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CORPORATE TAX SHELTERS: LOOKING UNDER THE ROOF

HEARING

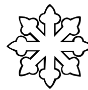
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

MARCH 21, 2002



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CORPORATE TAX SHELTERS: LOOKING UNDER THE ROOF

THURSDAY, MARCH 21, 2002

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

The hearing was convened, pursuant to notice, at 10:15 a.m., in room 215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Also present: Senators Graham, Grassley, and Thomas.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

Today we will consider corporate tax shelters. I imagine that as long as there have been taxes, there have also been shelters. But there is a difference, because today we are seeing increasingly complex transactions that take tax shelters to a new and disturbing level.

Each day, the newspapers run stories about various tax-motivated transactions designed to cut corporate tax bills. We have read press reports about Enron setting up hundreds of offshore entities, about Global Crossing incorporating overseas to escape U.S. tax.

Recently, we have even learned that some prominent U.S. companies are literally re-incorporating offshore tax havens in order to avoid U.S. taxes. They are, in effect, renouncing their U.S. citizenship to cut their taxes.

A partner in one of the firms marketing these so-called "inversion deals" admitted that some companies may be concerned that it is unpatriotic to abandon their U.S. corporate citizenship, but she went on to say that some companies are coming to the conclusion that "the improvement on earnings is powerful enough that maybe the patriotism issue needs to take a back seat."

You heard that right: "Maybe the patriotism issue needs to take a back seat." Obviously, very troubling, especially now as we all try to pull together, most particularly since September 11, as a Nation and work together to help our people meet the problems that we are facing.

These tax shelters could do serious harm. They clearly undermine public confidence in the tax system. They make average taxpayers feel like chumps; we have to pay more because the big guys are paying less.

And there is another important point: tax shelters are bad for the economy. Professor Michael Gretz once defined a tax shelter as a "deal done by very smart people that, absent tax considerations, would be very stupid."

Here is why. Abusive corporate shelters create a tax benefit without any corresponding economic benefit. No new product, no technological innovation, just a tax break. This could have a perverse effect, forcing perfectly honest companies to consider setting up a shelter of their own to avoid being placed at a competitive disadvantage. That, in a nutshell, is the problem.

With all modesty, I can say that this committee, the Finance Committee, has been working hard to try to find a solution. May of the year 2000, under the leadership of Senators Roth and Moynihan, the committee first issued draft legislation to limit aggressive tax shelters.

Since then, Senator Grassley and I have issued two further drafts which respond to comments from the Treasury and the public. We issued the most recent draft in August.

For a time, I must say the Treasury Department was also hard at work on the tax shelter problem. Secretary Summers called it our most significant tax compliance problem. I vividly remember him saying that.

But I was disappointed that, initially, the new administration did not seem to share that concern. Well, my view is, better late than never. Recently, Treasury Secretary O'Neill announced that the administration will aggressively address the issue and is working on both administrative and legislative proposals to curtail abusive tax shelters.

This is a good step in the right direction. Yesterday's more detailed announcement was another. I commend the Secretary and I hope that our witnesses will provide further insights.

With that background, let me turn to the details of today's hearing. We will hear from three distinguished American witnesses: the Assistant Secretary of Tax Policy, Mark Weinberger; IRS Chief Counsel, B. John Williams; IRS Commissioner of Large and Mid-Sized Businesses, Mr. Larry Langdon; and we also welcome Ms. Pam Olson, who will be called upon to explain some of the Treasury's proposals.

I have three general questions. First, what is the nature of these tax shelters? That is, what are they? How do they operate? What about the effect of recent court decisions? And, with some emphasis, what do we do about corporate inversions?

Second, what do we do about all of this? A few years ago, some people said we should wait for the new disclosure regulations to take effect. Now we are getting data on the operation of the regulations and it appears that compliance with the regulations are, to put it bluntly, a joke. What does Treasury propose, both administratively and legislatively?

Third, how can we work together? We clearly need some solutions. How can we cooperate to write meaningful and effective legislation this year?

With respect to tax shelters, my hope is that with the administration's cooperation we can refine various proposals and quickly develop anti-shelter legislation. I also think we should consider leg-

islation to put a brake on the potential rush to move U.S. corporate headquarters to tax havens through corporate inversions.

I understand that the corporate inversion question is complex. I also understand that over the long term we may need to consider whether the structure of U.S. international tax rules creates an incentive for U.S. corporations to shift their operations abroad in order to remain competitive.

But, in addition to the long term, we also have to think of the short term. At the same time that we study this issue, we may need to limit companies' abilities to engage in these transactions. Otherwise, we will be giving an advantage to the companies that decide that "maybe the patriotism issue needs to take a back seat."

One final point. The April 15 tax filing deadline is approaching. Most Americans will be sitting down at their kitchen tables or at their home computer trying to figure out their taxes. They will grumble a little bit. We all think taxes are too high. We all think the forms and calculations are too complex.

But, by and large, with quiet patriotism, average Americans will step up and pay their fair share. They are counting on us to make sure that sophisticated corporations also pay their fair share on April 15.*

To begin the hearing, I see no other Senators here, although I understand Senator Grassley is coming very quickly.

So, let me begin with you, Mr. Secretary. I would like to hear your views on this subject. All of your statements will automatically be included in the record. But I would just urge you to be candid, get to the heart of the matter, and go for it.

STATEMENT OF HON. MARK WEINBERGER, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF TREASURY, WASHINGTON, DC

Mr. WEINBERGER. Thank you, Mr. Chairman.

If I can, I would ask that my written testimony be included in the record.

The CHAIRMAN. It will be.

Mr. WEINBERGER. I have prepared oral testimony to outline our proposals and to address some of the questions that you have articulated. So, if I could read that, I would appreciate it.

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

Mr. WEINBERGER. Mr. Chairman, thank you for inviting the Treasury Department to testify today on the important issue of abusive tax avoidance transactions.

We appreciate the role that your committee has taken in considering these matters. Through your statements and the release of your staff's draft legislative proposals, along with those of Senator Grassley, you have taken a lead in the public discussion about how to address abusive tax avoidance transactions.

As I said in my confirmation hearing before this committee and in several speeches since, the administration will seriously examine

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*For more information, *see also*, "Background and Present Law Relating to Tax Shelters," Joint Committee on Taxation staff report, March 19, 2002 (JCX–19–02).

the issue of abusive tax avoidance transactions and how best to step up enforcement against them.

I asked for time to review the results of the first filing season of the new rules put in place in 2000. I appreciate the committee providing us that time. Making decisions based on evidence is always preferable.

The results are in. We have now received and reviewed the first year of filings and disclosures. We are disappointed in the number and types of transactions that have been disclosed. Accordingly, we are proposing significant regulatory and legislative changes to enhance enforcement of the law.

The vast majority of taxpayers and practitioners do their best to comply with the letter and spirit of the law. Some, however, are actively promoting or engaging in abusive tax avoidance transactions.

Abusive tax avoidance transactions are not structured for business reasons, but instead are transactions structured to take advantage of a complex Tax Code to obtain benefits that Congress did not intend.

The ability of taxpayers to engage in these types of transactions is one more reason why our complex tax system must be reevaluated and simplified so the opportunities for abusive tax practices that currently exist are eliminated.

All taxpayers have a stake in the government's success in establishing rules that assist in identifying and addressing these transactions. These transactions must be curbed because they violate Congress' intent, harm the public FISC, and erode the public sense of fairness. To address this problem, the system must include clear rules, more transparency, and stiffer penalties.

Transparency, that is, ensuring that questionable transactions are disclosed and subject to IRS scrutiny, is critical to the government's ability to identify and immediately address abusive tax avoidance practices.

Clear rules mandating transparency and vigorous enforcement are essential to curbing these transactions. Treasury believes that the existing enforcement regime must be expanded and enhanced to ensure that there is transparency.

This means more than just new rules. It means more action. In my written testimony, I have outlined several steps Treasury and the IRS have taken to intensify enforcement efforts against promoters of abusive tax practices.

As you know, Treasury and the IRS are proposing significant regulatory and legislative changes. Our proposals include administrative actions we are undertaking, as well as legislative proposals. They are similar in many respects to the proposals considered by your staffs in the draft legislation they have prepared.

The purpose of the proposals is to change the risk-reward analysis for taxpayers who would enter into questionable transactions and play the audit lottery to avoid paying their fair share of taxes.

We are simplifying disclosure rules to eliminate gray areas that have been used to avoid disclosure and in imposing new penalties on promoters and taxpayers for failure to disclose.

Simply put, if a taxpayer is comfortable entering into a transaction, a promoter is comfortable selling it, and an advisor is com-

fortable blessing it, they all should be comfortable disclosing it to the IRS.

Let me highlight just some of the administrative actions that Treasury and the IRS are undertaking to strengthen and improve the disclosure rules.

Treasury will expand and unify the definition of a reportable transaction for return disclosure, registration, and list maintenance. Currently, taxpayers are reading the disclosure requirements too narrowly and exceptions too broadly.

The new disclosure requirements will remove subjectivity and provide a clear, understandable set of criteria. The single definition will allow the IRS to move quickly from a taxpayer's disclosure to a promoter list of investors to other taxpayers who engaged in the same or similar reportable transactions. This will create a web that deters abusive tax avoidance transactions by increasing the certainty of IRS detection.

Treasury will expand the list of who must disclose questionable transactions to include partnerships, S corporations, trusts, and high-income individuals. Treasury will centralize the receipt and review of all disclosures in the Office of Tax Shelter Analysis.

This will give the IRS an early-warning mechanism to identify potentially abusive transactions. It also facilitates the process of identifying potentially abusive transactions, allowing the IRS to evaluate and quickly act.

Treasury and the IRS will clarify the definition of a listed transaction. Requiring disclosure of any transaction that relies on the same or similar strategies as a listed transaction will cut down on manipulation and will improve disclosure.

Treasury and the IRS will impose strict liability penalties on taxes owed if the taxpayer fails to disclose certain reportable transactions and the taxpayer substantially understates his or her tax liability. Taxpayers who fail to disclose will no longer be able to hide behind a tax opinion to escape an understatement penalty.

A strict liability on taxes owed will apply to taxpayers who fail to disclose the listed transaction, even if the understatement of tax is not substantial, as defined in the Tax Code.

Treasury will broaden the range of persons who are required to register reportable transactions and maintain lists beyond traditional definitions of promoters.

Finally, Treasury will provide a consistent form for return disclosures. A standard form will ensure that all relevant information is provided to the IRS in a manner that allows them to quickly identify, evaluate, and act on information.

Of course, Mr. Chairman, we also need your help. We urge Congress to enact legislation that will impose new penalties and enhance existing penalties for taxpayers' or promoters' failure to comply with the enhanced rules. Several of these proposals reflect those in your proposed draft legislation.

We are seeking legislation that penalties be imposed on the failure to disclose reportable transactions. The penalties can go as high as $200,000, plus 5 percent of any underpayments. Without penalties, taxpayers have less incentive to disclose. No penalties currently exist.

Moreover, Treasury proposes requiring corporate taxpayers to disclose to shareholders any penalties for failing to disclose listed transactions for any penalties resulting from an understatement of tax liability due to an undisclosed listed transaction. This should prove a significant deterrent.

Treasury proposes expanding and increasing the penalty on promoters for failure to register reportable transactions. The penalty will go up to the greater of 50 percent of fees, or $200,000. This is a significant penalty.

Treasury proposes increasing the penalty for failure to turn over investor lists in a timely fashion. The penalty would be $10,000 per day past 20 business days. Legislation is necessary to encourage promoters to respond more quickly to IRS requests.

Treasury proposes permitting injunctions against promoters who repeatedly refuse to turn over invester lists to the Internal Revenue Service.

Treasury proposes imposing a penalty for failure to report an interest in a foreign financial account. A civil penalty is necessary because many taxpayers are failing to comply with the rules and regulations requiring the reporting of information on foreign bank and financial accounts.

Treasury proposes increasing the penalty for frivolous tax returns in our budget from $500 to $5,000.

In addition to these important procedural legislative proposals, Treasury is today also asking for two substantive law changes. Treasury proposes curbing improper use of foreign tax credits.

To prevent taxpayers from improperly obtaining these credits, Treasury will seek legislation that will amend Section 901(k) of the Code to cover income streams—other than dividends—that are subject to foreign withholding taxes.

Finally, Treasury proposes curbing abusive income separation transactions. To prevent these income separation transactions, we would ask Congress to work with us to draft legislation.

In conclusion, Treasury and the IRS are committed to combatting abusive tax avoidance transactions. While the vast majority of taxpayers and their advisors attempt to comply with the letter and spirit of the law, the complexity of the current Code provides too many opportunities for some taxpayers to participate in transactions that generate tax benefits never intended by Congress.

The best way to eliminate these practices is to simplify the tax law and improve transparency so the questionable transactions are disclosed and subject to review. Treasury has set forth a number of administrative and legislative proposals to accomplish these goals.

Thank you again, Mr. Chairman, for the opportunity to speak today. We certainly look forward to working with you, the other members of this committee, and your staffs. I will be happy to answer any questions.

The CHAIRMAN. Thank you, Mr. Secretary.

Mr. Williams, please.

STATEMENT OF HON. B. JOHN WILLIAMS, CHIEF COUNSEL, INTERNAL REVENUE SERVICE, WASHINGTON, DC

Mr. WILLIAMS. Thank you, Mr. Chairman. I appreciate the opportunity to speak before the committee today about corporate tax shelters. The issue is a high priority in the Office of Chief Counsel, as well as at the Internal Revenue Service and Treasury Department.

I would like to speak today about some of the problems we face in dealing with these transactions and about the measures that the Office of Chief Counsel plans to take to address the problems.

I understand, Mr. Chairman, that my written statement will be included in the record?

The CHAIRMAN. It will be.

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

Mr. WILLIAMS. Thank you. I will just briefly summarize some of the highlights for the committee.

At my confirmation hearing in November, I made two points which you urged me to follow up on. One, the IRS must use available tools more effectively to gather information and to increase compliance. Second, the IRS must use the information in a more effective and timely manner.

As the Office of Chief Counsel brings its resources to bear on the tax shelter issue, the measures that we are taking will reflect this dual objective.

The committee also requested subsequent to that hearing a report detailing the IRS's current approach to the tax shelter problem in any proposals to improve compliance and enforcement in this area.

At the time last November, I committed to provide that report by March 31, 2002. With the delay in my confirmation, however, and given the nature and scope of the request, I find it is necessary to ask for an extension.

I hope that the committee would consider my testimony today an interim report. I will follow that up with a formal written report no later than May 31, if that is all right.

The CHAIRMAN. I look forward to it. That would be good. Thank you.

Mr. WILLIAMS. Thank you, Mr. Chairman.

I believe there are three major issues faced by the IRS in dealing with tax shelters. First, determining whether certain transactions are abusive is a difficult call and does not lend itself to simple answers.

Second, the IRS is falling behind the marketplace in identifying and addressing abusive transactions. Finally, the disclosure, registration, and list maintenance requirements have produced limited results.I am pleased to report to you that the IRS, the Office of Chief Counsel, and the Treasury Department are taking steps to address them.

Perhaps the most important and difficult issue is the question of what constitutes an abusive transaction. Some transactions are indisputably abusive. These tax shelters are based on misstatements of law or outright fraud. They are shams—in fact. The government's response to them requires no complex policy calls.

The tax shelters that we are discussing today, however, are sophisticated transactions based on technical arguments and it is less clear when they are truly abusive.

Some transactions may be technically sound and are therefore not necessarily abusive, even though the government may not like them. Shutting them down may require a change in law, either by amending regulations or by new legislation.

Other transactions take advantage of ambiguities or gaps in the tax law or they interpret current law in a manner not previously contemplated by the government.

These transactions often may seem to work on their face, but they lack economic reality or do not adhere to longstanding tax principles. These latter transactions are abusive.

The facts and circumstances of specific transactions must be examined to distinguish apparently technically sound transactions from the abusive ones that do not work under current law. It is a very resource-intensive undertaking.

This committee's work over the past couple of years has shown that it is not easy to define the difference between legitimate tax planning and abusive transactions that do not work under current law.

While not easy to define, transactions that are abusive can be recognized if spotted. For this reason, the best tool we have in dealing with them is early identification.

There are two ways to identify these transactions. First, the IRS may identify transactions through the examination process. Second, taxpayers and promoters are required to disclose or register questionable transactions.

Identifying questionable transactions early could permit the IRS to gather information and issue guidance, in some cases before the transactions even show up on tax returns.

Notifying the public of the IRS's position with respect to current transactions, coupled with a vigorous enforcement of the disclosure registration and list maintenance requirements, should discourage taxpayers from playing the audit lottery and participating in abusive transactions.

Although early identification is critical to stemming the tide of abusive transactions, the IRS has had difficulties identifying and responding to these transactions in a timely manner. Too often, the IRS is behind in the marketplace and the current effectiveness of the registration and disclosure requirements is questionable.

One major conclusion I have reached is that the IRS must rely principally on disclosure and registration to gain any chance of addressing questionable transactions early. Current disclosure and registration rules are complicated and need to be simplified and harmonized.

There are two measures that I would like to highlight in particular that I believe will improve the IRS's ability to address questionable transactions as they are discovered.

These are, number one, tax shelter task forces that will improve internal coordination and accelerate the issuance of public guidance responding to questionable transactions. Two, enforcement of the rules requiring taxpayer disclosure and promoter registration of questionable transactions and the production of investor lists.

To address a problem of internal delay, the Office of Chief Counsel and the Large and Mid-Size Business Division have agreed to implement transaction-specific task forces.

The task forces would be formed for specific transactions or a group of transactions and would include attorneys from the Operating Divisions of Chief Counsel, attorneys from the Technical Divisions of Chief Counsel, the Department of Treasury, and the Office of Tax Shelter Analysis.

In addition, revenue agents would be designated to assist each task force. The use of such task forces should allow us to distinguish between sound and problematical transactions, determine the kind of guidance necessary, and permit both follow-up on the transaction and prompt issuance of public guidance.

Decisions on whether to issue a notice alerting taxpayers that the IRS will challenge a transaction will be made jointly and early. The hope is that we will become aware of the transactions even before they are reported on a tax return and be able to get public guidance out in a way that is timely prior to the time the returns are filed.

The task forces will also achieve consistency through the system, coordinating the Office of Chief Counsel on the technical side in the national office, its field attorneys, and on the Commissioner's side, the revenue agents and appeals officers.

Furthermore, cross-checking of issues identified in the field with disclosure and registration becomes easier. This means a higher likelihood that taxpayers who have invested in questionable transactions will be identified and subject to examination.

We believe that the IRS must respond more quickly to the transactions. As you, Mr. Chairman, recognized in your luncheon speech before the Tax Executives Institute, delays mean that more taxpayers enter into those transactions and we think that is not good for the system or the public.

While abusive transactions will be challenged upon audit even where they have not yet been addressed by public guidance, informing the public that we are aware of such transactions will, in my view, encourage disclosure and should often discourage participation in those transactions.

Showing that we are aware of transactions currently in the market, and who has invested in them, should also reduce taxpayers' incentive to play the audit lottery.

Our commitment to serving the public demands that we announce early our views on new transactions that do not work and our views on those that do.

Because our Federal tax system is based on self-assessment, the IRS has a responsibility to assist taxpayers in determining what works and what does not.

The current level of published guidance is unacceptable to the Commissioner, to me, to Assistant Secretary Weinberger, and to the public.

The Office of Tax Policy and the Office of Chief Counsel are committed to early and joint policy review to increase the level of published guidance.

We are currently exercising our authority under the Internal Revenue Code to examine the nature and degree of compliance

with the current registration and disclosure rules. As Assistant Secretary Weinberger mentioned, our preliminary view is that they are not being complied with.

The IRS is gathering this information through the use of information document requests and summonses to promoters. I have personally committed to the Commissioner and to the Division Commissioners, including Commissioner Langdon, whatever support is necessary to pursue these matters.

Under this authority, the IRS has requested information from 30 promoters thus far to determine whether they have complied with the registration list maintenance requirements. Commissioner Langdon will have more to say on that subject.

Our attempts to remain current with the market, however, are hampered by their failure to cooperate. Many of the letters requesting this information were issued over 18 months ago, and some promoters have yet to provide us with information.

Specifically on these current matters, I have instructed chief counsel attorneys to issue summonses for the information we have requested and to pursue vigorous enforcement.

In that connection, we have coordinated with the Department of Justice to make sure that we can get quick enforcement, if necessary. Hopefully, it will not come to that.

Twenty-three summonses have already been issued as of yesterday, including 21 summonses issued on Tuesday, to one promoter, and more are likely to follow.

Once the information is gathered, we will be prepared, given the task forces that I have assembled, to act quickly upon the information to see if further investigation or public guidance is warranted.

We are presently seeking legislation in the proposals that Secretary Weinberger highlighted that would allow the government to seek injunctive relief against promoters who repeatedly disregard the registration and the list maintenance requirements.

Some promoters, I believe, are blatantly ignoring the rules and might continue to do so regardless of penalties. An injunction, however, would place a promoter, in a public proceeding, under a court order to comply with the rules.

Failure to comply with the rules would then place the promoter in contempt of court. I believe that even the threat of such an injunction and the associated publicity would be enough to end noncompliance, maybe even to forestall it.

In conclusion, Mr. Chairman, the Office of Chief Counsel is committed to supporting the IRS in its efforts to address tax shelters and to gain currency with respect to transactions that are occurring in the marketplace. We will assist in identifying and analyzing transactions to determine whether published guidance or legislative changes are needed.

When needed, we will provide published guidance in a timely manner. We will help the IRS gather the information if it needs to determine whether promoters and taxpayers are in compliance with disclosure registration and list maintenance requirements, and we will work with the IRS in processing the information it receives. This commitment, I believe, should help resolve the issues faced by the IRS in dealing with tax shelters.

Thank you, Mr. Chairman, for giving me this opportunity.

The CHAIRMAN. Thank you very much. Thank you, Mr. Williams. Mr. Langdon?

