)

PRESENT LAW

The Secretary of the Treasury must require citizens, residents, or persons doing business in the United States to keep records and file reports when that person makes a transaction or maintains an account with a foreign financial entity.[52] In general, individuals must fulfill this requirement by answering questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B of the IRS Form 1040. Taxpayers who answer "yes" in response to the question regarding foreign accounts must then file Treasury Department Form TD F 90–22.1. This form must be filed with the Department of the Treasury, and not as part of the tax return that is filed with the IRS.

The Secretary of the Treasury may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of $100,000; the minimum amount of the penalty is $25,000.[53] In addition, any person who willfully violates this reporting requirement is subject to a criminal penalty. The criminal penalty is a fine of not more than $250,000 or imprisonment for not more than five years (or both); if the violation is part of a pattern of illegal activity, the maximum amount of the fine is increased to $500,000 and the maximum length of imprisonment is increased to 10 years.[54]

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.[55] This report, which was statutorily required,[56] studies methods for improving compliance with these reporting requirements. It makes several administrative recommendations, but no legislative recommendations. A further report is required to be submitted by the Secretary of the Treasury to the Congress by October 26, 2002.

REASONS FOR CHANGE

The Committee understands that the number of individuals involved in using offshore bank accounts to engage in abusive tax scams has grown significantly in recent years. For one scheme alone, the IRS estimates that there may be one to two million taxpayers with offshore bank accounts attempting to conceal income from the IRS. The Committee is concerned about this activity and believes that improving compliance with this reporting requirement is vitally important to sound tax administration, to combating terrorism, and to preventing the use of abusive tax schemes and scams. Adding a new civil penalty that applies without regard to willfulness will improve compliance with this reporting requirement.

EXPLANATION OF PROVISION

The bill adds an additional civil penalty that may be imposed on any person who violates this reporting requirement (without regard to willfulness). This new civil penalty is up to $5,000. The penalty may be waived if any income from the account was properly reported on the income tax return and there was reasonable cause for the failure to report.

[52] 31 U.S.C. 5314.
[53] 31 U.S.C. 5321(a)(5).
[54] 31 U.S.C. 5322.
[55] A Report to Congress in Accordance with Sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, April 26,2002.
[56] Sec. 361(b) of the USA PATRIOT Act of 2001 (Pub. L. 107–56).

EFFECTIVE DATE

The provision is effective with respect to failures to report occurring on or after the date of enactment.

J. FRIVOLOUS TAX RETURNS AND SUBMISSIONS

(Sec. 213 of the bill and sec. 6702 of the Code)

PRESENT LAW

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of $500 imposed by the IRS (sec. 6702). The Code also permits the Tax Court[57] to impose a penalty of up to $25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless (sec. 6673(a)).

REASONS FOR CHANGE

The IRS has been faced with a significant number of tax filers who are filing returns based on frivolous arguments or who are seeking to hinder tax administration by filing returns that are patently incorrect. In addition, taxpayers are using existing procedures for collection due process hearings, offers-in-compromise, installment agreements, and taxpayer assistance orders to impede or delay tax administration by raising frivolous arguments. These procedures were intended to provide assistance to taxpayers genuinely seeking to resolve legitimate disputes with the IRS, and the use of these procedures for impeding or delaying tax administration diverts scarce IRS resources away from resolving genuine disputes. Allowing the IRS to assert more substantial penalties for frivolous submissions and to dismiss frivolous requests without the need to follow otherwise mandated procedures will deter frivolous taxpayer behavior and enable the IRS to use its resources to better assist taxpayers in resolving genuine disputes.

EXPLANATION OF PROVISION

The bill modifies the IRS-imposed penalty by increasing the amount of the penalty to up to $5,000 and by applying it to all taxpayers and to all types of Federal taxes.