STATEMENT OF LARRY LANGDON, COMMISSIONER OF LARGE AND MEDIUM BUSINESS DIVISION, INTERNAL REVENUE SERVICE, WASHINGTON, DC; ACCOMPANIED BY PAM OLSON, ASSISTANT SECRETARY FOR TAX POLICY

Mr. LANGDON. Thank you, Mr. Chairman, for the opportunity to address this matter. I do have the extended remarks that hopefully will be part of the record.

The CHAIRMAN. It will be.

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

Mr. LANGDON. Mr. Chairman and distinguished members of the committee, thank you for the opportunity to testify with regard to the IRS programs and actions to address the proliferation of abusive tax avoidance transactions. These transactions undermine voluntary compliance and threaten the fairness of our tax administration system.

The IRS's Large and Mid-Sized Business Division has made curbing abusive tax avoidance transactions a top priority. We have put in place a structure and organization to implement our strategy and plans. However, our task is extremely challenging and may require new tools to identify and halt their growth.

These transactions are designed and promoted by sophisticated tax professionals and used by both corporations and very wealthy individuals to reduce their taxes. They are crafted to exploit technical loopholes to obtain substantial and unintended tax benefits.

These transactions pose an enormous challenge for the IRS. They are very difficult to find on tax returns. Large corporations have complex, voluminous returns and the only clue to one may be buried deep in the return.

If a corporation or wealthy individual makes a concerted effort to hide an abusive tax avoidance transaction, even an experienced IRS examiner may not find it.

To complicate the issue further, these transactions are factually complex. They may involve multiple entries created solely for the purpose of investing in a shelter, as well as complex financial derivatives. Because taxpayers may not provide or have all of the relevant documents, we may have to seek information from third parties.

Abusive tax avoidance transactions are also legally complex, as has been pointed out by Mr. Williams. Promoters carefully scrutinize the tax laws to find loopholes and then design complex transactions to exploit them, and, Mr. Chairman, they always come with the blessing of a tax opinion.

For an investor, the tax opinion legitimizes the transaction, purporting to allow an investor to claim a reasonable belief that the tax benefit, no matter how outrageous, was legally justified.

Although corporations already have a disclosure requirement, many are parsing words, narrowly construing the disclosure rules and broadly construing exceptions. Taxpayers must adequately and properly disclose complex tax-motivated transactions.

In this regard, we believe the Treasury recommendations will provide another important tool that could greatly assist our efforts. With proper disclosure, we can conserve both taxpayers and our resources.

With clear and adequate voluntary disclosure by taxpayers, our audits may be more focused. We will be in a better position to more quickly and effectively perform the audits, and the system will become more transparent, requiring all taxpayers to fully disclose.

Mr. Chairman, disclosure is the key to shutting down tax shelters. With disclosure, we can aggressively pursue promoters and investors in these schemes. Equally important, with disclosure we can assess the propriety of a transaction, publish guidance, and quickly tell the public our position on a transaction.

Timely notices have been our most cost-effective tool in stopping these transactions. Mr. Chairman, disclosure makes a difference.

We look forward to working with you and members of the committee on this issue that is critical to the fairness of our tax administrative system. Thank you. I would be happy to answer any questions that you may have.

The CHAIRMAN. Well, thank you very much, Mr. Langdon.

We are joined by the Ranking Member of the committee, Senator Grassley, whom I think wishes to make a statement.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. If I could, I would appreciate it very much.

First of all, I really appreciate you, Mr. Chairman, holding this hearing. It is something that you and I were working on last year in the short period of time I was chairman. When you took over as chairman, we put out some principles on this issue last year. So, I thank you very much for following through on this.

You and I are following through on some things that Senator Roth and Senator Moynihan started as well. So, it seems to me that we have been involved with this, and it is has been a concern of this committee, for a long time.

I believe now we are ready to move to do something. Our staff has produced this discussion draft that I have referred to already. Our staff has taken comments from affected parties, and we have refined the draft several times.

It seems to me we have been fairly methodical in our approach. It seems that we have had a policy-driven approach. I think that this stands in contrast to unsuccessful attempts to politicize this issue by some.

In addition, this committee, working together with Treasury and our counterparts on Ways and Means, have shut down shelters on a case-by-case basis, which really is not the best way to do it, but is better than not responding at all. In the recent stimulus bill, we recently overturned a shelter known as the “Gitlitz case.”

I am critical of tax shelters for a couple of reasons. Probably more than that, but let me highlight. Foremost, though, is my feeling that all taxpayers should be operating under the same set of rules. This means that a family-owned feed store in my home county of Butler County, Iowa should be playing by the same playing

field as Compaq. Shelters are attempts to manipulate the tax system to the benefit of sophisticated corporations.

To the extent that this manipulation is successful, others like the feed store people pick up the slack. That seems to be the unfairness of all of this. That is not an unfairness that I have to prove.

That is an unfairness that you will understand very quickly when you go to the coffee shops. And I do not want to say just rural America, but I know more about rural America coffee shops than urban coffee shops.

But, either place, I do not think it is going to meet the test that a coffee shop would have, or the test of a 30-second commercial that sometimes we have to either explain things and cannot, or we have to respond to and sometimes cannot. There is the old 30-second commercial rule, that if you cannot explain it in 30 seconds, maybe you are wrong.

This deals with our problems of defining tax shelters. It is a very real problem for the people that are before us. It is a little bit like the Supreme Court defining pornography. As you know, one famous judge said something about, it may be difficult to define, but you know it when you see it.

Perhaps the most illuminating definition of a shelter comes from the street, as I have tried to indicate. It is a bad deal done by a lot of smart people who would not do it but for the tax benefits.

So, part of our job, Mr. Chairman, is to get a better handle on the specifics of these deals. We need to end the cat-and-mouse games between shelter peddlers and the IRS. That means disclosure must be enhanced.

To me, it is simple. If somebody goes to the great extent of giving a justification for a tax shelter and getting a written opinion on whether it is all right or not all right, if it is all right for company X it ought to be all right for my feed store operator.

Maybe he cannot take advantage of it, but he ought to at least know about it. I do not know how you are going to have the Tax Code fairly administered on a level playing field for everybody if there is some sort of secret.

Now, I know there is a certain amount of intellectual property involved in all of these people that think up these tax shelters and market them. But we are talking about how it affects the Tax Code and the amount of taxes people pay.

I am not going to sit around and respect anybody's right to have something if it affects somebody paying lower taxes, then somebody else is going to pick up the bill. So, that is why disclosure is so important.

Having said that, we need to be clear and not provide the IRS with tools that allow revenue agents to overreach. A taxpayer engaging in a legitimate business transaction should have safe harbor. It seems to me that we need to couple the safe harbor with disclosure, and that is what the Finance Committee product does. By the same token, we should make it clear that those who want to continue to play cat-and-mouse will face serious penalties.

So, that is our first principle, bring some transparency to these transactions, sunshine being a disinfectant. Transparency will enable the IRS, Treasury and policy makers on the Hill to get a better handle on what is going on in the marketplace. It will also

make clear to peddlers and others that there are consequences when games are played.

Another principle, is to reform the use of tax shelter opinions. Currently, taxpayers may rely on tax shelter peddlers' opinions as a defense against tax-related penalties. This is a bit like asking the fox in the white house whether the hens are in fact safe when he or she is around.

Under our Finance Committee proposal, taxpayers may rely on an opinion, but the opinion must be written by an independent professional tax advisor.

The third principle, is to make sure that all players in the tax shelter game are in the same net. We should not focus only on professionals like accountants or lawyers, but pick up investment bankers and promoters as well.

The Finance Committee proposal carries out this objective by beefing up the disclosure system. Specifically, the proposal puts teeth in the penalties for those who skirt their current laws' disclosure responsibilities.

Finally, Mr. Chairman, our Finance Committee proposal empowers the administration to modernize professional standards for those who practice before the IRS. Unfortunately, professional standards for some practitioners have been dumbed down when it comes to shelter transactions. That is an issue that has to change. If it does not change, these practitioners should face penalties.

I am pleased that the administration has now presented their testimony and the direction that they want to take on the shelter problem. I look forward to working with them, as well as with our Chairman, on bipartisan reform.

In finishing, I would like to note that we are proceeding on a separate track on corporate expatriation problems. These transactions, also known as inversions, involve the use of nominal corporate status in tax haven countries.

The most famous, obviously, recently in the news, Ingersoll-Rand, Stanley Toolworks. From what I have seen of these deals, they look like shams. I have also heard that there may be an effort to race these deals to market before Congress cracks down.

Let me be clear to everyone developing or contemplating one of these deals: you should proceed at your own peril. Let me repeat. Anyone thinking about rushing into an inversion transaction proceeds at their own peril.

Mr. Chairman, I am pleased to report that our staffs have been working together on this problem and expect that we will be producing legislation on this matter expeditiously. Mr. Chairman, I am pleased that we are proceeding in this bipartisan manner.

The CHAIRMAN. Thank you very much, Senator Grassley, for that statement. I deeply appreciate your hard work and your outrage against abusive shelters. I mean, this is clearly a problem that has to be addressed.

As you know, you and I are going to be introducing legislation jointly after the recess on both shelters and inversions to try to solve the problem, and to solve it this year. I believe it is very important that we act this year to do all we possibly can.

Let me start with you, Mr. Weinberger, on just a basic question. You, without being critical of your earlier positions, have sort of changed your view a little bit on this question.

It was not too long ago, I think, that you appeared before this committee in March, 1999, where you argued against the earlier administration's tax shelter proposals, saying they were unnecessary, and so on, and so forth.

But yet, in your more recent testimony here today, you are suggesting we probably need some changes. I am just curious. Is that because of what you have seen or what you have experienced? What explains the almost 180 degree change in view in how we address shelters?

Mr. WEINBERGER. Well, Mr. Chairman, it is not actually a 180 point of view change. As I said when I testified before this committee and during my confirmation, what I asked for was some time to review the first filing season of new rules that were put in place in 2000 to see what, if any, legislation would be needed. That was my position before I came here as well, that legislation might be premature.

Now that we have the filing season behind us, I think that it clearly demonstrates some problems, although well-intentioned, with the previous rules. They were extremely subjective and vague, and there were significant penalties that were contemplated in legislation based upon those vague standards.

In my view, that does not create the right environment to enforce the law, which is very important. Taxpayers not only have to have the right laws, but if they are not enforceable, they are not understood by taxpayers, and they cannot be applied by the IRS, they are not going to be effective.

The CHAIRMAN. Right.

Mr. WEINBERGER. So what we have done in our proposal, Mr. Chairman, and with the benefit of seeing the filings that have come in and seeing the types of transactions, is to provide for much clearer, specific rules that taxpayers can easily understand whether they fall in or out of.

When you have rules like that on whether or not you have to disclose a transaction and you know by looking at the letters of the law and the letters of the rules whether or not you should, in that situation, if taxpayers decide they do not want to disclose, they should be subject to penalties.

The CHAIRMAN. Right.

Mr. WEINBERGER. Under this regime, which is different than the last set of proposals that we were looking at, I think it is an appropriate set of actions that we have proposed.

The CHAIRMAN. The information I have, with respect to the year 2000 corporate returns, that the Service received 272 disclosures from 99 different taxpayers, and 64 involved listed transactions, 208 involved reportable transactions.

How many corporate taxpayers are there?

Mr. WEINBERGER. I do not know the answer to that, but there are hundreds of thousands.

Mr. LANGDON. There are 149,000 taxpayers that are subject to the jurisdiction of LMSB, of whom 60 percent are corporations. That ignores the small business taxpayers which have more than

$10 million in assets, and they tend not to participate in this sort of problem.

The CHAIRMAN. Alright, but what is the number of corporate taxpayers that presumably could, and might, if they were reported properly, have listed transactions as well as reportable transactions?

Mr. LANGDON. Probably 100,000 corporate taxpayers, which would include the large taxpayers and the so-called middle market taxpayers.

The CHAIRMAN. Alright, and the data shows that there were 272 disclosures, 99 from different taxpayers, 64 were listed, and 208 reportable. Does that sound right? To me it sounds like a lot of people did not disclose.

Mr. WEINBERGER. Well, Mr. Chairman, obviously, as you have heard from all of our testimonies, we were disappointed. We think a lot of our disappointment resulted from ambiguities in the rules.

While well-intentioned, you had the trigger two of five criteria to come within the requirements of filing. Then, once you triggered those, there were three very subjective exceptions to the rules that you could rely on to get out of having to disclose.

I think a lot of taxpayers were reading the rules broadly for the exceptions, narrowly for the requirements, so they, maybe correctly or maybe incorrectly, assumed they didn't need to file.

The CHAIRMAN. Right. I understand.

Now, is there as much ambiguity with respect to the 11 listed?

Mr. WEINBERGER. There actually is ambiguity.

The CHAIRMAN. As much ambiguity, I asked.

Mr. WEINBERGER. There is not as much ambiguity with respect to the listed transactions. We actually try and identify the specific transaction. We put it on a list.

But there is a provision that also says if you have a transaction that is similar to a listed transaction you are supposed to also register, and there is some ambiguity about what is similar, which we try to clarify in our proposals as well.

The CHAIRMAN. I am just curious. Why is not there not sort of a default, sort of a conservative default? I mean, if there is a question here, list it, instead of, if there is a question, do not list it?

Mr. WEINBERGER. Well, certainly our proposals aim to try and change the risk-reward ratio for people making those calculations, and we do it by, again, making it very clear and then imposing penalties if they do not follow the very clear rules.

The CHAIRMAN. Now, if I can ask my colleagues' slight indulgence here. When the box is marked "Listed" or "Transaction Reportable," what does the IRS do about that? Does it automatically audit that return, look at that return?

Mr. LANGDON. Yes. In fact, that is the role of our Office of Tax Shelter Analysis. In effect, what we do is basically review what is submitted and then, with advice of counsel, determine what should be our strategy.

If it is an unlisted transaction, obviously it needs to be further analyzed before we take action. Then we move it to the field and give the field team the following resources.

One, a technical advisor with regard to understanding what the technical aspects of the issue are; second, a specialist, as needed,

and who should be the contact in Chief Counsel's Office so, in effect, we can pursue the thing to resolution.

The CHAIRMAN. Alright. Are inversions reportable or listed?

Mr. LANGDON. They are not a listed transaction.

The CHAIRMAN. Or reportable?

Mr. WEINBERGER. Mr. Chairman, inversion transactions are public transactions that require shareholder vote, so there is not a problem with disclosure. You basically know when one of these transactions occurs.

The CHAIRMAN. Does that mean the Service knows of all inversions?

Mr. LANGDON. Yes. The challenge in that regard, frankly, is one of valuation, because typically what is involved is a transfer of technology or other assets offshore, which is typically taxable. Then determining the amount of the taxable is, frankly, the challenge.

The CHAIRMAN. Alright. I have taken too much of my time here. We will get into some of this a little later.

Senator Graham?

Senator GRAHAM. Thank you, Mr. Chairman. Thank you for holding this very important hearing.

Staying on the topic of offshore, about a year ago, representatives of the Treasury were taking a position that the United States should withdraw from the international effort, largely at that time involving the United States and European countries, to try to establish some stronger international controls over offshore tax haven/financial service-providing areas.

What is our current position relative to participation with our European allies in trying to tighten down on those offshore locations?

Mr. WEINBERGER. Thank you, Senator Graham, for asking the question. It is obviously an issue that has been very important to this Administration. We strongly believe—and this goes along the lines of our whole list of proposals—that transparency is very important.

We need to get the information from foreign countries about what our U.S. taxpayers are doing on a criminal and civil tax basis so that we can enforce our laws. Likewise, other countries need to get that information.

We have been pursuing that on two different levels. We have bilaterally reached the first agreements for tax information exchange in over a decade, since 1992, with low-tax-jurisdiction offshore financial centers: the Cayman Islands, the Bahamas, Antigua, and Bermuda. We reached agreements within the past 12 months. We have several more we hope to announce shortly.

This is a marked step, because our agreements allow us to override their bank secrecy laws and basically get the information we need. The project, Senator Graham, that you are referring to is the OECD project, which has a similar motive of trying to bring a number of countries together to come up with a model agreement. Then, those countries could enter into bilateral agreements about exchange of information. That model agreement basically mirrors the agreement that we have bilaterally reached with these other countries.

When we came into office, there were about 35 or so countries who had not agreed to sign up to enter into these types of information exchanges. The Secretary made it a priority, in a Senate hearing with Senator Levin, to commit to work both outside and inside the OECD to focus that project and get these agreements.

Since that time, we, working with other countries, have refocused the project solely on the issue you raised, which is to have greater transparency and get information exchange.

As a result, since the project has been refocused, 19 additional companies have signed up to exchange information, or intend to exchange information under these types of agreements.

The actual deadline was the end of February for getting these countries to sign up. They have not announced the list of final countries that have not officially signed up.

There are about a dozen that have as yet not signed up out of the 35 originally, but there was great expectation that more of those countries will sign up in the short term, so they are waiting on the deadline until we actually get that information. It has really turned into quite a success.

Senator GRAHAM. There was a concept which was novel to many of us that was announced concurrent with this discussion of how strongly we would react to offshore tax shelters.

The concept got the name "economic liberty," which many people interpreted as meaning that it was all right to use the most creative means, including offshore shelters, to avoid not only tax responsibility, but, indirectly, other legal obligations such as not to engage in money laundering.

What is the current attitude of the Treasury towards the concept of economic liberty?

Mr. WEINBERGER. Well, certainly, Senator, I think you know, especially in light of recent circumstances of 9/11, that the Treasury Department has stepped up quite dramatically its desire to go after a whole web of financial information.

Money laundering has always been a priority, but it has expanded into the web of financial terrorism as well. In addition, you are absolutely right. We firmly believe that if there are transactions going on that are otherwise hidden, like bank secrecy laws or laws like that, we have to have the ability to be able to pierce that and actually get the information so we can enforce our laws. That is the aim of these agreements.

Senator GRAHAM. So the Statue of Liberty does not stand for economic liberty any more.

Mr. WEINBERGER. I am sorry. I do not understand.

Senator GRAHAM. Well, the impression you got a year ago was that it was, give us your huddled masses yearning to be free of tax obligations and the ability to be able to manipulate money, for whatever purposes; that it is an inappropriate activity of government either on a unilateral basis, but particularly when governments work together to accomplish that to do so. That is in violation of this concept of economic liberty.

My question is, did I misstate what I thought was being said a year ago? If not, is that no longer the position of the Treasury?

Mr. WEINBERGER. I have never heard it stated as one of economic liberty or Statute of Liberty, so I apologize. But to be clear, I know

this Administration has always said, obviously, we want to be able to get the information necessary to enforce our laws.

Yes, we have to respect civil liberties of individuals and not be overly intrusive by casting a wide net trying to get any information we can or by sharing it with whomever might want it.

But these agreements that have been reached in the OECD model agreement, which is adopted after ours, have the appropriate balance of getting this information to enforce our laws and we are committed to that.

Senator GRAHAM. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Thomas?

Senator THOMAS. Thank you, Mr. Chairman.

I have not been as involved in this as my friends here, so I guess I would be less in detail and a little more basic.

How would you define a tax shelter?

Mr. WEINBERGER. You do not see us all jumping to the microphone to answer that one. [Laughter.] That is not an easy question. We have actually, if you have noticed—at least I have—tried to avoid the term, because it is undefinable.

At the beginning of my testimony, I said we were looking at abusive tax avoidance transactions. How I define those, Senator, are transactions where individuals try to work with the existing complicated Tax Code and use the rules within the Code to reach conclusions about the tax treatment of a transaction that are inconsistent with the Congressional intent. They may or may not be illegal.

There is tax evasion, where people just commit fraud. Basically, that is a separate issue. There are also situations where a transaction might actually work under the current rules. Those are a second category. Then there is a third category where, based on judicial doctrines, it is unclear if it works in the law and taxpayers take a very aggressive position. You have to evaluate those transactions.

As a result of the difficulty in defining it, what we have basically emphasized in our package of administrative items and we want to work with Congress on in legislative items, is to get the appropriate information about these transactions so we can make those evaluations.

Senator THOMAS. So all of the things that the Congress occasionally puts into the Tax Code which would allow certain people to have tax relief, you do not call those tax shelters. Tax shelters are all illegal then. Is that it?

Mr. WEINBERGER. No, I do not think that is true. Again, a tax shelter is hard to define. For example, I do not know if some people refer to the inversion transaction as a tax shelter or if an offshore partnership is a tax shelter. Those are clearly legal transactions that individuals can use with certain deductions and other techniques to lower their income, which is totally legitimate.

Senator THOMAS. I, of course, over-simplified. I would like to see a much simpler Tax Code. We have a whole industry apparently taking advantage of loopholes and so on.

Do you think our Tax Code, as complicated as it is, is part of the problem?

Mr. WILLIAMS. I personally believe it is, Senator. We are a country of rules and laws, and we expect people to adhere to them. But, when you get a system of laws in place that is so complicated, it becomes a little brittle.

Senator THOMAS. Yes. Are we spending as much time trying to find a simpler, more enforceable Code or to deal with the thing we have even though you might say it is not as workable as it should be?

Mr. WILLIAMS. I think we are very much interested in any effort to simplify, and that effort is ongoing. Of course, as long as the law is as it is, we have to deal with it.

Senator THOMAS. I understand. But you do have, I think, an opportunity and some responsibility, to suggest changes in the Code.

Mr. WEINBERGER. Senator, you are absolutely right. My boss, Secretary O'Neill, has been very outspoken about the complexity of the Code, calling it an abomination.

Senator THOMAS. I noticed that.

Mr. WEINBERGER. Yes. We all have. He is very committed to simplification. We will be proposing, and we announced in our budget, several simplification initiatives that we want to work with Congress to try and resolve.

Obviously, simplification sounds good and easy, but it is always hard to do. But we take that very seriously.

Senator THOMAS. I understand. I understand. And every time there is a problem in the world, the Congress comes up with some sort of a tax remedy for it, which I am tending not to agree with.

But, in any event, would you say, generally, that the abusive tax shelters are more prominent now than they were 10 years ago?

Mr. WILLIAMS. Senator, I was at the IRS 20 years ago. At that point, the shelter problem was enormous. When I was later appointed to the bench, there were 88,000 cases pending, most of which were tax shelters. Largely through changes in the law that this Congress passed, that wave has disappeared. What we are experiencing in its place is not, at this point, the volume of cases so much as the complexity of them.

Senator THOMAS. Well, I have taken my time. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Grassley?

Senator GRASSLEY. I went downstairs to ask questions of the FBI. That is why I was not here for everything.

Senator THOMAS. Did they ask you any, sir? [Laughter.] No, I am sorry.

Senator GRASSLEY. No. But I suppose, if they are mad at me, they will. [Laughter.]

Senator GRASSLEY. I would like to ask Treasury to address my concerns about U.S. companies that create fictional headquarters and tax havens in order to escape U.S. taxes. I think the bottom line of what I am talking about are fiscal headquarters that seem to be no more than a folder in a filing cabinet at corporate headquarters.

I have no problem, I want to make clear, with U.S. companies operating in low-tax jurisdictions, but they should only do that for legitimate business purposes. Companies from other countries obvi-

ously do this, and U.S. companies are going to have to be able to have a level playing field on the basis of legitimate business purposes in international markets.

However, there is, in my judgment, quite a world of difference between a U.S. company operating in low-tax countries for a valid business reason, and on the other hand a phony tax haven headquarter.

On one level, it might not be anything new. For years we have had U.S. insurance companies fleeing to Bermuda to eliminate U.S. taxes on their investments, and in the process gaining a huge advantage over U.S.-based insurers. I know that, starting in the previous administration, Treasury has not done anything to stop this from happening.

Then we have bigger deals now that I think we need to even be more concerned about. Recent propositions like this could not be done if it were not for two things. One of them, is that we are in a 2-year recession, at least a manufacturing recession of 2 years. We have net operating losses building up during this time. Those losses are used to shield the corporation from tax when it transfers paper assets to a tax haven country.

What is more troubling, is that to make these deals work, you have to have a depressed stock market. A depressed stock market reduces the tax on shareholders who approve of these deals. Why has our stock market been depressed? Everybody knows, except for manufacturing, the stock market is down because of what happened on September 11.

Now, I know it was going down in Nasdaq before September 11, and there were ups and downs before September 11, but real depression in stock at the time of September 11, with only a partial recovery at this point.

So, what happened after September 11? Ingersoll-Rand fled the country for Bermuda. It seems to be paying less than $20,000 a year in Bermuda and receives $40 million in U.S. tax savings.

Then we have Stanley Works Corporation, that you know makes these fine products as just one example. This American maker of fine tools has announced that it is skipping out of the U.S. to go to Bermuda. This company is proudly boasting that it is doing it to shave seven percent off of its annual tax rate.

Now, you have to imagine the situation we are in. We have our country at war. We have our country in recession. We have a major, well-respected U.S. corporation going to Bermuda to save 7 percent on taxes. It is a bad example of corporate tax cheating, particularly when it comes to a time of capitalizing on the twin towers of recession and terrorism.

I hope people remember this when they shop for products that this company offers. We ought to be able to expect American companies to have their heart in America.

Quite frankly, their heart does not seem to be in America, and they are getting their rear end out of America, at least for tax purposes. I think in time of war, you ought to have your heart in America and have your property here, and pay the fair share.

Now, Treasury has a response to this and it is authorizing a study. So my question to Treasury is, how long is this study going

to take, and what are we going to do about the corporate expatriations that occur in the meantime?

Mr. WEINBERGER. Thank you, Senator, for asking the question. Obviously, this is an emotional issue, as you describe. It is a very important issue. It has obviously got to be a tough issue for all Americans and for the companies and shareholders who actually make these decisions.

We owe it to ourselves in the tax system to find out what is causing, facilitating, or driving these transactions. We agree that this is an important issue. The market has seen an increase in the number and size of these transactions. They have been going on since the 1990's. You are absolutely correct.

It requires that we look at not only what effect our tax system plays in helping these companies make these decisions to move their headquarters, but also what effect these transactions have on the U.S. economy. This is a significant trend.

Obviously, we announced the study because, as you would expect, there is no necessarily easy answer. These companies have many ways to end up in the situation they are, which is to have a foreign parent owning a U.S. company.

We want to make sure whatever responses we look at to this problem do not end up exacerbating the situation or leading us to not getting out of the current tax conundrum we are in, which may facilitate or may play a role in these decisions.

But, because taxes do clearly play a role when you look at the public information of these decisions, we owe it to the system and we owe it to ourselves to look at the tax rules and find out what it is that actually is causing this.

In our study—and we have talked to your staff about this already, we have talked to the Joint Committee staff, we have talked to the House staff—we are looking at the tax treatment of these transactions, seeing what the tax treatment of these companies is before and after the transaction and seeing what in the U.S. tax laws may play a role in facilitating the decisions to move overseas. Frankly, we also have to step back and look at what role our overall tax system, as Senator Baucus said earlier, plays in the context of driving these companies to consider these measures. We have been talking to many practitioners who have been involved in these transactions.

We have been looking at all the documents available. We, again, as I said, have been talking to the staffs. We would hope to have some preliminary reactions, some preliminary suggestions to talk to staff about by the end of next month.

We are going to finalize the larger part of the study, which looks at our overall tax scheme and the competitiveness aspect of it and what might be driving companies to consider these moves, in a little bit longer timeframe, but I think we could have some early reactions as soon as the end of next month.

Senator GRASSLEY. Mr. Chairman, may I go ahead?

The CHAIRMAN. Please.

Senator GRASSLEY. Has Senator Graham?

The CHAIRMAN. He has not. Why do you not let Senator Graham go? He has been waiting a long time.

Senator GRASSLEY. Yes. I will wait.

Let me make one last point in the study. I just wondered if you could also include in your study this Bermuda re-insurance issue, and I think go at it the same way you just told us you are going to go at whether there is price advantage.

I would like to know about it in the re-insurance business as well. I would also like to know whether reinsurance between United States and foreign related parties has increased over the last 3 years.

Mr. WEINBERGER. Senator, we are happy to look at that as well.

The CHAIRMAN. Actually, it is my turn. [Laughter.] Thank you.

This question of inversions, I think, is a big problem, and the promoters are pushing them, and well-recognized promoters are pushing them. We looked on the Web this morning or yesterday. This is Baker & McKenzie. Basically, I will read one portion. "Many U.S. multinationals, as well as some foreign multinationals, are currently considering entering into corporate inversion transactions with the goal of drastically reducing their worldwide effective tax rate, achieving one or more important business objectives."

Then it goes on to say that "Baker & McKenzie has pioneered modern inversion transactions with the Helen of Troy inversion in 1994, and since then has provided tax and corporate advice to about half of all publicly disclosed inversion transactions. No other legal or accounting firm can make a comparable claim." That is, they are clearly pushing this.

I, for the life of me, have a real problem, as Senator Grassley mentioned, where a company has a couple of papers in Bermuda can therefore avoid U.S. tax.

You mentioned you are going through this study. What are some of the reasons why it might be appropriate for an inversion with respect to U.S. tax policy? Let me back up and make it easier for you, or maybe more difficult.

Mr. WEINBERGER. Can I start now, then?

The CHAIRMAN. No. [Laughter.] I start from the premise that inverting corporations overseas, whether it is to Bermuda or to any other country, is appropriate only if there is a significant, strong business or economic purpose other than taxes.

If that is the case, then I think that certainly we could look and see the degree to which it is appropriate. But where there is clearly no business or economic purpose other than lowering taxes, I think it should be disregarded, disallowed.

What is the business purpose in Bermuda, possibly, for Ingersoll-Rand, for Global Crossing, for any of these companies? What possibly, conceivably, with the most creative imagination, could be an economic business purpose other than taxes, other than a tax reduction for incorporating in Bermuda?

Mr. WEINBERGER. I do not know what the laws of Bermuda are with regard to headquarters and which rules you are subject to. There could certainly be some legal issues. I do not know. Certainly, taxes have to play quite a significant role in the decision.

The CHAIRMAN. Alright. Larry?

Mr. LANGDON. Let me make a couple of comments. One, ease of administration with regard to the corporate entity, namely, ability to hold board and other meetings outside of the jurisdiction and being able to move quickly with regard to making those decisions.

As you know, quite properly within the United States, most States have restrictions with regard to what you can do.

Second, if you take the insurance business as a whole, the regulatory requirements with regard to where you are based does make a difference with regard to reporting all of your activities.

So, in effect, there are legal rules that are basically more liberal in these so-called tax haven jurisdictions. They are also havens from regulatory and other requirements.

Obviously, if you have U.S. shareholders, you have got to worry about the SEC. But if you are a privately-owned company, you can, in effect, frankly, hide more transactions from regulatory authorities.

Then last, but not least, there are other rules within the U.S. relating to export controls that, if you are foreign based, you do not have to worry as rigorously about because in effect you do not have to meet their requirements.

The CHAIRMAN. Could you give me three reasons which go in the wrong direction, from my perspective?

Mr. LANGDON. From a U.S. policy perspective?

The CHAIRMAN. From a U.S. policy perspective. Can you give me three reasons to go in the direction of trying to escape being a U.S. citizen.

Mr. LANGDON. Right. But those are the rationales that are put up to avoid——

The CHAIRMAN. They are bad rationales, in my judgment.

Mr. LANGDON. Yes. Yes.

The CHAIRMAN. I mean, look at all the corporate governance questions which companies that incorporate in Bermuda avoid. Ease of administration. That is for the management of the directors. That is not for the shareholders or for the company. At least, not for the shareholders. It is an escape notice from shareholders, frankly.

The same thing with respect to export controls that you mentioned, and I have forgotten the first point that you mentioned. But nobody yet among the three of you—and Ms. Olson, you are welcome to chime in here—has given me a good, solid, economic reason, business reason, apart from fewer regulations, lower taxes, avoiding shareholder scrutiny, avoiding standard corporate governance rules, to do this.

I am waiting. Anybody want to give me a good, solid business purpose for doing this? I do not hear any.

Next question. If there is none, why should these not be disallowed under U.S. policy?

Mr. WEINBERGER. Well, the question, obviously, for all of us to consider is, what are the alternatives? Obviously, we are concerned about these transactions, so we have to see how we can try and change our rules to try and prevent them from happening.

How to do it is not as easy. Obviously, I do not think any of us would be any happier if U.S. companies were subject to take-over because they paid higher taxes and they had more regulations and everything else, and foreign countries companies would come in and buy them out. Or when there is a merger, like the DaimlerChrysler merger, we do not want to create an environment in a global economy where we disadvantage U.S. businesses either.

I think we have to come up with a balanced response that gets the types of transactions that are problematic, but without creating unintended consequences. That is the hard part.

The CHAIRMAN. If I could follow up on that. It is the point that Senator Grassley has made, I made, which all of us make. That is, the possible justification is because of international competitiveness in the international arena. It is not in the national arena. It is not in the confines of the United States of America. It is because of overseas competition.

A farmer in Montana, a shopkeeper in Iowa cannot do this. They cannot create an inversion to lower his or her taxes. He or she is an American. They are solid, patriotic Americans.

Ingersoll-Rand, Global Crossing, Stanley, whomever. The reasons I have heard why they are doing this, is because it lowers their taxes. Now, presumably that means they have a harder time competing with their competitors who presumably pay lower taxes. We have two goals running into each other in a collision here.

I do not think the solution should be to let American companies invert and not pay taxes, and that is it. If that is a competing consideration, that competing consideration has to be solved another way.

I do not know what those other ways are. One, might be greater pressure on other countries, on the Bermudas of the world, perhaps, to make sure that Bermuda stops this with respect not only to American companies, but other foreign countries.

I am obviously fishing around here, grasping and trying to find something. But the solution should not be that these companies should be able to proceed just because of some international competition. We should find another solution.

Mr. WEINBERGER. Mr. Chairman, we look forward to working with you on trying to identify the issues so you can resolve them and weight that balance and make decisions.

One thing I just wanted to make clear for the record, is they obviously still do pay taxes. All of their U.S. operations are still subject to tax. There is a question about whether they are going to have lower worldwide taxes, and there may be some U.S. taxes that they could actually also get out of, too. That is what we are looking at. That is what we want to find out.

Of course, when a U.S. company moves its headquarters somewhere else, to the extent it still has U.S. operations and income, it will pay U.S. income taxes.

The CHAIRMAN. To an extent, before income.

Mr. WEINBERGER. That is correct.

The CHAIRMAN. That is not with inversions. There are none with inversions in Bermuda.

Mr. WEINBERGER. With the inversions, you will have a foreign parent, maybe in Bermuda.

The CHAIRMAN. Right.

Mr. WEINBERGER. And they will have a subsidiary that is a U.S. company that will have U.S. operations. All of the U.S. operations will still be taxed in the United States.

The CHAIRMAN. Well, the U.S. operations will. That is correct. I understand that.

What are some other alternative solutions to this, other than saying, yes, it is alright to do this because you have competition?

Ms. OLSON. I think we are hoping we are going to be able, through our study, to identify what some of the alternatives are. Obviously, we want to make sure that the U.S. offers the best place in the world to do business on all levels. We want to move carefully to make sure that any proposals that we put forward for how you address this issue do, in fact, hit the target.

Right now, we still need information about exactly how the transactions are put together, exactly how they are taxed, and to fully evaluate the results after the transactions occur so that we make sure that we have identified all of the problems that there might be in our tax system that would be encouraging these kinds of transactions. That does not just mean looking at whether taxes are too high. That means looking at whether or not there are loopholes in the law right now that we need to identify so that we can work with you to close them.

The CHAIRMAN. Thank you.

You are next, again. Go ahead.

Senator GRAHAM. Thank you, Mr. Chairman. I must say, I am stunned. I cannot believe that the Treasury Department of the United States of America is as ignorant as to the motivation and the specific process of these movements of U.S. firms to offshore locations. I think it is clear that the purpose is to not only avoid U.S. taxation, but also to avoid many regulatory procedures.

My ears picked up, as the Chairman of the Select Committee on Intelligence, when you mentioned that one of the regulations that is avoided is some of our restrictions on exports. Those mainly are in the law to deal with national security issues.

We do not want firms which are involved in items that might have a military or dual use application to be moving out of the country without any scrutiny by the State Department, the Defense Department, and other people who have the responsibility of protecting our national security.

The idea that a firm which produced those could locate outside the United States could not only get the benefit of avoiding paying their share of all the costs of being a United States citizen or resident, but then further to be able to avoid our laws that protect us from weapons of potential lethal effect against U.S. citizens and residents going into the hands of unsavory regimes, is an appalling commentary.

I kind of feel as if we have the Mohammad Atta problem here, which I define as dozens of hands in the INS passing over a new student visa for Mohammad Atta, and nobody reading the fact, by God, this is Mohammad Atta, probably one of the most notorious names in the world, who is about to get a U.S. visa 6 months after he was killed because he drove an airplane into the World Trade Center.

I cannot believe that the Treasury Department has not been reading the Wall Street Journal, the New York Times, and multiple other publications that have been talking about the consequences of this issue and that we are still in the study phase. That is the editorial.

Now, let me ask another reporter's question. I have started by asking about, what is the U.S. position on this OECD study of these offshore tax havens? Are we now back participating with our European allies, or what is our role in this international effort?

Mr. WEINBERGER. Senator, we never did not participate. The United States actually was a leader in the beginning of this exercise, I think, in 1998 or 1999 when it started. This administration played a leading role in helping to redefine it.

Senator GRAHAM. I mean, there were very clear statements made approximately a year ago that the United States was going to change its relationship with the OECD because it thought that it was impinging on economic liberty.

Did we, in fact, not change our relationship with the OECD? If we did change our relationship, what was the change? Then, third, what is our current relationship to this effort?

Mr. WEINBERGER. Senator, in answer to your question, many press reports did write that, which is why, obviously, they do not pick up on necessarily all the facts all the time.

The Secretary was very clear. We never disengaged or left the OECD project. What we did, was refocus the subject of the project on transparency and information exchange.

Senator GRAHAM. As opposed to what was the previous focus?

Mr. WEINBERGER. There were a lot of different things. First of all, there was a discrepancy between certain developing countries and certain EU and developed countries that were treated differently. There were different standards being applied. We did not think that was appropriate.

The project also was looking at the so-called tax harmonization and a concept called ring fencing, where countries have special things in their laws to try and attract capital, especially in developing countries. The project was trying to tackle all of these issues, on top of the information exchange and transparency rules at the same time, and was having a very difficult time reaching agreement on what to do.

What we did is ask the OECD, and all other countries unanimously agreed, to refocus that project on transparency and information exchange. We have been a leading country in the effort to try and get as many countries as we can now to sign up to enter into agreements that would provide that information. We are still involved and still committed.

Senator GRAHAM. My time is about up. A final editorial comment is, I would suggest that if we are going to do this study—and I have raised my questions as to why we have to study an issue that is as direct and upon which there is as much information currently available.

But if that is the position that we are going to study, I would suggest that one area be, what should be the role of regulatory agencies? Maybe if a company decides that it wants to leave the United States it should not have access to the U.S. capital markets that it used to have.

Maybe if a company is leaving the United States in order to avoid, for instance, insurance laws, which are largely designed to protect American policyholders and to create a level playing field within the insurance industry, maybe there should be some special

rules to provide the same protection that would have been available had they not, in fact, skipped out of their United States corporate citizenship.

I think those would be some issues that ought to be covered in the study. Thank you.

Senator GRASSLEY. Thank you, Senator Graham.

Senator Baucus has just stepped out here for a minute, so I will step in with a few questions until he comes back.

I think the first one will not be a question. It is just going to be a comment on my part, something that just adds to the gall that a person can have of this inversion approach.

That is the fact that a lot of these corporations leaving the United States have huge Federal contracts with the U.S. Government. I will use the two that I have already mentioned. Stanley had 100 contracts during 2001 alone. Ingersoll-Rand had over 200 contracts in the year 2001.

So, we have corporations on the one hand evading U.S. taxes, and on the other hand making profits off of the taxes that people are paying because they are not leaving the country, the middle class Americans paying on the other hand. It seems to me that this further makes the issue of corporate greed paramount in the decisions as opposed to legitimate business decisions.

So, you heard me say earlier in my statement that corporations that engage in these sorts of transactions are going to do so at their own will, I think we have to go after their tax benefits.

Now, I think with this information, that it is legitimate to raise the question with them, if they are going to leave America to avoid taxes, should they also have the ability to have Federal contracts? Senator Baucus and I have instructed our staffs to come up with a comprehensive response to this issue.

I guess, in closing on that comment, I would encourage Treasury, but not necessarily ask for a response from, to get with this program if you could. I do not denigrate the issues you put on the table already in regard to the new regulations.

Getting back to this point that I made about intellectual property and the value of this sort of research that creates these shelters. I want to ask Treasury, and I will start with you, Mr. Weinberger, and you may be able to answer it for everybody.

I see that the regulations take confidential shelters out of the proposed tax shelter definition, but then you turn around and put them back in through what is defined as a reportable transaction.

Would you explain why you are doing that and if it takes care of the concern I raised?

Mr. WEINBERGER. Yes, Senator, it does. What we did is we put the confidentiality provision back into the disclosure regulations to prevent everybody else from moving back into confidential agreements. We said that if you enter into a confidential agreement and you have a certain criteria or threshold of dollars at stake, then you have to disclose it.

When we suggested taking the provision out of the statutory requirements, if we did not do such a thing, then maybe you would have people going back and entering into confidential agreements and thinking they could escape detection.

Senator GRASSLEY. Well, under your regulation then, if company A takes advantage of a shelter opportunity and Treasury says it is all right, is company B going to be able to take advantage of it on the same basis that company A could?

In other words, is the information going to be public enough so that another company would be able to take advantage of it and do the same thing that company A did?

Mr. WEINBERGER. Well, the disclosure only allows us to look at the transaction on the return. If we think there is a problem with that specific transaction—for example, if we think it is against the law—it allows us to go after and enforce the law against that taxpayer.

If we uncover something that is not against the law, but that we think should be shut down because it is outside the intent of Congress, then we would, on a prospective basis, have the ability to make public announcements so that everyone would benefit from our position.

Mr. WILLIAMS. I would like to add to that, Senator Grassley. The disclosure forms that come in are confidential tax information, so they are not public when they come in. But what we would like to do, is move to a much quicker publication of transactions that work and do not work.

I think you will see, I am hopeful you will see, in the next year or so that your point will be made. That is to say, when a transaction comes in that looks like it works, we will publish that so that everybody can see what works and that it is not limited to just the particular taxpayer that disclosed it.

Senator GRASSLEY. All right. I believe that that satisfies me.

Mr. WEINBERGER. Could I just add one more point, Senator? I think the reason we thought it was important to take the confidentiality exception out of the registration rules was because the exception is the reason most people are not registering. They are reading the exception in a way to avoid registering. We do think they should register more transactions.

Senator GRASSLEY. Let me ask another question. When can taxpayers rely on an independent tax advisor's opinion under your proposal and not be subject to penalties?

Mr. WEINBERGER. We make several changes here, obviously, Senator. If a taxpayer has a listed transaction where the IRS basically has said this transaction does not work, and they do not disclose the transaction, they will have no ability any more to have an opinion to escape from a penalty.

It is a strict liability penalty if you do not disclose. If you do not disclose a transaction and it is a listed transaction, in current law taxpayers have been relying on some opinions to be able to get out of a substantial underpayment penalty. What we do, is take away that ability.

If you do not disclose the transaction, you no longer have a reasonable basis, a reasonable cause out and you are going to have a strict liability. If you do not disclose, you have a penalty for nondisclosure as well.

Senator GRASSLEY. Let me ask the last question, since Senator Baucus has returned.

I noticed that the penalty on tax shelter promoters who fail to register their shelters will be capped at $200,000. So, I am asking about the efficacy and the discouragement of this, if you compare that $200,000 to a promoter who might be earning millions in selling the shelter.

Mr. WEINBERGER. Actually, Senator, our failure to register penalty on promoters is the greater of 50 percent of all fees or $200,000. If it is an intentional failure to register, it can go up to 75 percent of all fees.

Senator GRASSLEY. All right. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Thanks, Senator.

Mr. Williams, you were a tax court judge.

Mr. WILLIAMS. Yes, Mr. Chairman.