The provision also modifies present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration. The submissions to which this provision applies are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the provision permits the IRS to dismiss such requests. Second, the provision permits the IRS to impose a penalty of up to $5,000 for such requests, unless the taxpayer withdraws the request after being given an opportunity to do so.

The provision requires the IRS to publish a list of positions, arguments, requests, and proposals determined to be frivolous for purposes of these provisions.

[57] Because in general the Tax Court is the only pre-payment forum available to taxpayers, it deals with most of the frivolous, groundless, or dilatory arguments raised in tax cases.

EFFECTIVE DATE

The provision is effective for submissions made and issues raised after the date on which the Secretary first prescribes the required list.

K. Regulation of Individuals Practicing Before the Department of the Treasury

(Sec. 214 of the bill and sec. 330 of Title 31, United States Code)

PRESENT LAW

The Secretary of the Treasury is authorized to regulate the practice of representatives of persons before the Department of the Treasury.[58] The Secretary is also authorized to suspend or disbar from practice before the Department a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented). The rules promulgated by the Secretary pursuant to this provision are contained in Circular 230.

REASONS FOR CHANGE

The Committee believes that it is critical that the Secretary have the authority to censure tax advisors as well as to impose monetary sanctions against tax advisors because of the important role of tax advisors in our tax system. Use of these sanctions is expected to curb the participation of tax advisors in both tax shelter activity and any other activity that is contrary to Circular 230 standards.

EXPLANATION OF PROVISION

The bill makes two modifications to expand the sanctions that the Secretary may impose pursuant to these statutory provisions. First, the bill expressly permits censure as a sanction. Second, the bill permits the imposition of a monetary penalty as a sanction. If the representative is acting on behalf of an employer or other entity, the Secretary may impose a monetary penalty on the employer or other entity if it knew, or reasonably should have known, of the conduct. This monetary penalty on the employer or other entity may be imposed in addition to any monetary penalty imposed directly on the representative. These monetary penalties are not to exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. These monetary penalties may be in addition to, or in lieu of, any suspension, disbarment, or censure.

The bill also confirms the present-law authority of the Secretary to impose standards applicable to written advice with respect to an entity, plan, or arrangement that is of a type that the Secretary determines as having a potential for tax avoidance or evasion.

[58] 31 U.S.C. 330.

EFFECTIVE DATE

The modifications to expand the sanctions that the Secretary may impose are effective for actions taken after the date of enactment.

L. Penalties on Promoters of Tax Shelters

(Sec. 215 of the bill and sec. 6700 of the Code)

PRESENT LAW

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.[59] A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A "gross valuation overstatement" means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

The amount of the penalty is $1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity). A penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

REASONS FOR CHANGE

The Committee believes that the present-law penalty rate is insufficient to deter the type of conduct that gives rise to the penalty.

EXPLANATION OF PROVISION

The provision modifies the penalty amount to equal 50 percent of the gross income derived by the person from the activity for which the penalty is imposed. The new penalty rate applies to any activity that involves a statement regarding the tax benefits of participating in a plan or arrangement if the person knows or has reason to know that such statement is false or fraudulent as to any material matter. The enhanced penalty does not apply to a gross valuation overstatement.

EFFECTIVE DATE

The provision is effective for activities after the date of enactment.

[59] Sec. 6700.

III. OTHER PROVISIONS

A. AFFIRMATION OF CONSOLIDATED RETURN REGULATION AUTHORITY

(Sec. 301 of the bill and sec. 1502 of the Code)

PRESENT LAW

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. A condition of electing to file a consolidated return is that all corporations that are members of the consolidated group must consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for filing such return.[60]

Section 1502 states:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent the avoidance of such tax liability.[61]

Under this authority, the Treasury Department has issued extensive consolidated return regulations.[62]

In the recent case of *Rite Aid Corp.* v. *United States,*[63] the Federal Circuit Court of Appeals addressed the application of a particular provision of certain consolidated return loss disallowance regulations, and concluded that the provision was invalid.[64] The

[60] Sec. 1501.