The CHAIRMAN. There are many who think that tax courts, on these kinds of issues, tend to side in favor of the Service. I guess the argument is, they tend to understand these cases pretty well. Whereas, when they are appealed, the appellate court sides more often with the taxpayer, compact cases as an example.

Some suggest that, because these cases are fairly complex, maybe the tax court judge has a little better understanding of what is going on here, than the appellate court judges, since they handle so many different cases on so many different subjects and they are so busy, and the backlog is so great.

Your view?

Mr. WILLIAMS. Thank you, Mr. Chairman.

The CHAIRMAN. You are welcome. [Laughter.] You are no longer a judge.

Mr. WILLIAMS. Well, I do have former colleagues, though.

The CHAIRMAN. That is true.

Mr. WILLIAMS. I agree with your sense that the tax court understands transactions. I have always thought, and I continue to believe, notwithstanding the recent experience in some cases on appeal, it is very helpful for the system to have generalist judges reviewing the trial decisions of specialists.

I personally believe that those cases could have benefitted from a different litigation strategy. The appeals courts, I think, step back and do not have the same—I think the generalist judges have more of a sense that tax avoidance is a legitimate business objective than tax court judges do. I think how you evaluate that falls out on how you look at that, yourself.

The CHAIRMAN. I hear you saying that that is sort of the way it is, and it is probably going to stay somewhat, generally, that way.

Mr. WILLIAMS. One of the things I would like to do—because litigation is not the answer here. It really is not. What the answer is, and one of the things that we are really working hard to put into place in this early guidance system, is I believe that if we are able to get guidance out to the public early enough, that we will not see an avalanche of these things. It still means dealing with the current problem, but looking for the future.

I actually have optimistic views on large corporations' desire to comply with the tax law. I think that, as you mentioned, they are under a lot of pressure, and I have seen this personally, to invest

in these products as a matter of competitiveness with their neighbor.

I think, to the extent we can get out early warning guidance quickly, we will aid the tax directors of those corporations who want to comply, but are nevertheless under pressure, sometimes from their own auditors, to invest in these things, that we will see a lot of this going away. I might prove to be wrong, but I am very hopeful about that.

The other thing is, in terms of litigation, I am trying to design a program where we will get to court and have more control over which case gets to court and we will have more control over which case gets to court than we have in the past.

I am working with Commissioner Langdon specifically on that to make sure that the cases are developed well enough, the ones that we want to take to enforcement are developed well enough and early enough, so when we get to court, we move quickly.

I am concerned, I guess, that the longer we delay, the more taxpayers invest in these things and the less able we are to deal with the consequences because of the resources that are needed.

The CHAIRMAN. On that point, how can we help you? Does it help us to call you before us every 2 weeks and give you a hard time?

Mr. WILLIAMS. That is never helpful. [Laughter.]

The CHAIRMAN. But how can we be most helpful and help us mutually accomplish our objective?

Mr. WILLIAMS. Mr. Chairman, the legislative proposals that have been submitted, I think, are really critical. The injunction relief remedy that we could get against promoters who, as a pattern, fail to register or fail to disclose, the penalties that change, as Secretary Weinberger said, the calculus, are incredibly important to our ability to turn this around.

The CHAIRMAN. With respect to failure to disclose, so far that is the reportable or the disclosed transaction. Is the failure due more to ambiguity? Is it due more to insufficient penalties for failure? Is it due more to just arrogance? I mean, what do you think is the primary reason?

Mr. WILLIAMS. Mr. Chairman, I think we will know more about that when we get farther into the examination of the promoters that we're currently undertaking. We will have a more definite answer at that point.

At this point, I would say it is truly a combination of all of that, which is what the proposals that we have made attempt to address. We want to make sure that there are penalties for the failure to disclose, that it is the discrete behavior. It is separate from any of the other kinds of behavior that is penalized.

The CHAIRMAN. Do you have a target compliance goal? I am sure you would like 100 percent. But what is a good result?

Mr. LANGDON. Let me make a couple of comments in that regard. Obviously, if we can accomplish what Mr. Williams has described in moving more quickly, I think we can curtail substantially not only the current products that are out there, but perhaps more importantly the next generation of products.

Second, our actions with regard to promoters, I think, are bearing fruit. Our disclosure initiative, which was announced in December, frankly, we have almost gotten 200 disclosures based on that

immediately. So, I think concerted action on our part does bear fruit.

The CHAIRMAN. How is this committee going to know whether we are successful? Do we not need to benchmark this somehow, have a percentage goal or some numerical goal of some kind to know whether we are getting there or not instead of just, gee, we are working and making progress, and that kind of thing, the feel-good stuff. Does that not make sense? The company is run that way.

Mr. WILLIAMS. I think one of the problems, Mr. Chairman, is we do not know what the universe is. You mentioned there were 149,000.

The CHAIRMAN. Right.

Mr. WILLIAMS. Right. And maybe there are 100,000.

The CHAIRMAN. Correct.

Mr. WILLIAMS. All right. How many of those have invested? We do not know.

The CHAIRMAN. Will you be able to find out?

Mr. WILLIAMS. I do not know that, either.

The CHAIRMAN. Do you want to find out?

Mr. WILLIAMS. I do.

The CHAIRMAN. How would you find out?

Mr. WEINBERGER. I think Senator Grassley said at the beginning, tax shelters are something that "you know it when you see it." The problem is, we are not seeing it. So, what we need to do, is figure out ways to see it.

The CHAIRMAN. I understand that. So how are you going to figure out ways to be able to see it?

Mr. WEINBERGER. By encouraging more disclosure. We have done a number of things to do that. That is the only way we are going to know what is going on out there, actually, in the voluntary system. We have done it by changing the risk/reward ratio of playing the audit lottery by increasing penalties.

We have also, frankly, done another thing that is very important. By unifying the definition of what is reportable amongst promoters, taxpayers, and advisors, we now have the ability to get information from any number of sources.

If you think somebody else who entered a similar transaction or used your advisor is going to register and they do, we can trace it back to the promoter, then trace it to another person who entered into the transaction. It is going to be a much better web to be able to make sure people do comply, and it will be a greater deterrent. That is the best we can do.

The CHAIRMAN. You understand, though, Mr. Langdon, you have waived penalties to increase disclosure, kind of like amnesty, in effect. Now, what signal does that send? What is the effect then?

Mr. LANGDON. See, the interesting thing we did, because we wanted to affirm our ability to use penalties, that in effect we did two things. We did the disclosure initiative for about 120 days, but we also issued a memo that we publicized to taxpayers in our field with regard to implementing our existing penalty strategy. In effect, what that has done, is forced disclosure now.

Now, in fairness to corporate America, we have 19 notices out there that they have not reacted to. This, in effect, forced them to react to those notices.

The CHAIRMAN. I have two very basic questions. When are we going to know whether we are successful?

Mr. LANGDON. When we stop seeing promoters——

The CHAIRMAN. I want to know when. How long is it going to take? A month? Two months? Three months?

Mr. WEINBERGER. As long as we have a tax system that is as complex as it is, and we have voluntary compliance, it is going to be a constant effort to make sure that you go after people who are trying to take advantage of the law. It is not only in this area, it is across the board. I think this has to be a concerted, constant effort.

The CHAIRMAN. Well, wait a minute, here. That is a little bit of a weasel out, in my judgment. That is, I want to know more specifically when. That means if you have other suggestions that are necessary to accomplish that goal, we need to know what those suggestions are.

If they have to do with the complexity of the Code, or what all or whatnot, you need to tell us that. We want to cut down shelters, the wrong kind of shelters, to the point where applying the Justice Potter Stewart test, "we know it when we see it," means that we know there are basically not very many out there and we have done a pretty good job.

So, when? How soon? We need some accountability here. When are we going to know whether we have met our goal or not? You set the time, too.

Mr. WEINBERGER. Well, when Congress passes the legislation——

The CHAIRMAN. We will pass it.

Mr. WEINBERGER. We will have those tools. We are working right now, and will shortly have initial steps on what we can do administratively to increase disclosure and put the rules into effect.

I think, once we have those in effect, we have got to see the next filing season and see how much improvement we have, and determine what kind of things we are seeing. I think that is going to be our best test.

The CHAIRMAN. Alright.

Mr. WILLIAMS. Mr. Chairman, if I might add.

The CHAIRMAN. Certainly.

Mr. WILLIAMS. One of the reasons that we do not know what the universe is, is because we have been, in prior proposals, criticized for trying to drag too much into the net, trying to cast too wide a net.

Frankly, when I was in practice I shared that criticism because, as I mentioned, my hearing of, too frequently the IRS gets information and does not use it. I expect that we will hear criticism from some quarters with respect to our proposals along the same lines.

But I think that the proposals that we have made will give us a better feel for what the universe is. I think at that point we will be better prepared to estimate what the right goal is.

The CHAIRMAN. Well, I appreciate this. This is obviously a subject that is of deep concern, I think, to a majority of American people. We have got to solve this thing. We cannot let perfection be the enemy of the good. It is not going to be a perfect solution, but we need a good solution.

I am hopeful that we will mark up legislation that Senator Grassley and I will be introducing after the recess, that we will be marking that up quite quickly. I will not tell you a date on which we are going to come back and revisit this issue, but there is going to be one. So, I would just encourage all of us to keep working hard and doing the best we can. Thank you.

The hearing is adjourned.

[Whereupon, at 12:06 p.m. the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

**PREPARED TESTIMONY OF
LARRY R. LANGDON**

INTRODUCTION

Mr. Chairman, and distinguished members of the Committee, I thank you for this opportunity to testify on the IRS' programs and actions to address the proliferation of abusive corporate tax shelters. These transactions undermine voluntary compliance and threaten the fairness of our tax administration system.

The IRS Large & Mid-Size Division (LMSB) has made curbing abusive corporate tax shelters a top priority. We have put into place a structure and organization to implement our strategy and plans. As Secretary O'Neill recently stated, "we are going after them in a very tough-minded way." However, our task is extremely challenging and may require new tools to identify and halt the growth of abusive corporate tax shelters.

ISSUES AND CHALLENGES

These tax shelters are tax-motivated transactions designed and promoted by sophisticated tax professionals and used by both corporations and very wealthy individuals to reduce their taxes. They are highly complex transactions crafted to exploit technical loopholes in the internal revenue laws to obtain substantial and unintended tax benefits. Indeed, a better description of these devices might be "technical tax shelters."

These tax shelters pose an enormous challenge for the IRS. First and foremost, they are extremely difficult to find on tax returns. Large corporations have complex, voluminous returns, and the only clue to a shelter may be buried deep in the return.

Even if a taxpayer does not take measures to hide the shelter, finding it can be an investigative and time consuming challenge that requires the IRS to request information from a reluctant taxpayer to shed light on what underlies the return. If a corporation makes a concerted effort to hide a shelter, even an experienced IRS examiner may not find it on the return.

To complicate the issue further, technical tax shelters are factually complex. A typical transaction may involve multiple entities created solely for the purpose of investing in the shelter, as well as complex financial derivatives. Developing the facts requires an understanding of how complex transactions are structured. Because taxpayers may not provide or have all of the relevant documents, IRS examiners must the information from third parties.

Technical tax shelters are also legally complex. Tax shelter promoters carefully scrutinize the tax laws to find loopholes and then design complex transactions to exploit them. Consequently, technical tax shelters involve highly complex and very arcane areas of the tax laws. And, Mr. Chairman, they always come with the blessing of a tax opinion. This is a critical point.

For an investor, the tax opinion legitimizes the transaction, purporting to allow an investor to claim a reasonable belief that the tax benefit, no matter how outrageous, was legally justifiable. As a result of these tax opinions, technical tax shelters too frequently result in litigation. Moreover, the tax at issue is large enough, and the outcome is uncertain enough to encourage taxpayers to litigate the issue.

Although corporations already have a disclosure requirement, we believe too many are parsing words, narrowly construing the disclosure rules and broadly construing the exceptions. Taxpayers must adequately and properly disclose complex, tax-motivated transactions. The benefits are clear. With proper disclosure, we can conserve both our resources and the taxpayer's resources. With clear and adequate voluntary disclosure by taxpayers, our audits will be more focused. We will be in a better position to more quickly and effectively perform the audits. And the system would be more transparent, requiring all taxpayers to fully disclose complex, tax-motivated transactions.

Mr. Chairman, this is a two-way street. The process must be transparent from both sides. Taxpayers must disclose so that the IRS can identify and assess the propriety of the transaction. However, it is then our responsibility to use effectively the information by publishing guidance, telling the public our position on the transaction, and dealing with taxpayers who have invested in abusive ones.

In summary, if, as technical tax shelter promoters and investors claim, these transactions are proper, then they should not oppose our scrutinizing these transactions. The longer a technical tax shelter remains hidden, the longer the government is denied the tax dollars it is rightly due, the greater the resources that must be devoted to collecting those tax dollars, and the greater the number of taxpayers lulled into believing that the transaction is proper. Once again, the fairness of our voluntary compliance tax administration system is at risk and we, at the IRS, are making every effort to combat abusive tax shelter transactions.

ADMINISTRATIVE ACTIONS ADDRESSING TECHNICAL TAX SHELTERS

We have undertaken significant administrative actions to curb abusive corporate tax shelters. In February 2000, the IRS and the Department of Treasury issued the first set of tax shelter regulations. These regulations require corporate taxpayers to disclose reportable transactions, and require promoters to register confidential corporate tax shelters and maintain lists of tax shelter investors. Also, in February 2000, the IRS announced the creation of the Office of Tax Shelter Analysis (OTSA) to serve as the IRS' focal point for gathering and analyzing tax shelter information.

We continue to evaluate and improve our processes for eliciting tax shelter information and dealing with the information we obtain. As such, in December 2001, we announced a temporary disclosure initiative designed to encourage greater voluntary disclosure of questionable transactions. (I will discuss the disclosure initiative in more detail later.) We have also continued to make fundamental organizational changes to improve our overall capabilities to identify and resolve tax shelter issues. While we have made progress, we are finding that taxpayers and promoters are interpreting the current disclosure rules very narrowly and are disclosing few transactions. Consequently, it is our view that the disclosure regulations need to be revised and expanded. The set of initiatives described by Assistant Secretary Weinberger fills those needs.

Tax Shelter Registrations

One component of the February 2000 disclosure regulations are rules requiring promoters to register confidential corporate tax shelters. All registrations are now filed with the Ogden Service Center. Today, we review all promoter registrations for completeness and compliance with the tax shelter registration regulations prior to the issuance of the tax registration number. We evaluate all of the registrations to identify transactions that warrant further legal analysis or compliance attention. Over the past several years, we have initiated compliance actions on promoters based on information obtained from our evaluations of promoter registrations. For example, the Custom Adjusted Rate Debt ("CARDs") transactions that was recently made a listed transaction was identified from promoter registrations filings and other tax shelter information in our OTSA office.

In 2001, 945 registration statements were received. Of these, 670 were confidential corporate tax shelter registrations (section 6111(d)), and 275 were ones filed under section 6111(c), which requires registration of any transaction in which total gross deductions in the first five years are projected to be more than twice the invested amount.

Promoter Contacts

A second component of the February 2000 tax shelter regulations are rules requiring promoters to maintain lists of tax shelter investors. Upon request, a promoter is required to provide its list to the IRS. The list is to be provided within 10 days of a request and the IRS is not required to issue a summons.

Using our authority under section 6112, we have been attempting to penetrate one of the most important sources of information about technical tax shelters – the persons and entities that develop and promote them. As such, we have contacted over 30 entities in connection with promoting technical tax shelters. However, we are finding that too frequently, we are not receiving the information on a timely basis, forcing us to initiate a promoter audit and issue a summons. To date, we have initiated 16 promoter audits to obtain investor information.

Through our promoter compliance actions, we have identified and are evaluating several transactions that appear to be potential abusive tax shelters and have identified other transactions that have been promoted by an individual promoter. Also, we have identified investors who have engaged in abusive tax shelter transactions and have initiated audits of those taxpayers.

Corporate Disclosures of Reportable Transactions

The third component of the February 2000 tax shelter regulations are rules requiring corporate taxpayers to disclose reportable transactions on their returns and send a copy of the disclosure statement to OTSA. Reportable transactions fall into two categories: (1) listed transactions, which are transactions the IRS has identified in published guidance as tax-avoidance transactions; and (2) other reportable transactions, which are transactions that have at least two of five characteristics common to technical tax shelters. Corporate returns that were filed during the fall 2001 filing season were the first to be fully covered by the taxpayer disclosure regulations.

However, as I have previously indicated, we believe that corporate taxpayers are narrowly construing the disclosure requirement while broadly construing the exceptions to disclosure. Last year, 99 corporations disclosed 272 transactions. Only 64 listed transactions were disclosed. The remaining 208 disclosures were other reportable transactions.

The disclosure statements received by the IRS have included both listed and unlisted transactions. All disclosure statements are reviewed by OTSA, cross-matched to other OTSA information and sent to a field office for examination action. To date, we have identified taxpayers, who should have previously made disclosure, and have identified names of promoters who have marketed tax shelter transactions.

Disclosure Initiative – Announcement 2002-2

On December 21, 2001, the IRS issued Announcement 2002-2, announcing a temporary disclosure initiative designed to encourage greater voluntary disclosure. The period of the announcement runs from December through April 23, 2002. During this period, taxpayers may disclose questionable transactions and other items that may result in an underpayment of tax. The initiative is not limited to reportable transactions. As an incentive, the IRS will waive any accuracy-related penalty that might be applicable if additional tax ultimately is due, but taxpayers must disclose all relevant information about the transactions, including the identity of any promoter.

The number of disclosures received has been both encouraging and discouraging for us. In the context of the program, the results are encouraging because over 100 taxpayers have disclosed transactions, and we expect many more. With the information we receive, we are pursuing promoters, identifying taxpayers who have not disclosed reportable transactions, and evaluating new types of transactions that are identified.

However, in the broader context of tax administration, the results are discouraging. The fact that so many taxpayers have only now disclosed these transactions illustrates our concern that these transactions are taking place frequently and without transparency on the returns.

The disclosure initiative has identified promoter participation in listed transactions not previously known. It also identified several new transactions that are currently not listed and are being evaluated with the Office of Chief Counsel.

LMSB ORGANIZATIONAL STRUCTURE

Having identified and designated abusive tax shelters as one of its strategic initiatives, LMSB has put into place an organizational structure to implement its plans and to establish coordination and oversight of the IRS' tax shelter activities. This organizational structure is designed to promote internal and external awareness and training on tax shelter issues, direct appropriate resources to tax shelter compliance activities, and greatly enhance coordination with the Department of Treasury, the Office of Chief Counsel, IRS Appeals, and other IRS operating divisions.

LMSB Tax Shelter Committee

Executive oversight of LMSB's tax shelter program lies with the LMSB Tax Shelter Committee, which is composed of the LMSB Commissioner and Deputy Commissioner, five Industry Directors, the Director of the Field Specialists, the Director of Pre-filing & Technical Guidance, the Director of International, the Director of Strategy, Research & Program Planning, and the LMSB Division Counsel. The Tax Shelter Committee sets LMSB's tax shelter compliance strategy and coordinates compliance issues with other IRS operating divisions, the Office of Chief Counsel, the Office of Appeals, and the Department of the Treasury. The Tax Shelter Committee also monitors significant tax shelter activity with the goal of improving the IRS' ability to coordinate and deal effectively with tax shelter cases.

The Tax Shelter Committee is responsible for coordination and oversight of all tax shelter activities. To enhance the IRS' compliance capabilities and efficiencies, the five LMSB Industry Directors are assigned to significant tax shelter issues for development, coordination, and resolution. By designating an issue champion for specific tax shelter issues, LMSB ensures uniform and consistent audit treatment of the tax shelter issues.

Office of Tax Shelter Analysis

A key organizational component to the IRS' tax shelter strategy, OTSA, is the IRS' focal point for gathering and analyzing tax shelter information from internal and external sources. *(Please see appendix: Announcement 2000-12, 2000-12 IRB 835).* As the clearinghouse and information resource for all tax shelter information, OTSA obtains tax shelter information from a variety of sources, including the tax shelter hotline, corporate disclosure statements, IRS field surveys, and promoter registrations. OTSA analyzes the information to identify potential tax

shelter issues and to compare corporate disclosures, tax shelter registrations, hotline information, and other information to identify taxpayers and promoters for further compliance action.

Office of Pre-filing & Technical Guidance (PFTG)

This LMSB office is responsible for providing technical assistance to field personnel in the development and resolution of shelter tax issues. PFTG has a technical advisor identified for each listed transaction. Technical advisors are issue specialists who support the examination teams with issue identification and development. The technical advisors are the focal point for information sharing and disseminating information related to a specific tax shelter transaction and provide technical training to field examiners.

LMSB Division Counsel

The Office of Division Counsel (LMSB) is an important organizational component and resource for LMSB personnel. This office provides a wide range of legal assistance and support to examination teams, technical advisors, and headquarters personnel. It also has a designated Senior Legal Counsel for Corporate Tax Shelters who participates in all tax shelter matters within LMSB.

CONCLUSION

Mr. Chairman, in spite of our multi-faceted approach and efforts to curb abusive corporate tax shelters, or technical shelters, the problem persists. Although we have a solid foundation to address the problem, we believe the Treasury recommendations will provide another important tool that could greatly assist our efforts. We look forward to working with you and the Members of the Committee on this issue that is critical to the fairness of our tax administration system. Thank you and I would be happy to answer any questions you have.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

May 2, 2002

The Honorable Max Baucus
Chairman, Committee on Finance
United States Senate
Washington, D.C. 20510-6200

Re: March 21, 2002, Hearing on Abusive Corporate Tax Shelters

Dear Senator Baucus:

On behalf of the Treasury Department, Commissioner Langdon and Chief Counsel Williams, I am pleased to submit the attached responses to the Committee's written questions regarding abusive corporate tax shelters.

Please contact me if you have any questions, or if you desire any further information.

Very truly yours,

Pamela F. Olson
Acting Assistant Secretary
for Tax Policy

Attachment

Cc: Larry Langdon
B. John Williams

QUESTIONS REGARDING INVERSIONS*
BY CHAIRMAN BAUCUS

1. To what extent is the Administration concerned by corporate inversions?

The Treasury Department's concern with corporate inversions motivated our study of the issues implicated by these transactions. While these transactions are not new, the transactions are occurring with increasing frequency and involve larger companies in a broader range of industries. It is our job to look carefully at these transactions to understand the implications for our tax system and our economy. We must identify any inadequacies in our current tax rules that facilitate these inversion transactions or that can be taken advantage of as a consequence of reincorporating outside the United States. We intend to work with the IRS and the Congress to address any such inadequacies promptly and fully. As a longer term matter, we also believe it is important to understand if there are aspects of our international tax rules that are driving companies to consider leaving the United States for competitiveness reasons. Much of our international tax system was developed several decades ago when the global economy was very different than today. If legislative changes are needed to update our international tax rules for today's world, we look forward to working with the Congress to develop and implement appropriate reforms.

2. What evidence do you have suggesting that inversions might indeed be a "mega trend" as firms have been representing to potential clients?

In recent months, there have been several announcements of transactions involving U.S.-based multinational corporations reincorporating outside the United States. Transactions of this sort have been occurring since the 1990s. However, these inversion transactions are increasing both in number and in size. They are no longer merely isolated occurrences. In addition, statements by tax advisors and tax directors indicate that more U.S.-based multinationals are considering the possibility of engaging in an inversion transaction. While the phrase "mega trend" may be hyperbole coined by those who seek to market these transactions, the increase in the frequency and size of these transactions is marked enough, and the potential implications of the transactions serious enough, to demand our immediate and thorough attention.

3. Legislation has been introduced in the U.S. House of Representatives that would basically prevent corporations from avoiding the U.S. income tax by reincorporating in a foreign country. What are your views on the approaches taken by Members of the House of Representatives?

At the present time, we are still studying the inversion transaction issue. This is a complex issue and we believe it is our responsibility to analyze the transactions fully to assess the implications for our tax system and our economy. We intend for this technical and policy analysis to help inform the debate regarding the most appropriate response to these

* Pamela F. Olson, Acting Assistant Secretary for Tax Policy, is responding on behalf of the Treasury Department.

developments. As part of this work, we are evaluating the full range of potential responses to address the situation, including, of course, any needed legislative action. This study is a matter of priority for the Treasury Department, and we intend to release our preliminary views shortly. We look forward to working with the Committee and the Congress on any necessary legislative response.

4. **Treasury's inversion study will focus on the tax treatment of inversion transactions and will also include an examination of the U.S. international tax rules more generally and how they affect multinational companies headquartered in the U.S. Examining our international tax laws is an enormous undertaking. When will your final report be issued?**

One aspect of our study is to understand the impact of the U.S. international tax rules on the ability of U.S.-based companies to compete in the global marketplace. We believe that it is imperative that we understand if there are aspects of international tax rules that are driving companies to consider the drastic step of reincorporating outside the United States for competitiveness reasons. As a longer-term matter, we must be prepared to address these incentives by rationalizing and modernizing a system of international tax rules that may not be optimal in today's global economy.

As a more immediate matter, we need to identify any loopholes or other inadequacies in our tax rules that may be exploited through these inversion transactions. We intend to work with the IRS and the Congress to address those issues promptly. We believe our technical and policy analysis will be useful in the ongoing debate on these issues. Therefore, the study is a high priority. We expect to issue shortly our preliminary views on these matters and we look forward to continuing to work with the Congress to address the complex issues these transactions raise.

QUESTIONS REGARDING SECTION 419A(f)*
BY CHAIRMAN BAUCUS

The Treasury Department's tax shelter regulations require reporting of certain kinds of multiple employer welfare benefit plans under Section 419A(f)(6). The Committee also understands that Treasury is planning to issue guidance or regulations in this area in the near future.

1. **The typical 419A(f)(6) plan is designed to provide benefits only to a selected group of highly-compensated employees and owners. Promoters advertise the availability of deductions that can far exceed the annual cost of the provided benefits, and recent court cases clearly indicate a distortion of Congressional intent in applying a definition of experience rating. Which, if any, of these elements of a 419A(f)(6) plan do you believe constitute an abusive tax shelter? Are there other elements of 419A(f)(6) plans that you believe provide opportunities for inappropriately sheltering income?**

Claiming deductions in excess of the current cost of benefits under a 419A(f)(6) plan provides the opportunity to shelter income from tax. That is, an employer's ability to deduct a large contribution to the plan in one year, when the amount of the contribution in excess of the current year's cost of benefits is carried forward to future periods to provide benefits for the employees, inappropriately accelerates the deduction. In addition, if the surplus assets are invested in insurance contracts, the arrangement will shelter the income on those assets from corporate income tax.

In addition, these plans sometimes are used to provide deferred compensation. The Internal Revenue Code provides for a current deduction for deferred compensation in advance of a matching inclusion in the employee's taxable income only for "qualified plans" that meet specific requirements, including nondiscrimination in coverage and benefits. In contrast, other types of nonqualified deferred compensation do not result in an immediate deduction for the employer. If an employer has the opportunity to make contributions to a 419A(f)(6) plan that has no limitations and is taxed as favorably as a contribution to a qualified plan that is subject to nondiscrimination and coverage rules, the employer may well choose the 419A(f)(6) plan and exclude lower-paid employees from coverage. This would not be allowed if the employer contributed to a qualified plan.

2. **Addressing 419A(f)(6) is an item on Treasury's current business plan. As you know, we on this Committee anticipate addressing tax shelters and issues raised by executive compensation in the very near future. Having Treasury's recommendations on 419A(f)(6) available in time for consideration of that legislation would be very helpful. When do you expect to issue your guidance in this area?**

The Treasury Department's current business plan year ends on June 30, 2002. A team of IRS and Treasury Department personnel is working to prepare regulations regarding Section

* Pamela F. Olson, Acting Assistant Secretary for Tax Policy, is responding on behalf of the Treasury Department.

419A(f)(6), and we anticipate issuing that guidance before the end of the current business plan year.

3. **In your opinion, will Congress need to enact further legislation in the 419A(f)(6) area, or will your proposed guidance solve the problems that have created the tax shelter opportunity currently being widely used in the marketplace?**

We are optimistic that our forthcoming regulations will stop most of the problems. Nonetheless, while the forthcoming regulations under the current statute should work to prohibit improper and excessive deductions by 10-or-more employer welfare benefit plans, enforcement requires a resource-intensive analysis of the facts and circumstances. For any single arrangement, application of the statute typically requires an examination of several layers of interlocking entities. As such, in many ways, legislation could be more effective and efficient than regulations to shut down the abuse of 419A(f)(6) plans. For example, restricting the types of welfare benefits that a 419A(f)(6) plan could offer would limit the opportunity for abuse as well as the scope of analysis required to determine if the plan provides an inappropriate deduction.

We note that some legislative proposals in this area, while providing certainty in the application of the rules for specific products already in existence, do not address the broader tax policy and equity issues discussed in our answer to Question 1. We believe that it would be appropriate as part of any review of 419A(f)(6) plans to examine whether the tax-favored treatment for certain benefits provided by these plans generally is consistent with broader tax policy goals, rather than targeting a legislative response to certain plans already in existence.

QUESTIONS REGARDING ABUSIVE TAX SHELTERS*
BY CHAIRMAN BAUCUS

1. How many corporations do you suspect engaged in a transaction that should have been disclosed on the Federal income tax return?

The existing disclosure rules have proven to be overly subjective, and taxpayers have interpreted these rules in a manner that has allowed them to avoid disclosure. Without disclosure, it is difficult for the Treasury Department and the IRS to assess the number of corporations that are engaging in transactions that should be disclosed. However, based on anecdotal evidence, we believe that more transactions should have been disclosed by taxpayers. For this reason, we believe that the current enforcement regime for disclosure, registration, and customer-list maintenance must be changed significantly to make the rules clear and eliminate the opportunities for parsing the statute and regulations to avoid disclosure.

The Treasury Department's Enforcement Proposals, issued on March 20, 2002, set out a comprehensive set of administrative, regulatory, and legislative actions and proposals, including new penalties on a taxpayer's failure to disclose a reportable transaction. These Enforcement Proposals are designed to create a web of rules that will ensure that the IRS has multiple sources of information about potentially abusive tax avoidance transactions. This web of rules will decrease the likelihood that a taxpayer will be able to avoid scrutiny by not disclosing a transaction – if either the promoter or another taxpayer who participated in the same transaction with the help of the same promoter registers or discloses the transaction, the IRS will be able to trace the transaction back to the nondisclosing taxpayer. These proposals, along with existing ongoing efforts by the Treasury Department and the IRS to enhance enforcement efforts, will ensure certainty of detection of questionable transactions, certainty of enforcement, and certainty of penalty application in appropriate cases.

2. The New York Times reported on January 3, 2002, that the IRS estimated that "corporations have acknowledged saving at least $14.7 billion in 2000 through the use of tax shelters, many of them illegal." What is the scope and magnitude of the shelter problem?

The corporate return disclosures filed in 2001 (for the 2000 taxable year) consisted of 272 disclosure statements reporting total tax savings of $14.9 billion for all years affected by the disclosed transactions. The 2001 filing season (for the 2000 taxable year) was the first to be fully covered by the current temporary disclosure regulations under Section 6011 of the Code. It is important to note that 97 of these disclosures were for leveraged lease transactions, which typically are not abusive tax avoidance transactions, and disclosing taxpayers in many of the other transactions legitimately may contest any adjustments to their tax liability with respect to those transactions. Accordingly, the $14.9 billion amount does not reflect the amount of tax savings that ultimately may be determined to be improper.

* Pamela F. Olson, Acting Assistant Secretary for Tax Policy, is responding on behalf of the Treasury Department.

It is very difficult to ascertain the scope and magnitude of the tax shelter problem without more disclosure and more information. As discussed in the Response to Question 1, the Treasury Department recently has issued a comprehensive set of regulatory and administrative actions and legislative proposals. The proposed changes will significantly alter a taxpayer's risk-reward calculus in deciding whether to engage in an abusive transaction. The Treasury Department and the IRS believe that these actions, when adopted and implemented, will shed light on the types and number of abusive transactions in the marketplace and will have a deterrent effect.

3. In 2001, less than 1,000 registrations were filed with the IRS by tax shelter promoters. In your estimate, how many should have been filed?

In calendar year 2001, 1049 promoter registrations were filed with the IRS: 330 were registrations under Section 6111(c) of the Code (i.e., transactions meeting a minimum benefit-to-investment base ratio), and 719 were registrations under Section 6111(d) (i.e., confidential corporate tax shelters). While we believe that the number of promoter registrations is low, it is not surprising because the registration requirement under Section 6111(d) is limited to *confidential* corporate tax shelters. Our understanding is that many promoters have lifted confidentiality restrictions to avoid registration, which has reduced the number of required registrations. (The lifting of confidentiality restrictions, however, may have hastened public knowledge of particular transactions.)

The Treasury Department's Enforcement Proposals include a legislative proposal to remove both the conditions of confidentiality and corporate taxpayer requirements in Section 6111(d), and to further modify this provision to allow the Treasury Department to conform the definition of a reportable transaction for purposes of the disclosure, registration, and list-maintenance rule. Under the conformed definition, one of the transactions that must be disclosed and registered is a transaction that is promoted under considerations of confidentiality, which should help keep transactions in the sunshine. In addition, the Enforcement Proposals will broaden the range of persons who will be required to register reportable transactions with the IRS. These proposals will increase the number of registrations that promoters are required to make.

4. How many tax shelter promoters are there?

Although we cannot estimate a number with certainty, we believe that there are a limited number of substantial promoters of sophisticated tax avoidance transactions for corporations and wealthy individuals. (These promoters are separate from the promoters of tax scams such as slavery reparation credits and Section 861 "Zero Tax" schemes.) The substantial promoters of sophisticated tax avoidance transactions include some large accounting firms, law firms, financial firms and specialty boutique firms.

To date, the IRS has contacted 30 promoters of sophisticated tax avoidance transactions in connection with their marketing activities. The Treasury Department's Enforcement Proposals will help the IRS to identify and pursue additional promoters by creating a web of rules that will provide the IRS with multiple sources of information about the participants and promoters of

questionable transactions.

5. Promoters are required to maintain and make available investor lists to the IRS. Are promoters making these lists available? To what extent have there been any problems?

As indicated above, the IRS has contacted 30 promoters of sophisticated tax avoidance transactions for corporations and wealthy individuals. The IRS has made informal requests to these promoters, through so-called "soft letters," for customer list information pursuant to Section 6112, as well as information regarding promoted transactions that were required to be registered under Section 6111.

Although we expect to obtain the information requested from these persons, they have not been as forthcoming as we had hoped, in part because of claimed ambiguities in the current enforcement regime and in part, we believe, because of a desire to extend the enforcement process. The IRS has served summonses where appropriate and, in conjunction with the Justice Department, will move to enforce these summonses in court. The IRS already has received a significant amount of information in response to these summonses and is working to obtain information from all of the promoters that have been contacted. The IRS will continue to seek information from those promoters as appropriate and will issue additional summonses as necessary. In addition, to encourage prompt compliance with IRS requests for customer lists, the Treasury Department is proposing an escalating penalty for promoters who fail to provide requested customer list information within 20 business days after a written request from the IRS. After 20 business days, the promoter would be penalized $10,000, and this amount would increase by $10,000 for each additional day that a promoter fails to provide the requested information.

6. How important are judicial doctrines of "economic substance," "business purpose," and others to resolving the current shelter problem?

The judicial doctrines of economic substance and business purpose underlie our tax rules. The Joint Committee on Taxation, in a recent report on tax shelters, stated,

> In addition to the statutory provisions, the courts have developed several doctrines over the years to deny certain tax motivated transactions their intended tax benefits. These doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. There is considerable overlap among the doctrines, and typically more than one doctrine is likely to apply to a transaction. Because of these considerations, invocation of these doctrines can be seen as at odds with an objective, "rule-based" system of taxation.

Joint Committee on Taxation, "Background and Present Law Relating to Tax Shelters" (March 19, 2002).

We agree that the judicial doctrines such as economic substance and business purpose are

important tools for attacking tax avoidance transactions. Before relying on these judicial doctrines, however, it is necessary to engage in a rigorous analysis of the transactions to determine whether they satisfy the technical rules that purportedly permit the tax benefits claimed. Oftentimes, tax avoidance transactions will fail to satisfy the technical requirements of the Code or Treasury regulations.

7. **Should Congress clarify and/or strengthen any of the existing doctrines to help address the shelter problem and to ensure that judges are applying the same standard?**

The application of these common law judicial doctrines depends on the particular facts of each case. It would be extremely difficult to legislate a rule for either business purpose or economic substance that would address adequately the multitude of situations where these doctrines may be applicable. An inflexible, mechanical rule may be too broad or too narrow, or both. A statutory rule that is sufficiently flexible necessarily would be subjective and thus would not provide more certainty than these existing judicial doctrines.

The proper application of the judicial doctrines is best ensured by asserting them in appropriate cases and supporting the legal arguments with fully developed facts. While it is necessary to evaluate transactions using the judicial doctrines, they are not a substitute for a rigorous, technical analysis of each problematic transaction, combined with timely regulatory or legislative changes where needed.

8. **For example, some have suggested establishing a floor for purposes of determining "economic substance." If the courts say a modicum of "economic substance" is enough to obtain tax benefits, how will the IRS win the war against abusive shelters?**

The question of how much economic substance is required before a transaction is respected is a fact-specific inquiry not susceptible of a "one size fits all" legislative response. A minimum level of risk and minimum level of profit may be appropriate in some cases, while in others a more significant level of risk and/or profit may be required. Attacking the economic substance of transactions in appropriate cases, supported by a full presentation of the relevant facts, will allow the courts to better define those situations where economic substance is lacking.

The IRS can prevail in addressing abusive transactions by requiring disclosure of questionable transactions, addressing those transactions early through the published guidance process, and challenging abusive transactions on their merits. The IRS will use the judicial doctrines where appropriate, but not rely solely on those doctrines to attack abusive tax avoidance transactions.

9. **What other substantive mechanisms are available to the IRS when taxpayers engage in artificial transactions designed only to reap tax benefits, but also to comply with literal Code requirements?**

The IRS can, and should, consider technical arguments first and foremost – those based on the substantive provisions – as well as the common law judicial doctrines, including the

economic substance, sham, step-transaction, and substance-over-form doctrines. In some cases, the alleged compliance with the technical Code requirements may not withstand rigorous scrutiny. In cases where there may be some ambiguity in the law that is perceived to allow the purported tax benefits of the transaction, the Treasury Department and the IRS must be ready to respond quickly to shut down abusive tax avoidance transactions through published guidance, including regulations. If a transaction is not susceptible to challenge under existing statutes and judicial doctrines, it is necessary to be ready to move quickly and propose legislative changes to shut the transaction down.

The Treasury Department and the IRS believe that this approach will work best if the IRS learns of potentially problematic transactions as they occur. The Treasury Department's Enforcement Proposals include proposals to make the rules for disclosure, registration and customer-list maintenance clearer, and to impose stiff penalties for the failure to follow these rules. The transparency achieved by these rule changes will be critical to any effort to shut down abusive tax avoidance transactions.

10. In Knetsch v. United States, the Supreme Court denied the taxpayer an interest deduction "because there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction." The Court reached this conclusion even though Mr. Knetsch complied with the literal requirements of the Code. Was the Supreme Court wrong in the Knetsch decision?

Knetsch is a good example of a case where a court applied the economic substance doctrine to achieve the correct answer. In that case, the Court applied the economic substance doctrine to determine that, in substance, nothing happened to support the taxpayer's receipt of the claimed tax benefits. One also might also characterize the Court's analysis as a substance-over-form analysis.

11. How else could the IRS have denied Knetsch his deduction?

The underlying statutory provisions at issue in Knetsch were amended in response to the Knetsch transactions. See I.R.C. § 264.

12. Treasury issued a notice the week of the March 21, 2002 Senate Finance Committee hearing describing a type of transaction that it will treat as a tax shelter. The transaction involves the use of a loan assumption agreement to claim an inflated basis in assets acquired from another party. Didn't this shelter comply with the literal language of the Code?

Notice 2002-14, 2002-14 I.R.B. 730, involves the purported assumption of a loan in exchange for assets that produces a claimed basis in the assets in excess of the assets' fair market value. (The assets then are sold and a tax loss is claimed.) For the reasons set out in Notice 2002-14, the transaction does not yield the result claimed under Section 1012 of the Code, the regulations thereunder, and the applicable case law interpreting Section 1012.

13. The IRS has recently lost several cases at the appellate level which it won at the Tax Court level. It appears that Tax Court judges are more willing to rely on judicial doctrines to overturn these types of transactions than the appellate courts. Why do you think that is the case and what can be done to address this variant interpretation?

As discussed above, the business purpose and economic substance doctrines are tools that judges can use to determine whether the tax benefits associated with a transaction that satisfies the technical provisions of the Code and regulations may nevertheless be denied. These doctrines involve a fact-specific inquiry, and different judges, therefore, may disagree on their application. The appellate courts in some cases have reversed the Tax Court's application of these judicial doctrines; in other cases, the appellate courts have affirmed the Tax Court's application of these doctrines (see Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313 (11th Cir.), cert. den., 2002 U.S. LEXIS 2363 (U.S. April 15, 2002) (affirming Tax Court's determination that COLI transaction at issue lacked economic substance)). Although judges may disagree on their application, we believe that these common law doctrines have continuing strength and vitality and will be applied in appropriate cases to facts that have been fully developed.

14. The lower court rulings had been considered major victories in an uphill campaign by the IRS to narrow the scope of abusive tax shelters. What is the explanation for these losses at the appellate level?

See Response to Question 13. In addition, we believe that the recent appellate court reversals highlight the importance of putting into place a system that will allow the IRS to get information about a potentially abusive transaction early so that the IRS can fully develop the facts, understand the technical merits of the transaction, and, where appropriate, challenge the transaction using the best possible arguments, including arguments that the transaction fails to satisfy the technical rules purportedly allowing the claimed tax benefits and that the transaction cannot be sustained under the common law judicial doctrines. The Treasury Department and the IRS, including Chief Counsel, are committed to a strategy of designating appropriate cases for trial, which means taking cases to trial only if the facts and the technical arguments are properly developed.

15. To what extent do these cases represent a shift in the pendulum back in the direction of corporate taxpayers?

These recent reversals by the appellate courts do not represent a shift of the pendulum back to corporate taxpayers. These cases indicate that the appellate courts sometimes side with the taxpayer and sometimes side with the Government. These cases also highlight that the system works best when transactions are brought to light early so that they can be addressed either through guidance (including, as appropriate, guidance that curbs certain transactions and guidance that may approve of other transactions) or through legislation. The most recent taxpayer victories – Compaq and IES – already were addressed legislatively in Section 901(k) of the Code. To prevent further abuses, the Treasury Department also has included in its Enforcement Proposals a proposal to expand Section 901(k) to cover similar transactions using

foreign income streams subject to foreign withholding taxes.

16. Some have suggested that the Compaq case is "disastrous for the integrity of the tax system." How can the Congress prevent corporations from using a patina of legitimacy to justify abusive tax shelters?

Although we disagree with the appellate court's decision in Compaq (and the Justice Department has requested a rehearing of the case), we do not believe that the decision is disastrous for the integrity of the tax system. The Compaq decision emphasizes, however, the importance of a proactive approach to tax administration. That is, there is no substitute for the vigorous enforcement of the tax laws and the early evaluation of questionable transactions. The IRS will engage in the rigorous analysis needed to determine if the taxpayer's position is correct under the law, and, if so, whether a prospective change in the law is needed to change that result. The Treasury Department's Enforcement Proposals will allow this analysis to take place as questionable transactions occur because taxpayers and promoters will be required to disclose and register these transactions. Taxpayers claiming a "patina of legitimacy" will know that their transactions will be scrutinized and challenged as appropriate.

17. Where do you draw the line between a transaction that is adopted solely for the purpose of inventing a tax deduction and a transaction that has some real business purpose?