[61] Sec. 1502.

[62] Regulations issued under the authority of section 1502 are considered to be "legislative" regulations rather than "interpretative" regulations, and as such are usually given greater deference by courts in case of a taxpayer challenge to such a regulation. See, S. Rep. No. 960, 70th Cong., 1st Sess. at 15, describing the consolidated return regulations as "legislative in character". The Supreme Court has stated that "* * * legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Chevron, U.S.A., Inc.* v. *Natural Resources Defense Council, Inc.,* 467 U.S. 837, 844 (1984) (involving an environmental protection regulation). For examples involving consolidated return regulations, see, e.g., *Wolter Construction Company* v. *Commissioner,* 634 F.2d 1029 (6th Cir. 1980); *Garvey, Inc.* v. *United States,* 1 Ct. Cl. 108 (1983), aff'd 726 F.2d 1569 (Fed. Cir. 1984), cert. denied 469 U.S. 823 (1984). Compare, e.g., *Audrey J. Walton* v. *Commissioner,* 115 T.C. 589 (2000), describing different standards of review. The case did not involve a consolidated return regulation.

[63] 255 F.3d 1357 (Fed. Cir. 2001), reh'g denied, 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001).

[64] Prior to this decision, there had been a few instances involving prior laws in which certain consolidated return regulations were held to be invalid. See, e.g., *American Standard, Inc.* v. *United States,* 602 F.2d 256 (Ct. Cl. 1979), discussed in the text infra. see also *Union Carbide Corp.* v. *United States,* 612 F.2d 558 (Ct. Cl. 1979), and *Allied Corporation* v. *United States,* 685 F.2d 396 (Ct. Cl. 1982), all three cases involving the allocation of income and loss within a consolidated group for purposes of computation of a deduction allowed under prior law by the Code for Western Hemisphere Trading Corporations. See also *Joseph Weidenhoff* v. *Commissioner,* 32 T.C. 1222, 1242–1244 (1959), involving the application of certain regulations to the excess profits tax credit allowed under prior law, and concluding that the Commissioner had applied a particular regulation in an arbitrary manner inconsistent with the wording of the regulation and inconsistent with even a consolidated group computation. Cf. *Kanawha Gas & Utilities Co.* v. *Commissioner,* 214 F.2d 685 (1954), concluding that the substance of a transaction was an acquisition of assets rather than stock. Thus, a regulation governing basis of the assets of consolidated subsidiaries did not apply to the case. See also *General Machinery Corporation*

particular provision, known as the "duplicated loss" provision,[65] would have denied a loss on the sale of stock of a subsidiary by a parent corporation that had filed a consolidated return with the subsidiary, to the extent the subsidiary corporation had assets that had a built-in loss, or had a net operating loss, that could be recognized or used later.[66]

The Federal Circuit Court opinion contained language discussing the fact that the regulation produced a result different than the result that would have obtained if the corporations had filed separate returns rather than consolidated returns.[67]

The Federal Circuit Court opinion cited a 1928 Senate Finance Committee Report to legislation that authorized consolidated return regulations, which stated that "many difficult and complicated problems, * * * have arisen in the administration of the provisions permitting the filing of consolidated returns" and that the committee "found it necessary to delegate power to the commissioner to prescribe regulations legislative in character covering them."[68] The Court's opinion also cited a previous decision of the Court of Claims for the proposition, interpreting this legislative history, that section 1502 grants the Secretary "the power to conform the applicable income tax law of the Code to the special, myriad problems resulting from the filing of consolidated income tax returns;" but that section 1502 "does not authorize the Secretary to choose a

v. *Commissioner,* 33 B.T.A. 1215 (1936); *Lefcourt Realty Corporation,* 31 B.T.A. 978 (1935); *Helvering* v. *Morgans,* Inc., 293 U.S. 121 (1934), interpreting the term "taxable year."