As the Committee knows, it is very difficult to define an abusive tax avoidance transaction. There are various places in the Code where the Congress has approved transactions engaged in solely for the attendant tax benefits. In contrast, the abusive tax avoidance transactions that the Treasury Department and the IRS are concerned about often involve the manipulation of the technical rules to create a transaction generating purported tax benefits outside the scope of Congressional intent. Therefore, we must evaluate each transaction to determine whether the transaction undertaken by the taxpayer is in substance the transaction intended by the Congress to be covered by the statute, as the Supreme Court observed in Gregory v. Helvering, 293 U.S. 465, 469 (1935) ("But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.").

18. Do you believe that to be truly effective in preventing these kinds of transactions, policy makers need to establish some kind of floor with regard to "economic substance?"

For the reasons discussed above, we believe that the fact-specific nature of the inquiry necessary for application of the economic substance doctrine makes it very difficult, if not impossible, to craft a single definition or floor that can be uniformly applied and produce appropriate results.

ADDITIONAL QUESTIONS REGARDING ABUSIVE TAX SHELTERS
BY CHAIRMAN BAUCUS (TO ASSISTANT SECRETARY WEINBERGER)*

19. Treasury's recommendations, issued the day before the Senate Finance Committee hearing on abusive tax shelters, doubled the threshold for non-listed transactions from the current level of $5 million to $10 million. Under current law, two of five characteristics, if met, require disclosure. Treasury's proposal requires only one characteristic for the disclosure requirement. Nonetheless, with the significant increase in the threshold, on what basis does Treasury project more disclosures?

The Treasury Department's Enforcement Proposals will lead to greater compliance with the disclosure rules by (i) providing clear, bright-line rules for when a transaction must be disclosed; (ii) eliminating the exceptions to the current definition, which have been interpreted broadly by taxpayers to avoid disclosure (see Response to Question 20); and (iii) providing for new and significant penalties for the failure to disclose a transaction. Although this Response will focus on corporate disclosure, we note that the Treasury Department will extend the disclosure requirements (with requirements that vary slightly from the rules discussed here) to individuals, trusts, partnerships and S corporations.

Under the current disclosure rules, a "reportable transaction" is either a listed transaction or a transaction that satisfies a 2-of-5 factor test. A reportable transaction also must satisfy a projected tax effect test and not fall within one of the exceptions to disclosure. The 2-of-5 factor test, the projected tax effect test, and the exceptions will be replaced under the Enforcement Proposals with a list of four bright-line triggers, and a transaction that trips *any* of these four triggers must be disclosed. The new triggers will provide clear, bright-line rules that will result in fuller disclosure than the existing enforcement regime, which has resulted in limited disclosure.

Some of the monetary thresholds in this proposed definition of a reportable transaction differ from the existing definition. For instance, the projected tax effect test applicable to the current definition requires a reduction in tax *liability* of $5 million in any single year (or $10 million in any combination of years), in addition to satisfaction of the 2-of-5 filter test (one factor of which is a Schedule M-1 adjustment of $5 million or more). In contrast, any corporate transaction generating a tax *loss* of $10 million in any single year (or $20 million in any combination of years) will be subject to disclosure under the Treasury Department's proposed definition, which is a broader rule. Similarly, any book-tax difference of $10 million or more under the Treasury Department's proposed definition would be subject to disclosure with no additional requirements. The Treasury Department believes that its proposed triggers will result in more disclosures of potentially problematic transactions.

* Pamela F. Olson, Acting Assistant Secretary for Tax Policy, is responding on behalf of the Treasury Department.

20. Treasury has mentioned an "angel list" of exceptions. How will those exceptions differ from the current exceptions that taxpayers appear to be construing very broadly?

The current definition of a reportable transaction contains several potentially broad exceptions, including an exception for transactions for which there is a generally accepted understanding that the taxpayer's intended tax treatment is properly allowable, as well as an exception for transactions that the IRS has "no reasonable basis" to challenge. Some taxpayers have construed these exceptions to exclude virtually all transactions from the disclosure requirements. The Treasury Department's proposed definition of a reportable transaction will eliminate these exceptions.

In place of these existing exceptions, the Treasury Department and the IRS will identify in published guidance specific transactions that do not need to be disclosed – the so-called "angel list." The critical difference compared to the existing exceptions is that the Treasury Department and the IRS will identify specific kinds of transactions that do not need to be disclosed. The IRS will establish procedures for taxpayers to request that transactions be added to the angel list and for taxpayers to obtain a prompt pre-filing determination that their transactions do not need to be disclosed.

21. To what extent have the recent adverse court cases affected your thinking?

The recent reversals in the appellate courts have not changed our thinking. We continue to believe that the best way to address abusive tax avoidance transactions is for the IRS to obtain information as early as possible so that appropriate enforcement, administrative, or legislative action can be taken. This is the focus of the Treasury Department's Enforcement Proposals.

22. What do you expect the impact of these adverse cases will be on the tax shelter market if we don't act by the end of the year?

The Treasury Department's Enforcement Proposals are designed to give the IRS the information and tools necessary to stop the proliferation of abusive tax avoidance transactions. These Enforcement Proposals in many respects reflect and build upon the draft proposals developed by the Committee Staff after extensive analysis, and we look forward to working with the Committee and the Congress to enact our legislative proposals this year. In the meantime, as discussed above, the Treasury Department and the IRS will work together closely and use the tools currently available.

23. Senior members of your office have previously stated that we do not need new penalties to address shelters and that increased penalties will not improve compliance. Given the proposals you released yesterday, please explain why your thinking has changed and how these penalties will improve compliance?

We do not believe penalties are appropriate where the standards are not clear. New penalties or higher penalties only deter behavior if their application is certain. The Treasury Department's Enforcement Proposals will significantly simplify and coordinate the rules for

disclosure, registration, and customer-list maintenance under Section 6011, 6111, and 6112 of the Code. These rules will be clearer and easier for taxpayers to apply, and easier for the IRS to administer. Because the standards will be clear under these proposals, we believe that new penalties for the failure to disclose transactions and enhanced penalties for the failure to register and maintain customer lists for transactions are appropriate and will be an effective deterrent against non-compliance.

24. Briefly summarize the similarities and differences between Treasury's March 2002 proposals and the proposal released by Chairman Baucus and Ranking Member Grassley. Please explain the reason for any differences.

Please see the attached comparison.

ADDITIONAL QUESTIONS REGARDING ABUSIVE TAX SHELTERS BY CHAIRMAN BAUCUS (TO CHIEF COUNSEL WILLIAMS)

19. You were involved in the effort to address the individual tax shelter problem of the 1980s. We attacked that breed of shelters initially with litigation and procedural measures. Eventually, a substantive law change was needed to end those shelters – enactment of the passive loss rules. We now have a new breed of tax shelters, targeted to both individuals and corporations. Based upon your experience, do you believe that procedural steps and litigation will eliminate the current abusive tax shelter problem? Please explain.

The new breed of abusive tax avoidance transactions is different in that they are much more varied and not amenable to a single rule that can resolve a range of issues, in contrast to the passive loss rule enacted in 1986. The current breed includes complex transactions that combine complicated rules to achieve unintended results. A single rule intended to stop these transactions on substantive grounds (like the passive loss rule) would run the risk of being both too broad and too narrow.

The Treasury Department and the IRS believe that the best response is early disclosure, rigorous analysis of both the facts and the applicable technical rules, timely guidance (including legislative and regulatory changes where necessary), and, where appropriate, litigation to enforce rules (but not to establish rules). Disclosure is crucial because it acts as an early warning system for the IRS. Although some may argue that the Treasury Department's proposals to mandate disclosure – including the broadening of the types of transactions that must be disclosed and the enactment of stiff penalties for the failure to disclose – are overbroad, the Treasury Department and the IRS believe that the potential for overbreadth in a disclosure regime is not objectionable so long as the disclosure rules are clear, easy for taxpayers and their advisors to apply, and easy for the IRS to administer. If a taxpayer is comfortable in entering into a transaction, if the taxpayer's advisors are comfortable recommending the transaction, and if the promoter is comfortable selling the transaction, then neither the taxpayer nor the promoter should object to either disclosing or registering the transaction and subjecting it to IRS review.

The Treasury Department and the IRS are committed to the Treasury Department's Enforcement Proposals and already are working to implement many of the administrative actions. The Treasury Department and the IRS look forward to working with the Committee to enact the legislative proposals achieving the objectives in the Treasury Department's Enforcement Proposals, as well as other legislation to address unintended tax benefits as abusive tax avoidance transactions are identified. As an example of how the system should work, the Treasury Department's Enforcement Proposals contain two substantive proposals for legislation to shut down specific types of transactions that have been identified as abusive.

20. The Treasury and IRS recently issued new standards of practice under Circular 230. Do you believe that the IRS and Treasury have an interest in ensuring that tax practitioners maintain certain levels of professionalism, particularly with respect to tax opinion writing?

The Treasury Department, the IRS, tax practitioners and the taxpaying public all have an interest in high standards of professionalism, especially in opinion writing. We have received numerous comments and continue to receive comments about the proposed regulations under Circular 230. We are reviewing these comments carefully and are committed to finalizing the regulations as expeditiously as possible.

21. Last year, before you assumed your current position as IRS Chief Counsel, you said that tax opinions didn't constitute "practice" before the IRS, for purposes of regulation of tax opinion writers. Given your previous statement, do you now believe that Treasury has authority under current law to regulate tax opinions? If so, what has caused your view to change?

My views have not changed. I remain concerned that the mere issuance of opinions may not constitute practice before the IRS. However, the Treasury Department and the IRS have the authority to prescribe standards for opinions that may be relied upon by taxpayers to satisfy the reasonable cause and good faith defense under Section 6664 of the Code.

22. What changes, if any, would you make to the recently-issued opinion writing standards applicable to tax shelters?

I am actively involved, along with others in my office and representatives of the Treasury Department, in the project regarding the regulations under Circular 230. We have received many comments on the opinion writing standards in the proposed regulations. We are carefully considering these comments and will make appropriate changes reflecting these comments.

23. In your confirmation hearing, you said that you only wanted to litigate cases where clear answers had already been provided in guidance. Can you explain how you would apply this strategy in the tax shelter arena, where the transactions are contrived and are typically matters of first impression?

I continue to believe that the best way to tell taxpayers the IRS' position on a complicated issue is through published guidance. However, that does not mean that complicated transactions work unless the Treasury Department and the IRS expressly deny the tax benefits. Taxpayers must take reasonable steps to determine whether their tax positions are proper, and tax advisors must comply with the applicable professional standards in advising whether a transaction is valid.

The IRS will litigate cases when a taxpayer has manipulated the rules and regulations, including published guidance, to obtain unintended tax benefits. In addition, when justified by the facts, the IRS will challenge transactions based on the common law judicial doctrines. The

decision to litigate a case, however, must be a considered one, and one of my priorities, as discussed below, is to ensure that the right cases are designated for litigation.

24. During the March 21, 2002 hearing, you stated that "litigation is not the answer here." Will you vigorously defend the tax laws by pursuing corporations engaged in abusive tax shelters through litigation? If so, how do you reconcile this with your answers to questions 24 and 25?

One of my priorities as Chief Counsel is to ensure that the IRS rigorously identifies, develops and litigates appropriate cases in all areas, including abusive tax avoidance transactions. Litigation will always remain an important facet of the IRS' effort to combat abusive tax avoidance transactions, but litigation cannot be the answer to the problem. Litigation is far too costly, time-consuming, and fact-specific to address fully abusive tax avoidance transactions. Spending 5 to 10 years, or more, to litigate a case to conclusion is no substitute for learning about transactions as they occur and moving quickly with published guidance or legislative changes to stop the transactions.

The Treasury Department's Enforcement Proposals, with their focus on transparency, will provide the IRS with the information needed to be proactive in addressing the problem of abusive tax avoidance transactions. Certainly, if litigation is needed to enforce existing laws and ensure that all taxpayers pay their fair share, the IRS will litigate and litigate vigorously. The focus, however, must be on making sure that the rules are clear and administrable.

25. During the March 21, 2002 hearing, you stated:

> **"The other thing is, in terms of litigation, I am trying to design of a program where we will get to court and have more control over which case gets to court and we will have more control over which case gets to court than we have in the past. I am working with Commissioner Langdon specifically on that to make sure that the cases are developed well enough, the ones that we want to take to enforcement are developed well enough and early enough, so when we get to court, we move quickly."**

Are you saying that, for the cases where the IRS won in the Tax Court but lost on appeal, the problem was that the IRS didn't develop the case well enough or early enough and that is why the case won in the tax court but lost on appeal?

It is difficult to generalize why the IRS did not prevail in specific cases or why the appellate courts in those cases did not agree with the Government's arguments. I believe, however, that these cases highlight the importance of rigorously developing the facts and legal arguments early on in the examination process to ensure that the most appropriate cases are litigated and the best arguments advanced. As I stated at the Committee's hearing, I believe that the Compaq case could have been litigated differently. For instance, one could argue that in Compaq nothing, in substance, happened – i.e., the taxpayer never really owned the stock at issue for tax purposes because it lacked any real economic risk in the transaction. However, the case

was not litigated on those terms. Moreover, virtually every case involves close calls. That is why it is important to develop the cases fully and to assess carefully litigation hazards.

26. During the March 21, 2002 hearing, you also stated that "generalist judges have more of a sense that tax avoidance is a legitimate business objective than tax court judges do." Don't your statements (see also question 26) support the notion that either tax court judges should have exclusive jurisdiction over abusive tax shelter cases or the statute must be more explicit as to the standard for determining whether a transaction is an abusive tax shelter?

Although Tax Court judges and appellate court judges may disagree in their interpretation and application of the judicial doctrines, this does not mean that these doctrines are defective or that the appellate court judges are applying them incorrectly. Appellate court judges, who by nature must be generalists, bring a broader view to tax cases and an important balancing perspective. Because of their generalist perspective, they may approach tax cases in a manner similar to other business cases and may give more weight to the notion that tax minimization is an acceptable goal, even if that minimization is accomplished by means that the IRS may view as improper. Nonetheless, where appellate court judges reach the wrong results from a tax policy and tax administration perspective, the Treasury Department and the IRS may pursue further appellate review and consider proposing changes to the statute or regulations. For example, the Treasury Department supported the recently enacted change to the S corporation basis rules relating to discharge of indebtedness in response to the Gitlitz Supreme Court decision.

27. Given that "clear answers" may never appear in complex transactions in a complex economy, how will you address the proliferation of abusive tax shelters as IRS Chief Counsel?

I plan to work diligently with the Treasury Department toward completion of the administrative and legislative changes that are part of the Treasury Department's Enforcement Proposals. In addition, I plan to work with Commissioner Rossotti to make sure that IRS agents and taxpayers have prompt guidance about transactions that do not work and transactions that do. In addition, I plan to use the tools currently at my disposal (and the new tools described in the Enforcement Proposals, including new and increased penalties and injunctive relief, once they are available) to target abusive tax avoidance transactions and their promoters to achieve better compliance with the tax rules we now have in place. Finally, as a separate matter, where possible I hope to propose clear rules that are not one sided, which makes the rules susceptible to gaming, and I look forward to working with Treasury and the Congress on efforts to simplify the tax laws.

ADDITIONAL QUESTIONS REGARDING ABUSIVE TAX SHELTERS
BY CHAIRMAN BAUCUS (TO COMMISSIONER LANGDON)

19. How many corporations file Federal income tax returns?

In FY 2001, 5,491,000 corporations filed Federal income tax returns. Of these, 87,417 tax returns (Form 1120 series) were identified as Large and Mid-Size Business Division (LMSB) taxpayers, with assets of $10 million or more.

20. Were you concerned as a tax director that your competitors would say yes to a product, when you would say no, thereby granting an advantage over your previous employer?

I am concerned that some tax directors may be faced with the dilemma contemplated in your question. I believe that abusive tax shelter transactions are a serious problem that threatens our system of voluntary compliance. It therefore is important for effective and fair tax administration that we take appropriate measures to deter the proliferation of abusive tax avoidance transactions and ensure compliance by all taxpayers.

As Commissioner, Large and Mid-Size Business Division, my challenge is to improve voluntary compliance and ensure the fair treatment of all taxpayers by enhancing the IRS' ability to combat abusive tax avoidance transactions. The Treasury Department's Enforcement Proposals will improve the IRS' ability to combat abusive tax avoidance transactions.

21. Recently, your office waived penalties to increase disclosures. What effect do you believe that had on taxpayers' expectation regarding the imposition of penalties? Is the IRS all "carrot" and "no stick"?

We implemented the disclosure initiative under Announcement 2002-2 to encourage taxpayers to voluntarily disclose their participation in tax avoidance transactions and other transactions that might be subject to the accuracy-related penalties. As of April 30, 2002, the Office of Tax Shelter Analysis (OTSA) had received 621 disclosures from 577 taxpayers, and OTSA may receive additional disclosures as those that were sent by mail are delivered. We believe the disclosure initiative is good for tax administration by providing the IRS with information about questionable transactions and provides taxpayers an opportunity to disclose their participation in a tax avoidance transaction. In addition, we have identified new potentially abusive tax avoidance transactions and tax shelter promoters through this disclosure initiative.

Complementing the disclosure initiative, LMSB provided guidelines to IRS examiners regarding the consideration of the accuracy-related penalty under Section 6662 of the Code in examinations involving listed transactions and other potentially abusive tax avoidance transactions. Together with the disclosure initiative, the penalty guidelines create a compliance incentive by ensuring that in appropriate circumstances the IRS will consider and apply penalties consistently, impartially, and fairly among all taxpayers. Our penalty policy shows that we intend to use the "stick" in appropriate circumstances.

22. Do you believe that the imposition of greater penalties will improve compliance? Please explain.

We believe compliance can be improved by ensuring that penalties are considered and applied consistently, impartially and fairly among all taxpayers, including large corporations. Although increased penalties, such as those contained in the Treasury Department's Enforcement Proposals, create noncompliance disincentives, penalties that are excessive may prove difficult to administer and enforce and may result in a compromise of the underlying tax liability.

23. Do you think taxpayers believe the IRS will actually enforce, through imposition and collection, the heightened penalty proposed by Treasury?

Yes. The IRS, through recently issued guidelines from the IRS' Large and Mid-sized Business Division (LMSB), has taken an important step in this direction for accuracy-related penalties under Section 6662 of the Code. These guidelines, which apply in all cases involving potentially abusive tax avoidance transactions, will ensure that penalties are considered fairly, impartially, and consistently in all cases. The guidelines include instructions to our examiners, through LMSB Commissioner guidelines, regarding the development and imposition of penalties and also provide for executive oversight by Directors of Field Operations (DFOs). This approach will be expanded if the penalties proposed by the Treasury Department are enacted.

With respect to promoters, LMSB created a Section 6700 Committee to consider and approve all tax shelter promoter investigations and penalties to ensure consistency and fairness. This committee is chaired by one of our LMSB Industry Directors, and its membership includes the Manager, Office of Tax Shelter Analysis.

We fully support the Treasury Department's legislative proposals for penalties, including the penalty for failure to disclose reportable transactions, the increased penalty on promoters for failure to register reportable transactions, and the increased penalty for failure to turn over investor lists in a timely manner.

24. What history does IRS have in enforcing corporate penalties (e.g., amount imposed, collected, written off, compromised)?

We do not have complete information on IRS enforcement of penalties against large corporations. Our penalty enforcement against these corporations historically has been limited, although penalties have been asserted in particularly egregious situations. However, the new penalty policy recently promulgated by LMSB requires examiners to consider accuracy-related penalties and develop them during examinations of tax avoidance transaction cases. The policy provides for executive-level approval by DFOs of all decisions to impose or not impose penalties on abusive tax avoidance transactions. DFOs also will ensure that penalties are properly considered and applied consistently, fairly, and impartially among all taxpayers. Concerning promoter investigations, the IRS recently secured an agreement with a major Wall Street firm, which included a significant penalty for failure to register certain transactions.

25. Other than resources, what will it take for IRS to be able to properly enforce penalties?

We have put in place the mechanisms to enforce penalties. These include the designation of DFOs to oversee our penalty policies in the field, and instructions to agents to consider and develop penalties during the conduct of examinations. We have also included a chapter on penalties in our soon-to-be-released Tax Shelter Audit Technique Guide, and will be developing additional training tools for our examiners. When appropriate, Chief Counsel assistance will be utilized in penalty enforcement actions.

QUESTIONS REGARDING TREASURY'S TAX SHELTER PROPOSAL BY RANKING MEMBER GRASSLEY (TO CHIEF COUNSEL WILLIAMS)

1. **You are asking for legislation permitting injunctions against shelter promoters. In your testimony, you say you have 6 injunctions against promoters. Why do you need this legislation?**

The existing injunction authority under Section 7408 of the Code permits the Government to seek injunctions against persons who engage in conduct subject to penalty under Section 6700 and 6701. These are the promoter penalties for false or fraudulent statements in connection with the promotion of a tax avoidance scheme and for aiding and abetting the understatement of tax liability. These penalties apply most readily in cases where promoters are marketing tax scams based on arguments that are patently false or facts that simply are not true.

I believe that the Government also should have the power to enjoin promoters who repeatedly disregard the registration and list-maintenance requirements for tax avoidance transactions. (Not surprisingly, these promoters often urge taxpayers that these transactions are not covered by disclosure requirements.) For these promoters, the threat of penalties often is not enough. An injunction would place a promoter under court order to abide by the registration and list-maintenance requirements, with the threat of being held in contempt of court if the promoter fails to do so.

2. **The IRS has lost some big cases recently – Compaq and IES. Don't these cases seriously undermine the economic substance test? How will these cases affect your enforcement efforts? Should Congress do anything to bolster the economic substance test?**

The question of how much economic substance is required before a transaction is respected is a fact-specific inquiry not susceptible of a "one size fits all" codification of the doctrine. We continue to believe that the level of risk or expected profit necessary in a particular case will depend on the facts of the case, and Compaq and IES highlight the importance of the IRS' need to rigorously develop the facts in all cases as well as the best arguments to attack the transactions at issue.

More broadly, the IRS can prevail in addressing abusive tax avoidance transactions by encouraging disclosure of questionable transactions, addressing those transactions early through the published guidance process, and challenging abusive transactions on their merits. (In some cases a statutory change may be needed to address a transaction. Section 901(k), for instance, addresses the transaction at issue in both Compaq and IES, and the Treasury Department is proposing to expand Section 901(k) to address similar transactions.) This means the IRS will use the judicial doctrines where appropriate but not rely solely on those doctrines to attack abusive transactions.

3. **You have issued summonses to 30 shelter promoters who refuse to give you information. If these promoters shred evidence, like they did in Enron, can you bring criminal charges against them?**

   Yes, under Section 7212 and/or 18 U.S.C. § 371.

4. **You say that taxpayers will be able to come to you for opinions on their transactions and the IRS will not always be a "nay-sayer". Does that mean you intend to bless some transactions.**

Yes. One purpose of the published guidance process is for the Treasury Department and the IRS to tell taxpayers when transactions do not work, and when they do. In some cases, a transaction may be legitimate. In those cases in which the Treasury Department and the IRS believe that the transaction is legitimate but the result inappropriate, it is up to the Treasury Department and the IRS to address the transaction prospectively either by publishing guidance or by seeking statutory changes (as we have done with two particular types of transactions in the Treasury Department's Enforcement Proposals).

5. **You say that some professional tax advisors issue favorable tax opinions on transactions that lack economic reality and violate established tax principles. How can they get by with that? Aren't there state ethics board violations? Is it illegal for CPAs and attorneys to do this?**

Because of the fact-specific nature of the application of many of the rules and regulations to particular fact situations, as well as judicial doctrines such as economic substance and business purpose, many of the judgment calls reflected in opinions that appear questionable in retrospect may not rise to the level of an ethical violation. In other cases, such as factual misrepresentations, a violation will be clearer. Where the IRS determines that there has been a violation of the standards of practice before the IRS, the IRS will pursue those violations and may seek to bar the tax practitioner from practice before the IRS. In addition, such violations may be referred to state ethics boards, which in turn would determine whether the behavior constituted an ethical violation under their particular rules. The IRS is examining how to address concerns with Section 6103 of the Code in this regard.

6. **You state that you formed "transaction-specific task forces" to combat the disconnects within the IRS itself. How long have these task forces been in place and what results have they achieved?**

The idea of transaction-specific task forces is to create a mechanism to analyze promptly questionable transactions that the IRS identifies through registration by promoters, disclosure by taxpayers, and examination of taxpayers by revenue agents. I intend to form task forces for transactions that require coordination between the IRS field team, the National Office technical experts, and the Treasury Department. An example of the success of these task forces is the recently issued Notice 2002-21, which targets transactions involving the use of a loan assumption agreement to claim an inflated basis in assets. With the changes to the disclosure and

registration rules that the Treasury Department has proposed, I anticipate that we will see more transactions that require a rapid response. The transaction-specific task forces will be an important mechanism for how we process the information that we gather using the existing and new tools, and they will allow us to act quickly based on that information.

QUESTIONS REGARDING TREASURY'S TAX SHELTER PROPOSAL
BY RANKING MEMBER GRASSLEY (TO COMMISSIONER LANGDON)

1. You stated that last fall 99 corporations disclosed over 272 transactions on their tax returns. How many of these transactions were possible shelters?

The IRS received 272 corporate disclosure statements in calendar year 2001, of which 64 were for listed transactions (i.e., transactions that the IRS has identified in published guidance as tax avoidance transactions) and 208 were for other reportable transactions (i.e., transactions that satisfy the 2-of-5 filter test in the current temporary regulations). Of these 208 disclosures for other reportable transactions, 97 were for leveraged lease transactions, which typically are not abusive tax avoidance transactions. We are investigating the remaining 111 other reportable transactions to determine how many of them are abusive tax avoidance transactions.

2. What are you doing about the ones that may be shelters?

Upon receipt, all corporate disclosure statements are reviewed by the Office of Tax Shelter Analysis (OTSA) and categorized by the nature of the potential abusive tax avoidance transaction involved. In the case of newly identified abusive tax avoidance transactions, a legal analysis is undertaken to evaluate the transaction. The disclosure statements are forwarded to the appropriate industry director within the Large and Mid-Size Business Division (LMSB) for compliance action. Field examination teams are supported by technical advisors (tax shelter issue specialists) and local tax shelter Chief Counsel attorneys on the development of the potential tax issues.

In any specific case, a deficiency will be asserted when justified by the facts of the case and the applicable law. Recently issued penalty guidelines require the development and consideration of penalties, and executive-level oversight will ensure that all penalties are considered fairly, impartially, and consistently. As discussed by Chief Counsel Williams, we also will work closely with his office to develop cases for potential designation for litigation. In addition to challenging individual transactions as appropriate, we will work with the Office of Chief Counsel and the Treasury Department to issue guidance and develop legislative proposals to prevent other taxpayers from entering into transactions that are improper.

3. You have indicated your disappointment with the low number of disclosures last fall. Some people have argued that this is evidence that corporate tax shelters don't really exist. How do you respond to those people?

We believe that the number of corporate taxpayer disclosures filed in 2001 was low. For example, Section 6112 of the Code requires promoters to maintain a list of taxpayers investing in their transactions. As part of our enforcement efforts against promoters with respect to the registration and list-maintenance requirements, we recently secured an investor list from a professional services firm. A number of different transactions and related investors are included on this list. For one of these transactions, 17 investors are listed, but only 5 of these 17 investors had filed corporate disclosure statements. Based on this and other similar experiences, we

believe that a number of corporations may not have complied with the temporary regulations for corporate disclosures under Section 6011. We believe that taxpayers have applied the rules narrowly and the exceptions broadly.

4. In 2001, you received 945 promoter registration statements. How many of these were shelters and what are you doing to pursue them?

In calendar year 2001, 1049 tax shelter registrations were filed with the Internal Revenue Service. Of these, 330 were Section 6111(c) registrations (i.e., transactions meeting a minimum benefit-to-investment base ratio), and 719 were Section 6111(d) registrations (i.e., confidential corporate tax shelter transactions). Many of the registrations are for listed transactions, including Rev. Rul. 99-14 (LILOs), Notice 99-59 (BOSS), Notice 2001-45 (Basis-Shift) and Notice 2002-21 (tax avoidance using inflated basis). In addition, 402 registrations relate to the Sale-in-Lease-out (SILO) transaction, which involves foreign exempt entities that have characteristics similar to the Lease-in-Lease-out (LILO) transaction. A Chief Counsel task force team is reviewing the SILO transaction to determine whether it is potentially abusive.

The IRS is using registration information to obtain investor lists from the promoters, and using these investor lists to take appropriate enforcement action against participating taxpayers. The IRS uses promoter registrations as an information source to initiate contact with promoters to obtain investor lists and to request additional information about registered (and possibly other) transactions. We are using all available tools in our enforcement efforts, including the use of summonses to force promoters to provide information and the assertion of penalties where justified. We also are using information from taxpayer disclosures to identify additional promoters for investigation.

5. Mr. Weinberger states that the amnesty program disclosed more that 150 transactions. Your testimony says over 100 taxpayers have disclosed under the program. Does this mean that some taxpayers disclosed more than one tax shelter?

Yes, some taxpayers have disclosed participation in more than one potentially abusive tax avoidance transaction. As of April 30, 2002, OTSA had received 621 disclosures from 577 taxpayers, and OTSA may receive additional disclosures as those that were sent by mail are delivered. We are in the process of reviewing the transactions that have been disclosed.

6. Why do you expect more taxpayers to enter the amnesty program?

We expect to receive additional disclosures based on telephone inquiries and practitioner comments. Taxpayers who do not disclose run the risk that another investor involved in the same abusive tax avoidance transaction will make a disclosure and, in accordance with the terms of the disclosure initiative, identify the promoter. Once we know the name of the promoter, we will request that the promoter provide us with its list of investors pursuant to Section 6112 of the Code. We anticipate that taxpayers, wary of this possibility, will disclose to avoid the consequences of being identified (which could include a deficiency assessment and the assertion of penalties).

7. Why did you start the amnesty program in December, and were you planning this legislation at that time?

The disclosure initiative under Announcement 2002-2 is another in a series of steps that the Treasury Department and the IRS have taken to identify and shut down abusive tax avoidance transactions. We initiated the program because we had reason to believe that taxpayers were not complying with the disclosure requirements under the temporary regulations to Section 6011 of the Code and the registration requirements under Section 6111 either because they were playing the audit lottery or because they were afraid of penalties if the tax benefits of a disclosed transaction were disallowed. The IRS took this step because information obtained through disclosures helps the IRS more readily identify promoters of abusive tax avoidance transactions who have not registered as well as other taxpayers who have not disclosed their participation in a tax shelter.

The Treasury Department, starting with Assistant Secretary Weinberger's confirmation hearing, indicated it wanted to evaluate the regulations and the results of the fall 2001 filing season before considering what, if any changes, might be appropriate for both the regulations and the Code. The fall 2001 filing season, for calendar year 2000 corporate returns, was the first to be covered fully by the temporary disclosure regulations under Section 6011. The IRS began evaluating the disclosures filed by corporations in fall 2001 as they were received, and, as discussed above, the number of disclosures filed was disappointing. As the Committee knows, the IRS has briefed periodically your staffs on the efforts to address abusive tax avoidance transactions and the IRS' experience with the disclosure regulations. In early 2002 the IRS began working with the Treasury Department on potential legislative and regulatory changes to improve the effectiveness of the current enforcement regime. We are pleased now to have the opportunity to work with the Committee on appropriate legislative actions to improve disclosure and compliance.

8. How much money has the amnesty program brought in?

The disclosure initiative under Announcement 2002-2 had a 120-day life that expired on April 23, 2002. At this time, disclosures are still being received and processed, and we will not be able to ascertain the additional revenue impact until all of the disclosed items have been examined and resolved. As of April 30, 2002, OTSA had received 621 disclosures from 577 taxpayers, and OTSA may receive additional disclosures as those that were sent by mail are delivered. Of these 577 taxpayers, 105 disclosed over $12 billion of deductions or losses. (We note that the disclosure initiative does not require a concession by a taxpayer that a disclosed transaction was improper, and therefore the disclosed deductions and losses may not necessarily result in adjustments.) The other taxpayers did not disclose dollar amounts of deductions or losses. We will examine the disclosed transactions to determine if they are improper and assess deficiencies as appropriate.

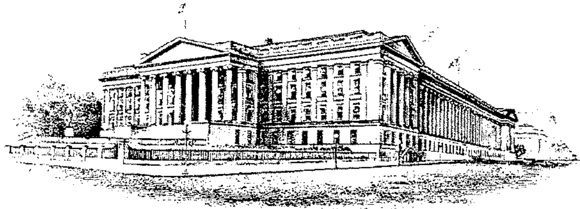
9. You state that one of the problems under current law is that shelters come with the blessing of a tax opinion.

a. I know those opinions are often given by someone hired by the promoter or are given by the promoter itself.

b. So when can taxpayers rely on an independent tax advisor's opinion and not be subject to penalties under your proposal?

Taxpayers frequently base their defense to the accuracy-related penalty under Section 6662 of the Code on an opinion from a tax practitioner regarding the tax consequences of the transaction. Based upon our audits, we are concerned that many of these opinions reflect inadequate due diligence and analysis on the part of the practitioner with respect to the underlying facts of the transaction or the applicable substantive law. We believe that such opinions cannot serve as a defense to the penalty.

Under the Treasury Department's Enforcement Proposals, a taxpayer would not be able to rely upon an opinion to establish a defense to the accuracy-related penalty if the transaction at issue was a reportable transaction, as defined in the Enforcement Proposals, that was not disclosed. Even if a transaction is disclosed, an opinion can serve as a basis for a defense to the penalty only if it reflects an appropriate degree of due diligence and analysis with respect to the relevant facts and substantive law.



DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

FOR IMMEDIATE RELEASE
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Contact: Tara Bradshaw
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Statement of
Mark A. Weinberger
Assistant Secretary of the Treasury for Tax Policy
Committee on Finance
United States Senate

Mr. Chairman, Mr. Grassley and other members of the Committee, thank you for inviting the Treasury Department to testify today on the important issue of abusive tax avoidance transactions. We appreciate the role that your Committee has taken in considering these matters. Through your statements and the release of your staff's draft legislative proposals, you have taken the lead in the public discussion about how best to address abusive tax avoidance transactions.

Abusive tax avoidance transactions are designed to take advantage of the incredible complexity of the tax law to obtain benefits that Congress never intended. Abusive tax avoidance transactions pose a threat to the integrity of our self-assessment tax system by eroding the public's respect for the tax law. They also waste public and private resources and harm the public fisc. As long as the tax law retains its current complexity, promoters will continue to develop these transactions and market them to corporate and individual taxpayers. As Secretary O'Neill has stated, we must simplify the Internal Revenue Code. Its complexity effectively aids and abets those who seek to improperly reduce their taxes. Nevertheless, until we simplify the Code, the Treasury Department and the IRS will continue to vigilantly pursue enforcement of our laws, within the contours of the current system, to address abusive tax avoidance transactions.

As you know, the Treasury Department has been evaluating the effect of the current disclosure regime, particularly the effect of the disclosure regulations issued in February 2000, before initiating a new course of action. We appreciate very much, Mr. Chairman, that the Committee has given us the time to complete our evaluation because what we have learned will result in more effective rules. Constant change is not helpful

to tax administration; it makes it harder for taxpayers to comply with the law and harder for the IRS to administer the law. Accordingly, we should act deliberately to change the rules only after appropriate evaluation and analysis.

Treasury's testimony today will highlight the measures that we believe are necessary to address abusive tax avoidance transactions. Our proposals include administrative actions we already are beginning to undertake, as well as legislative proposals. Our administrative and legislative initiatives are similar in many respects to the proposals considered by your staff in the draft legislation they previously prepared.

The goal we all share is to ensure that each taxpayer pays its fair share of tax. We do not wish to interfere with legitimate business tax planning, but we must curb abusive tax practices that take advantage of complex tax laws to obtain unintended tax benefits. This goal can best be achieved through transparency and certainty. Transparency means that questionable transactions are disclosed for the IRS to review. Certainty means that taxpayers and promoters are subject to rules that clearly identify which transactions must be disclosed and registered and which transactions require list maintenance. Certainty also means that taxpayers and promoters cannot avoid detection. Finally, certainty means that rules will be enforced and penalties will be imposed in appropriate circumstances.

The measures we propose will provide transparency and certainty. These measures will create a web of rules that reinforce each other by requiring information reporting to the IRS about a questionable transaction both by the taxpayers participating in the transaction and by the promoters. These disclosure rules will allow the IRS to identify promoters from taxpayer disclosures, and other taxpayers from promoter disclosures. Taxpayers and promoters who fail to provide the required disclosure will be subject to significant penalties.

Treasury believes that if a taxpayer feels comfortable entering into a transaction, if a promoter feels comfortable selling a transaction, and an advisor feels comfortable recommending a transaction, they all should feel comfortable detailing the transaction for the IRS.

Before providing details about our new course of administrative actions and our legislative proposals, I think it would be helpful first to provide a context for our measures by describing the actions that Treasury and the IRS are currently taking to combat abusive tax avoidance transactions, and why we have concluded that more needs to be done. In the final analysis, however, we all must recognize that the complexity of the tax Code is the fundamental reason why taxpayers have the opportunity to engage in abusive transactions, and only by simplifying the entire system will such opportunities be eradicated.

Current Enforcement Status

Treasury and the IRS are working together closely to combat abusive tax practices. Some recent and important steps include a new voluntary disclosure initiative,

new penalty guidelines, guidance that shuts down several abusive transactions, improved resource allocation and inter-agency coordination, enhanced tax information exchange agreements with offshore financial centers, and intensified enforcement efforts against the promoters of abusive tax avoidance transactions. Treasury and the IRS will continue pursuing steps that will enhance the Government's ability to curb abusive tax avoidance transactions.

Disclosure Initiative and New Penalty Guidelines

The IRS recently issued Announcement 2002-2, which provides an incentive for taxpayers to disclose questionable transactions. Under this program, which runs through April 23, 2002, the IRS will waive the accuracy-related penalty if a disclosed transaction results in an underpayment. The taxpayer, however, remains liable for the additional tax and interest. In order to obtain the benefits of the program, the taxpayer must disclose to the IRS all relevant information about the transaction, including the identity of any promoter. Almost 150 transactions already have been disclosed, and the IRS expects many additional disclosures in the coming weeks. The IRS will use the information received to identify promoters and taxpayers who have not disclosed transactions. For example, one recent IRS inquiry of a promoter resulted in a list of 17 investors. All 17 of the investors should have disclosed their participation to the IRS, but only 5 of the investors actually disclosed.

Along with this disclosure initiative, the IRS announced new penalty guidelines that will be used by the IRS' Large and Mid-Size Business Division. These guidelines make clear that penalties are an important tool to encourage voluntary compliance. The new guidelines require IRS agents to consider the appropriateness of penalties for certain transactions and require an agent's decision to assert or not assert penalties to be reviewed by a Director of Field Operations. The guidelines will ensure that penalties are impartially, fairly, and consistently considered in all tax avoidance cases.

Guidance Shutting Down Various Transactions

Treasury and the IRS are continually evaluating transactions that come to the Government's attention. When an abusive tax avoidance transaction is identified, Treasury and the IRS will issue guidance shutting down that transaction. For example, Treasury and the IRS recently published (i) a notice warning taxpayers that the IRS will challenge transactions using a loan assumption agreement to claim an inflated basis in assets acquired from another party (Notice 2002-21), (ii) a notice warning taxpayers that the IRS will challenge transactions improperly shifting basis from one party to another (Notice 2001-45), (iii) a notice announcing Treasury's intention to promulgate regulations that prevent the duplication of losses by a consolidated group (Notice 2002-18), and (iv) final regulations on hedging transactions that prevent employers from deferring tax on income from investments used to fund non-qualified deferred executive compensation (Treasury Regulation Section 1.1221-2). Treasury and the IRS are working to expedite the issuance of additional notices and guidance.

Improved Resource Allocation and Inter-Agency Coordination

Government resources must be used as efficiently and effectively as possible. Treasury has worked with the IRS to issue published guidance in controversial areas (such as research credit, accounting method and timing issues), that have consumed significant IRS examination resources. According to the IRS' Large and Mid-Size Business Division, these areas previously used as much as 40% of large case audit resources across industry groups. That placed an unacceptable burden on both taxpayer and IRS recourses. Treasury and the IRS believe that IRS resources are better used to address other important issues, including abusive tax avoidance transactions. Moreover, taxpayer resources are better allocated to growing their businesses.

The IRS also is working with the Department of Justice to ensure that the Government has a single, coordinated approach to cases in litigation.

Enhanced Tax Information Exchange with Offshore Financial Centers

It is more important than ever not to allow the financial institutions of any country to be used for an illicit purpose, including cheating on taxes. Treasury is working to ensure that the necessary tax information exchange relationships are in place so that no country serves as a safe haven for those who wish to hide income from the IRS. Secretary O'Neill made a commitment last summer to significantly expand our network of tax information exchange agreements, with a particular focus on achieving such agreements for the first time with significant offshore financial centers that have not been interested in cooperating with us on tax matters in the past. Importantly, these civil and criminal tax information exchange agreements will override bank secrecy laws.

Over the past few months the United States has signed important new tax information exchange agreements with the Cayman Islands, Antigua and Barbuda, and The Bahamas. These agreements, with jurisdictions that are major international financial centers located in our own neighborhood, will be an invaluable source of information to the IRS. These were the first agreements signed in nearly a decade.

However, Treasury is not stopping there. We are in ongoing discussions with many other jurisdictions, and we expect to be able to announce additional new agreements very soon. We remain committed to establishing a complete network of tax information exchange relationships as quickly as possible.

Treasury also is continuing to work within the OECD to keep international attention focused on the need for cooperation on information exchange on tax matters. We have been successful in refocusing the OECD project on its core element: the need for countries to be able to obtain specific information from other countries upon request in order to prevent noncompliance with tax laws. Treasury is very pleased that nineteen jurisdictions have committed to improving their transparency and information exchange practices since the refocusing of the OECD project last year. We look forward to

continuing to work together with other countries to achieve real advances in this critically important area.

Intensified Enforcement Efforts Against Promoters of Abusive Tax Avoidance Transactions

Some promoters proliferate abusive tax avoidance transactions by developing them and marketing them to a large number of taxpayers. Because these promoters play a role in the existence of abusive tax avoidance transactions, the IRS is taking vigorous actions to curb their activities with respect to both corporations and individuals.

The IRS has contacted 30 promoters of corporate tax avoidance transactions and is working with the Department of Justice to ensure that these promoters provide us with information on questionable transactions, including the identity of the taxpayers who participated in them. The IRS and the Department of Justice are ready to go to court to ensure that promoters comply with the IRS' requests for information. Once the IRS obtains from promoters the identity of participating taxpayers, the IRS will initiate appropriate enforcement action against those taxpayers, including examinations and penalty consideration. The IRS also has opened 14 penalty audits with respect to promoters of corporate tax avoidance transactions.

In addition, the IRS is focusing on promoters of tax schemes that are directed primarily at individuals and small businesses. Although often less sophisticated than corporate tax avoidance transactions, these schemes are equally damaging to the fairness of our tax system. The IRS, working with the Department of Justice, already has obtained 6 injunctions against promoters of these schemes, and 12 other cases have been or soon will be filed. The IRS also is working to stop the use of offshore accounts that allows U.S. residents to hide assets in a tax haven country while using a credit card to spend that money in the United States. The IRS, again in coordination with the Department of Justice, has issued summonses to some of the major credit card networks and plans to issue summonses to certain vendors to identify the thousands of taxpayers who are participating in these schemes.

Treasury's Assessment of the Current Disclosure Regime

The current disclosure regime is a key component in combating abusive tax avoidance transactions. Under the current disclosure regulations, corporate taxpayers are required to disclose certain reportable transactions on their tax returns, and promoters are required to register confidential corporate tax shelters with the IRS and maintain lists of investors. Disclosure allows the IRS to identify potentially abusive transactions early in the process, to evaluate those transactions, to provide guidance on whether those transactions are proper, and, if necessary, to change the regulations or recommend legislative changes to shut down those transactions. Disclosure also helps the IRS identify taxpayers who participate in abusive transactions and promoters who market such transactions. Effective disclosure rules also are important to deter taxpayers from engaging in abusive tax avoidance transactions. A disclosure regime that increases the

probability of IRS detection will change the taxpayer's risk/reward analysis and discourage taxpayers from playing the audit lottery.