[65] Treas. Reg. Sec. 1.1502–20(c)(1)(iii).

[66] Treasury Regulation section 1.1502–20, generally imposing certain "loss disallowance" rules on the disposition of subsidiary stock, contained other limitations besides the "duplicated loss" rule that could limit the loss available to the group on a disposition of a subsidiary's stock. Treasury Regulation section 1.1502–20 as a whole was promulgated in connection with regulations issued under section 337(d), principally in connection with the so-called *General Utilities* repeal of 1986 (referring to the case of *General Utilities & Operating Company* v. *Helvering,* 296 U.S. 200 (1935)). Such repeal generally required a liquidating corporation, or a corporation acquired in a stock acquisition treated as a sale of assets, to pay corporate level tax on the excess of the value of its assets over the basis. Treasury regulation section 1.1502–20 principally reflected an attempt to prevent corporations filing consolidated returns from offsetting income with a loss on the sale of subsidiary stock. Such a loss could result from the unique upward adjustment of a subsidiary's stock basis required under the consolidated return regulations for subsidiary income earned in consolidation, an adjustment intended to prevent taxation of both the subsidiary and the parent on the same income or gain. As one example, absent a denial of certain losses on a sale of subsidiary stock, a consolidated group could obtain a loss deduction with respect to subsidiary stock, the basis of which originally reflected the subsidiary's value at the time of the purchase of the stock, and that had then been adjusted upward on recognition of any built-in income or gain of the subsidiary reflected in that value. The regulations also contained the duplicated loss factor addressed by the court in Rite Aid. The preamble to the regulations stated: "it is not administratively feasible to differentiate between loss attributable to built-in gain and duplicated loss." T.D. 8364, 1991–2 C.B. 43, 46 (Sept. 13, 1991). The government also argued in the *Rite Aid* case that duplicated loss was a separate concern of the regulations. 255 F.3d at 1360.

[67] For example, the court stated: "The duplicated loss factor * * * addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165." 255 F.3d 1357, 1360 (Fed. Cir. 2001).

[68] S. Rep. No. 960, 70th Cong., 1st Sess. 15 (1928). Though not quoted by the court in *Rite Aid*, the same Senate report also indicated that one purpose of the consolidated return authority was to permit treatment of the separate corporations as if they were a single unit, stating "The mere fact that by legal fiction several corporations owned by the same shareholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit." S. Rep. No. 960, 70th Cong., 1st Sess. 29 (1928).

to choose a method that imposes a tax on income that would not otherwise be taxed."[69]

The Federal Circuit Court construed these authorities and applied them to invalidate Treas. Reg. Sec. 1.1502–20(c)(1)(iii), stating that:

> The loss realized on the sale of a former subsidiary's assets after the consolidated group sells the subsidiary's stock is not a problem resulting from the filing of consolidated income tax returns. The scenario also arises where a corporate shareholder sells the stock of a non-consolidated subsidiary. The corporate shareholder could realize a loss under I.R.C. sec. 1001, and deduct the loss under I.R.C. sec. 165. The subsidiary could then deduct any losses from a later sale of assets. The duplicated loss factor, therefore, addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165.[70]

The Treasury Department has announced that it will not continue to litigate the validity of the duplicated loss provision of the regulations, and has issued interim regulations that permit taxpayers for all years to elect a different treatment, though they may apply the provision for the past if they wish.[71]

REASONS FOR CHANGE

The Committee is concerned that the language and analysis in the Rite Aid decision might lead taxpayers to attempt to challenge other Treasury consolidated return regulations that prescribe a tax result different from the result that would occur if separate returns were filed.

The Committee is concerned that any such challenges may lead to protracted litigation and commitment of Internal Revenue Service resources to defending the consolidated return provisions.

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[69] *American Standard, Inc.* v. *United States*, 602 F.2d 256, 261 (Ct. Cl. 1979). That case did not involve the question of separate returns as compared to a single return approach. It involved the computation of a Western Hemisphere Trade Corporation ("WHTC") deduction under prior law (which deduction would have been computed as a percentage of each WHTC's taxable income if the corporations had filed separate returns), in a case where a consolidated group included several WHTCs as well as other corporations. The question was how to apportion income and losses of the admittedly consolidated WHTCs and how to combine that computation with the rest of the group's consolidated income or losses. The court noted that the new, changed regulations approach varied from the approach taken to a similar problem involving public utilities within a group and previously allowed for WHTCs. The court objected that the allocation method adopted by the regulation allowed non-WHTC losses to reduce WHTC income. However, the court did not disallow a method that would net WHTC income of one WHTC with losses of another WHTC, a result that would not have occurred under separate returns. Nor did the court expressly disallow a different fractional method that would net both income and losses of the WHTCs with those of other corporations in the consolidated group. The court also found that the regulation had been adopted without proper notice.

[70] *Rite Aid*, 255 F.3d at 1360.

[71] See Temp. Reg. 1.1502–20T(i)(2). The Treasury Department has also indicated its intention to continue to study all the issues that the original loss disallowance regulations addressed (including issues of furthering single entity principles) and possibly issue different regulations (not including the particular approach of Treas. Reg. Sec. 1.1502–20(c)(1)(iii)) on the issues in the future. See Notice 2002–11, 2002–7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (March 12, 2002); REG–102740–02, 67 F.R. 11070 (March 12, 2002); see also Notice 2002–18, 2002–12 I.R.B. 644 (March 25, 2002).

The Committee wishes to clarify that the fact that a result under the consolidated return regulations differs from the result under separate returns does not provide a basis to challenge a Treasury consolidated return regulation.

The Committee believes that the result of the case with respect to the type of factual situation in *Rite Aid,* involving the "duplicated loss factor" portion of Treasury Regulation section 1.1502–20, which Treasury has announced that taxpayers need not follow, should not be overturned. Therefore, the committee legislatively allows the specific result of the case to stand for the taxpayer in *Rite Aid* or any similarly situated taxpayers.

Apart from that specific result, the Committee disagrees with the reasoning of the case and believes it should not be applied to support any challenge to other consolidated return regulations. The Committee also wishes to reaffirm the broad authority of the Treasury Department to issue consolidated return regulations.

EXPLANATION OF PROVISION

The provision confirms that, in exercising its authority under section 1502 to issue consolidated return regulations, the Treasury Department may provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

Thus, under the statutory authority of section 1502, the Treasury Department is authorized to issue consolidated return regulations utilizing either a single taxpayer or separate taxpayer approach or a combination of the two approaches, as Treasury deems necessary in order that the tax liability of any affiliated group of corporations making a consolidated return, and of each corporation in the group, both during and after the period of affiliation, may be determined and adjusted in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such liability.

Rite Aid is thus overruled to the extent it suggests that there is not a problem that can be addressed in consolidated return regulations if application of a particular Code provision on a separate taxpayer basis would produce a result different from single taxpayer principles that may be used for consolidation.

The provision nevertheless allows the result of the *Rite Aid* case to stand with respect to the type of factual situation presented in the case. That is, the legislation provides for the override of the regulatory provision that took the approach of denying a loss on a deconsolidating disposition of stock of a consolidated subsidiary [72] to the extent the subsidiary had net operating losses or built in losses that could be used later outside the group.[73]

Retaining the result in the *Rite Aid* case with respect to the particular regulation section 1.1502–20(c)(1)(iii) as applied to the factual situation of the case does not in any way prevent or invalidate the various approaches Treasury has announced it will apply or that it intends to consider in lieu of the approach of that regulation, including, for example, the denial of a loss on a stock sale if

[72] Treas. Reg. Sec. 1.1502–20(c)(1)(iii).

[73] The Committee does not intend to overrule the current Treasury Department regulations, which allow taxpayers for the past to follow Treasury Regulations Section 1.1502–20(c)(1)(iii), if they choose to do so. Temp. Reg. Sec. 1.1502–20T(i)(2).

inside losses of a subsidiary may also be used by the consolidated group, and the possible requirement that inside attributes be adjusted when a subsidiary leaves a group.[74]

EFFECTIVE DATE

The provision is effective for all years, whether beginning before, on, or after the date of enactment of the provision.

No inference is intended that the results following from this provision are not the same as the results under present law.

IV. BUDGET EFFECTS OF THE BILL

A. COMMITTEE ESTIMATES

In compliance with paragraph 11(a) of rule XXVI of the Standing Rules of the Senate, the following statement is made concerning the estimated budget effects of the committee amendment to the bill as reported.

[74] See, e.g., Notice 2002–11, 2002–7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (Mar. 12, 2002); REG–102740–02, 67 F.R. 11070 (Mar. 12, 2002); see also Notice 2002–18, 2002–12 I.R.B. 644 (Mar. 25, 2002). In exercising its authority under section 1502, the Secretary is also authorized to prescribe rules that protect the purpose of *General Utilities* repeal using presumptions and other simplifying conventions.

ESTIMATED REVENUE EFFECTS OF S. 2498, THE ''TAX SHELTER TRANSPARENCY ACT,'' AS REPORTED BY THE COMMITTEE ON FINANCE

[Fiscal years 2002–2012, in millions of dollars]

Provision	Effective	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2002–07	2002–12
1. Provisions relating to reportable transactions and tax shelters (sections 101, 102, 104, 201 through 203, and 215) [1].	various dates after DOE [2]	16	55	98	121	124	124	127	132	139	148	160	540	1,247
2. Modification to the substantial understatement penalty (section 103) [1]	tyba DOE	....	....	....	8	11	19	23	26	30	34	38	38	188
3. Actions to enjoin conduct with respect to tax shelters (section 204)	DOE	Negligible Revenue Effect												
4. Understatement of taxpayer's liability by income tax return preparer (section 211)	dpa DOE	Negligible Revenue Effect												
5. Impose a civil penalty (of up to $5,000) on failure to report interest in foreign financial accounts (section 212).	DOE	([3])	([3])	([3])	([3])	([3])	([3])	([3])	([3])	([3])	([3])	([3])	1	3
6. Frivolous tax submissions (section 213)	DOE ([4])	....	3	3	3	3	3	3	3	3	3	3	15	30
7. Regulation of individuals practicing before the Department of Treasury (section 214)	ata DOE	No Revenue Effect												
8. Affirmation of consolidated return regulation authority (section 301)	([5])	Negligible Revenue Effect												
Net Total	....	16	58	101	132	138	146	153	161	172	185	201	594	1,468

Legend for ''Effective'' column: ata=actions taken after; DOE=date of enactment; dpa=documents prepared after; tyba=taxable years beginning after.

[1] Failure or substantial delay of forthcoming regulations for section 6011 of the Internal Revenue Code and other administrative actions to be taken by the Treasury Department or the Internal Revenue Service would reduce the estimated revenue effects of these provisions.

[2] Effective dates for provisions relating to reportable transactions and tax shelters: section 101 is effective for returns and statements the due date of which is after the date of enactment; section 102 is effective for taxable years ending after the date of enactment; section 104 is effective for communications made on or after the date of enactment; section 201 is effective for transactions with respect to which material aid, assistance or advice is provided after the date of enactment; section 202 is effective for returns the due date for which is after the date of enactment; section 203 is effective for requests made after the date of enactment; and section 215 is effective for activities after the date of enactment.

[3] Gain of less than $1 million.

[4] Effective for submissions made and issues raised after the first list is prescribed under section 6702(c).

[5] Effective for all taxable years, whether beginning before, with, or after the date of enactment.

Note.—Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.

B. Budget Authority and Tax Expenditures

Budget authority

In compliance with section 308(a)(1) of the Budget Act, the Committee states that the revenue provisions of the committee amendment to the bill as reported involve no new or increased budget authority.

Tax expenditures

In compliance with section 308(a)(2) of the Budget Act, the Committee states that there are no revenue-reducing provisions in the committee amendment to the bill, and the revenue-increasing provisions of the committee amendment to the bill involve reduced expenditures (see revenue table in Part IV.A., above).

C. Consultation With Congressional Budget Office

In accordance with section 403 of the Budget Act, the Committee advises that the Congressional Budget Office ("CBO") has not submitted a statement on the bill. The letter from CBO was not received in a timely manner, and therefore will be provided separately.

V. VOTES OF THE COMMITTEE

In compliance with paragraph 7(b) of rule XXVI of the Standing Rules of the Senate, the following statements are made concerning the votes taken on the Committee's consideration of the amendment to the bill.

Motion to report the committee amendment

The amendment to the bill was ordered favorably reported by a voice vote, a quorum being present, on June 18, 2002.

Votes on other amendments

An amendment by Senator Baucus in a Chairman's modification to the bill adding the provision regarding the affirmation of the consolidated return regulation authority was agreed to by voice vote.

VI. REGULATORY IMPACT AND OTHER MATTERS

A. Regulatory Impact

Pursuant to paragraph 11(b) of rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of the bill as amended.

Impact on individuals and businesses

With respect to individuals and businesses, the bill modifies the rules relating to (1) the disclosure of reportable transactions and tax shelters; (2) the substantial understatement penalty; (3) actions to enjoin conduct with respect to tax shelters; (4) an understatement of a taxpayer's liability by an income tax return preparer; (5) the imposition of a civil penalty (of up to $5,000) on a failure to report interest in foreign financial accounts; and (6) frivolous tax submissions. The provisions relate to taxpayers that engage in certain tax avoidance transactions. The provisions do not impose increased regulatory burdens on individuals or businesses.

Impact on personal privacy and paperwork

The provisions of the bill do not impact personal privacy. The provisions relate to taxpayers that engage in certain tax avoidance transactions. The bill does not impose increased paperwork burdens on individuals. Individuals who elect to engage in these types of transactions, and certain advisors that provide material aid, assistance or advice with respect to these transactions, may in some cases need to file certain disclosure statements with the IRS.

B. Unfunded Mandates Statement

The information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995 (P.L. 104–4).

The Committee has determined that the following provisions of the bill contain Federal mandates on the private sector: (1) provisions relating to reportable transactions and tax shelters; (2) modifications to the substantial understatement penalty; (3) actions to enjoin conduct with respect to tax shelters; (4) understatement of taxpayer's liability by an income tax return preparer; (5) the imposition of a civil penalty (of up to $5,000) on a failure to report interest in foreign financial accounts; and (6) frivolous tax submissions.

The costs required to comply with each Federal private sector mandate generally are no greater than the estimated budget effect of the provision. Benefits from the provisions include improved administration of the Federal income tax laws and a more accurate measurement of income for Federal income tax purposes.

C. Tax Complexity Analysis

Section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998 (the "IRS Reform Act") requires the Joint Committee on Taxation (in consultation with the Internal Revenue Service and the Department of the Treasury) to provide a tax complexity analysis. The complexity analysis is required for all legislation reported by the Senate Committee on Finance, the House Committee on Ways and Means, or any committee on conference if the legislation includes a provision that directly or indirectly amends the Code and has widespread applicability to individuals or small businesses.

The staff of the Joint Committee on Taxation has determined that a complexity analysis is not required under section 4022(b) of the IRS Reform Act because the bill contains no provisions that amend the Code and that have "widespread applicability" to individuals or small businesses.

VII. CHANGES IN EXISTING LAW MADE BY THE BILL AS REPORTED

In the opinion of the Committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill as reported by the Committee).

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