For the year 2000 corporate returns, which were filed primarily in the fall 2001 filing season, only 272 transactions were disclosed by 99 corporate taxpayers. Treasury and the IRS are disappointed with the small number of disclosures. Treasury and the IRS also are disappointed with promoter compliance with the list maintenance rules. Some promoters are claiming they are not required to maintain investor lists or are refusing to provide the lists to the IRS in a timely manner.

After reviewing the operation of the current rules, Treasury and the IRS have concluded that significant changes to the rules are necessary. Treasury and the IRS have identified which rules are effective and which are ineffective. Based on this analysis, we are proposing changes that build on what has proven effective and alter what has proven ineffective.

The primary feature of an effective regime is certainty - certainty that transactions will be identified, certainty that the rules will be enforced, and certainty that applicable penalties will be imposed. Regardless of how artful or conceptually perfect the rules in the Code and the regulations are drafted, if they are not enforced – and especially if the tax community perceives that they are not being enforced – they will prove ineffective. The current rules do not provide the necessary certainty.

The current rules do not provide certainty in part because of their complexity. This complexity arises because the disclosure, registration, and list maintenance rules are different from one another and because they are each difficult to apply. For example, under the current rules, a transaction must be disclosed if it satisfies two of five filters, but does not qualify for any one of three exceptions. Some of the exceptions are highly subjective, including the exception if there is a "generally accepted understanding" that the tax benefits are allowable and the exception if there is "no reasonable basis" for the IRS to deny the tax benefits. Taxpayers and promoters are parsing these rules to avoid disclosure. They are interpreting the filters narrowly and reading the exceptions broadly.

In addition, the system must alter the risk/reward analysis for participating in questionable transactions by increasing the cost of not complying with the rules. The current rules do not provide incentives to disclose transactions because they do not impose meaningful penalties on taxpayers and promoters who fail to comply. For example, under the current rules, there are no clear penalties if a taxpayer fails to disclose a reportable transaction.

The existing rules were intended to create a web that would allow the IRS to identify and halt abusive tax avoidance transactions by tracing transactions through the system from promoters to taxpayers and vice versa. The possibility of the IRS finding out about a transaction from alternative sources would increase the "risk" of detection. However, the complexity and subjectivity of the current rules and the lack of meaningful penalties -- essentially, holes in the web -- do not afford certainty of disclosure,

identification, or enforcement. Without this certainty, the current disclosure rules do not have the necessary deterrent effect.

Yesterday, Treasury announced an initiative to improve the disclosure and penalty regime through a combination of administrative actions already underway and new legislative proposals. These actions will increase certainty and make the disclosure regime more effective. A detailed description of the proposals is attached to this testimony. We have met with your staffs to provide an overview as well.

Administrative Changes

Many of the administrative actions will simplify and broaden the rules governing taxpayer disclosure and promoter registration and list keeping. For example, Treasury and the IRS intend to provide a single definition of a reportable transaction for purposes of the disclosure, registration, and list maintenance rules. The definition will provide clear, bright line tests that leave no room for interpretation or subjective inquiries. This single definition will allow the IRS to move quickly from a taxpayer's disclosure to a promoter's list of investors to other taxpayers who engaged in the reportable transaction. This will create a more perfect web that deters abusive tax avoidance transactions by increasing the certainty of IRS detection.

The IRS also is developing a new disclosure form that will be centrally filed with the Office of Tax Shelter Analysis. The form will request specific information needed to evaluate whether a transaction is an abusive tax avoidance transaction. The form will greatly help the IRS identify and evaluate transactions for which further action may be needed.

The new rules will deliberately cast a broader net than exists under the current disclosure and registration rules. For example, the initiative will extend the disclosure requirements to partnerships, S corporations, trusts, and certain individuals. In addition, the initiative will apply the disclosure, registration and list maintenance requirements to more transactions. Under the current rules, transactions that the IRS has identified as tax avoidance, or listed, transactions, must be disclosed, and we will keep that rule. We are replacing, however, the 2-of-5 filter test and eliminating the related exceptions in the current rules. In their place, we are creating clear categories designed to require disclosure of the types of transactions we are most concerned about. These include transactions that generate large tax losses, transactions that result in tax credits where the underlying assets are held a brief period of time, transactions that generate significant book-tax differences, and transactions marketed on a confidential basis. We recognize that these rules will require disclosure of many legitimate transactions, and we are eager to work with taxpayers to ensure that these rules are appropriately tailored. Simplicity and clarity, however, will remain our paramount goals.

Treasury and the IRS also will undertake administrative actions to increase penalties on taxpayers who fail to disclose reportable transactions. For example, Treasury and the IRS will amend the regulations to impose a strict liability accuracy-

related penalty on taxpayers who do not disclose a listed transaction and who have an underpayment resulting from the transaction. In addition, the amended regulations will provide that taxpayers cannot rely on a favorable tax opinion as a defense to the imposition of the accuracy-related penalties if the taxpayer did not disclose a reportable transaction or a return position based on the invalidity of a regulation.

Because taxpayers rely on opinions for assurance that transactions are proper and will not be subject to penalties, Treasury and the IRS believe that tax opinions regarding tax avoidance transactions need to be regulated. We are currently taking steps administratively to mandate and enforce standards for opinions used to support tax avoidance transactions.

Legislative Proposals

Treasury's legislative proposals focus on enhanced penalties for taxpayers and promoters who fail to follow the disclosure, registration, and list maintenance rules. For example, Treasury is seeking a new and substantial penalty for taxpayers who fail to disclose reportable transactions. A corporate taxpayer, for instance, would be subject to a penalty of $200,000 for failure to disclose a listed transaction, regardless of whether the tax benefits of the transaction are ultimately sustained on the merits. Further, if the corporate taxpayer fails to disclose and loses on the merits, the taxpayer would be liable for a new strict liability penalty of 25% of its claimed tax savings. Treasury is also seeking legislation requiring public disclosure by corporate taxpayers of penalties for the failure to disclose listed transactions and accuracy-related penalties resulting from an undisclosed listed transaction.

For promoters, Treasury is recommending legislation that would enhance the existing penalties for failure to register a transaction. For example, a promoter who fails to register a listed transaction generally would be subject to a fine of $200,000 or 50% of its fees, whichever is greater.

Because Treasury wants to make sure that promoters identify taxpayers who have invested in reportable transactions, we are seeking an escalating penalty that would increase by $10,000 for each day that a promoter fails to turn over a list of investors requested by the IRS in writing. The IRS is facing too many delay tactics, and this needs to stop.

In addition to the preceding penalty proposals, Treasury believes that other legislative measures should be taken to curb abusive tax avoidance transactions. For example, legislative revisions to Code Section 6111 may be necessary for Treasury and the IRS to create a consistent definition of a reportable transaction for purposes of the disclosure, registration and list maintenance rules.

Treasury also proposes two substantive law changes. The first substantive proposal would amend Section 901(k) of the Code to deal with trading in foreign tax credits. Under the proposed rule, a minimum holding period for ownership of property

would be required before taxpayers could claim tax credits associated with income from the property. The second substantive proposal would add a new provision to deal with a broad range of income stripping transactions. The new provision would address stripping transactions in a manner that would match the tax treatment with the economics of the transactions.

Conclusion

In conclusion, Treasury and the IRS are committed to combating abusive tax avoidance transactions. While the vast majority of taxpayers and their advisors attempt to comply with the letter and spirit of the law, the complexity of the current tax system provides too many opportunities for some taxpayers to participate in transactions that generate tax benefits never intended by Congress. The best way to eliminate these practices is to simplify the tax law and improve transparency so that questionable transactions are disclosed and subject to IRS review. Treasury has set forth a number of administrative and legislative proposals that provide clear and simple rules for disclosure, registration and list maintenance. We also propose new and increased penalties for failure to comply with these rules. Treasury and the IRS are moving forward to implement the administrative actions that can be undertaken without further action by Congress. In addition, we urge Congress to move forward with Treasury's legislative proposals. If enacted, these proposals would improve the effectiveness of the disclosure, registration and list maintenance rules, thereby changing the risk/reward analysis for taxpayers who otherwise might play the audit lottery to avoid paying their fair share of taxes.

Thank you again, Mr. Chairman, for the opportunity to speak today. The Treasury Department looks forward to working with the Finance Committee on the important task before us. I will gladly answer any questions the Committee may have.

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The Treasury Department's Enforcement Proposals Penalty Structure for Listed and Unlisted Reportable Transactions		
	Listed Transactions (strict liability)	**Unlisted Reportable Transactions**
Corporations	<u>Failure to disclose</u>: $200,000 SEC reporting <u>Accuracy-related penalty:</u> Additional 5% of underpayment Deemed negligence/disregard of rules No reasonable cause SEC reporting	<u>Failure to disclose</u>: $50,000 <u>Accuracy-related penalty</u>: No reasonable cause (strict liability if lose and have substantial understatement)
Partnerships, S Corporations, and Trusts	<u>Failure to disclose</u>: $200,000	<u>Failure to disclose</u>: $50,000
Individuals	<u>Failure to disclose</u>: $100,000 <u>Accuracy-related penalty</u>: Additional 5% of underpayment Deemed negligence/disregard of rules No reasonable cause	<u>Failure to disclose</u>: $10,000 <u>Accuracy-related penalty</u>: No reasonable cause (strict liability if lose and have substantial understatement)
Promoters	<u>Failure to register</u>: Greater of 50% of fees or $200,000 (increased to 75% if intentional) <u>Failure to produce investor list</u>: $10,000 per day past 20 business days	<u>Failure to register</u>: $50,000 <u>Failure to produce investor list</u>: $10,000 per day past 20 business days

THE TREASURY DEPARTMENT'S ENFORCEMENT PROPOSALS FOR ABUSIVE TAX AVOIDANCE TRANSACTIONS

EXECUTIVE SUMMARY

The Treasury Department is announcing an initiative that will give the Treasury Department and the IRS the tools needed to combat abusive tax avoidance transactions. The mind-numbing complexity of the Internal Revenue Code underlies these transactions. While the vast majority of taxpayers and their advisors do their best to comply with the law, the Code's multitude of rules creates opportunities for those who would seek to reduce improperly their tax liabilities. Fundamental fairness requires that questionable transactions be disclosed and evaluated so that all taxpayers bear their fair share of taxes.

Transparency – insuring that questionable transactions are disclosed and subject to IRS scrutiny – is at the core of the Treasury Department's initiative. The current enforcement regime, which includes the temporary regulations that were issued in February 2000, provides for the disclosure by taxpayers of potential abusive tax avoidance transactions, and the registration of these transactions and the maintenance of investor lists by promoters. The Treasury Department and the IRS' experience with this current enforcement regime – and especially with the return disclosures filed in fall 2001 – has been disappointing and points to the apparent willingness by taxpayers and promoters to interpret and manipulate the rules to avoid disclosure.

Clearer rules and stiffer penalties are needed to ensure transparency. The Treasury Department's initiative will create 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 also is proposing new and substantial penalties, and significant increases to existing penalties, for those taxpayers and promoters who fail to obey these rules.

The Treasury Department's initiative will build upon ongoing Treasury Department and IRS efforts to combat abusive tax practices. Recent actions have focused on both individual and corporate tax avoidance transactions, and on both taxpayers and promoters.

- The IRS announced in December 2001 a limited-time program to encourage disclosure of questionable transactions. A taxpayer who discloses a transaction, and who identifies all promoters of the transaction, will avoid accuracy-related penalties. The taxpayer, however, will still be liable for interest on any underpayment of tax. To date, almost 150 transactions have been disclosed, including many that the IRS already has identified as tax avoidance transactions. Along with this disclosure initiative, the IRS issued penalty guidelines for all tax avoidance transactions that require the full, fair, and consistent consideration of penalties.

- The Treasury Department and the IRS are working closely together to streamline the evaluation of transactions, including the determination of whether a transaction should be identified as a listed (i.e., tax avoidance) transaction for taxpayer disclosure purposes.
- The Treasury Department and the IRS are working to re-deploy additional resources to deal with tax avoidance transactions and have increased their coordination with the Department of Justice.
- The IRS is working actively to obtain transaction and investor information from some 30 promoters of tax avoidance transactions. These efforts have and will continue to include the use of judicial summonses for those promoters who prove reluctant in providing this information.
- The IRS, in coordination with the Department of Justice, is working to shut down the promoters of abusive tax schemes directed primarily at individuals and small businesses. Courts already have issued six injunctions, and a number of additional cases are pending.
- The IRS is investigating a major abusive tax avoidance scheme used by individuals to evade U.S. tax by placing assets in banks located in foreign tax havens. Thousands, and potentially tens of thousands, of individuals are participating in these schemes. Through judicial summonses, the IRS is working to identify these individuals and is in the process of initiating enforcement action, including audits and criminal actions.
- Treasury and the IRS recently published a notice warning taxpayers that the IRS will challenge transactions using a loan assumption agreement to claim an inflated basis in assets acquired from another party.
- Treasury and the IRS recently published a notice warning taxpayers that the IRS will challenge transactions improperly shifting basis from one party to another.
- Treasury and the IRS recently published a notice announcing Treasury's intention to promulgate regulations that prevent the duplication of losses by a consolidated group.
- Treasury and the IRS recently published final regulations on hedging transactions that prevent employers from deferring tax on income from investments used to fund deferred executive compensation.
- Treasury is actively pursuing, and has had remarkable success in obtaining, tax information exchange agreements with offshore financial centers. These agreements allow us to pursue information on civil and criminal tax evaders even when countries have bank secrecy laws.

The Treasury Department recognizes that more must be done to curb abusive tax practices, and this initiative, by establishing clear rules for transparency and stiff

penalties who attempt to avoid scrutiny, will allow the Treasury Department and the IRS to devote more resources to evaluating and addressing questionable transactions.

Administrative Actions - Highlights

- Expand Disclosure – Individuals, partnerships, S corporations, and trusts, in addition to corporations, will be required to disclose questionable transactions. Current rules cover only corporations.
- Expand and Unify the Definition of a Reportable Transaction – Current rules contain different definitions of a transaction for disclosure, registration, and list maintenance. A single, clear definition will be established that will curtail the apparent manipulation of the current rules by come taxpayers and promoters.
- Impose Accuracy-Related Penalties for Reportable Transactions that are not Disclosed – Current rules permit taxpayers to assert as a defense to the accuracy-related penalty that they have received a tax opinion regarding that transaction. Amended regulations will prohibit this defense with respect to undisclosed reportable transactions and will increase the penalty in certain cases. These amended regulations also will address undisclosed transactions that are based on the invalidity of a regulation.
    - If a listed transaction is not disclosed, an strict liability accuracy-related penalty of 25% will be imposed on any underpayment resulting from the transaction regardless of the amount of the understatement. This would be in addition to a new $200,000 penalty for the failure to disclose a listed transaction. Legislative changes would be required for these new and increased penalties. See attached penalty chart.
    - If a non-listed reportable transaction is not disclosed, the existing defenses to any accuracy-related penalty (e.g., reasonable cause, substantial authority) will not be available for any underpayment resulting from the transaction.
    - If a transaction based on the invalidity of a regulation is not disclosed, an strict liability accuracy-related penalty will be imposed on any underpayment resulting from the transaction regardless of the amount of the understatement.
- Broaden the Registration and List-Maintenance Requirements – The persons responsible for registering transactions and maintaining investor lists will be broadened to insure that this information is available to the IRS. The list-maintenance requirements will be mandatory for all material participants in the promotion of a reportable transaction.
- Establish Standards for Legal Opinions– The Treasury Department and the IRS are revising the proposed rules in Circular 230 governing the legal opinions used to market and support tax avoidance transactions.

Legislative Proposals – Highlights

- Impose a Penalty on the Failure to Disclose Reportable Transactions – Significant new penalties will apply to the failure to disclose reportable transactions. No penalty currently exists.
- Increase the Penalty for the Failure to Timely Turn Over Investor Lists – The existing penalty will be significantly enhanced, particularly to address promoters who delay in providing the IRS with required information.
- Require Corporations to Publicly Disclose to Shareholders Penalties for the Failure to Disclose Listed Transactions and Accuracy-Related Penalties Resulting from Listed Transactions that are not Disclosed – Corporations would be required to disclose publicly the payment of a penalty for failure to disclose a listed transaction or an accuracy-related penalty imposed as a result of an undisclosed listed transaction.
- Permit Injunction Actions against Promoters who Repeatedly Disregard the Registration and List-Maintenance Requirements – The Government will be permitted to enjoin the most egregious promoters of abusive tax avoidance transactions, as it is doing currently with promoters of tax scams directed primarily at individuals and small businesses.
- Impose a Penalty for the Failure to Report an Interest in a Foreign Financial Account – A new civil penalty will be imposed on the failure to disclose foreign financial accounts, which often are used in tax avoidance transactions.
- Expand Section 901(k) – Additional restrictions will eliminate any additional efforts to traffic in foreign tax credits.
- Curb Abusive Income-Separation Transactions – New rules will curtail tax avoidance transactions that separate the periodic income stream from an underlying income-producing asset in order to generate an immediate tax loss for one taxpayer and the conversion of current taxable income into deferred capital gain for another.

THE TREASURY DEPARTMENT'S ENFORCEMENT PROPOSALS FOR ABUSIVE TAX AVOIDANCE TRANSACTIONS

The Treasury Department is announcing an initiative that will ensure that the Treasury Department and the IRS have the tools to combat abusive tax avoidance transactions. Fairness requires that the Treasury Department and the IRS identify these transactions (along with the taxpayers who invest in them and the persons who promote them), evaluate the tax positions taken, and take appropriate enforcement actions.

What underlies these transactions is the mind-numbing complexity of the Internal Revenue Code. Its multitude of rules provide the opportunities for those who would seek improperly to reduce their tax liabilities. Rules that provide for nonrecognition of gains and losses, a two-tier tax system, mechanical basis adjustments, rules for allocation of income and losses among partners, crediting of foreign taxes paid – all rules that serve important purposes – are just some of the rules that may be used in these transactions to create unintended tax benefits. These abusive transactions harm the public fisc, erode the public's respect for the tax laws, and consume valuable public and private resources.

Transparency – insuring that questionable transactions are disclosed and subject to IRS review – is critical to the Government's ability to identify and address abusive tax avoidance practices. The Treasury Department believes that clear rules mandating transparency and vigorous enforcement are essential to curbing abusive tax avoidance transactions. If a promoter is comfortable with selling a transaction, a taxpayer is comfortable with entering into that transaction, and a tax practitioner is comfortable with advising that the transaction is proper, then they all should be comfortable with the IRS knowing about and understanding the transaction.

The existing enforcement provisions in the Internal Revenue Code (Code) for tax avoidance transactions, along with the temporary regulations issued in February 2000, are designed to give the Treasury Department and the IRS the opportunity to evaluate questionable transactions at the earliest opportunity. Section 6111 of the Code requires promoters who market transactions to register with the IRS transactions that either will generate a certain level of tax benefit or are corporate tax avoidance transactions that are marketed on a confidential basis. Section 6112 requires that promoters maintain lists of investors in registered transactions as well as other potential tax avoidance transactions. The regulations under Section 6011 require corporate taxpayers to disclose on their tax returns transactions that the IRS has identified as tax avoidance transactions or that have certain characteristics common to tax avoidance transactions.

Since the beginning of this Administration, the Treasury Department has made clear its commitment to curtailing abusive tax practices. The Treasury Department in particular wanted to evaluate the return disclosures from the 2000 corporate filing season, which ended in the fall of 2001, to determine whether the existing enforcement regime is working and, if not, what additional measures are required. This review is complete. The apparent willingness of certain taxpayers and their advisors to parse words in a manner that narrows requirements and expands exceptions has been disappointing.

The Treasury Department's enforcement initiative, which includes both administrative actions and legislative proposals, will significantly enhance the current enforcement regime and curtail the use of abusive tax avoidance transactions. These proposals focus on increased transparency and enhanced penalties. Transparency is central to the Treasury Department and the IRS' ability to evaluate promptly new tax avoidance transactions and to address them quickly. Enhanced penalties are necessary to alter the "risk/reward" analysis taxpayers undertake when entering into these transactions.

The Treasury Department has concluded that a more effective enforcement regime would be created by a web of rules – rules that reinforce each other by requiring the same information about a questionable transaction to be provided to the IRS both by the taxpayers participating in these transactions and by the promoters and their advisors, who also will be required to maintain lists of investors. These rules will allow the IRS to identify taxpayers who fail to disclose based on the promoter's registration of the transaction with the IRS, promoters who fail to register based on a taxpayer's disclosure or based on a taxpayer's audit, and other taxpayers who fail to disclose based on a promoter's investor list.

One of the primary goals of these proposals is certainty. Clearer disclosure rules, without exceptions and perceived loopholes, will be easier for taxpayers and their advisors to apply, harder for taxpayers and their advisors to manipulate, and easier for the IRS to administer and enforce. 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 IRS will have multiple sources of information about questionable transactions, including the identity of the participants. Taxpayers and promoters will find avoiding IRS scrutiny of questionable transactions to be difficult.

Taxpayers and promoters also will find avoiding IRS scrutiny to be hazardous. The Treasury Department is proposing enhanced penalties for the failure to disclose and maintain the information required by the IRS to enforce the tax laws. The Treasury Department, for instance, will seek legislation creating a new strict liability penalty for a taxpayer's failure to disclose a listed transaction. This penalty for the first time would sanction taxpayers for failure to obey the disclosure rules. More generally, taxpayers and promoters who disregard the rules for disclosure, registration and list-keeping will face an increased risk of penalties.

2001 Taxpayer Return Disclosures

The corporate returns that were filed during the fall 2001 filing season were the first to be fully covered by the revised disclosure regulations under Section 6011 of the Code. To date, 99 corporate taxpayers have disclosed 272 transactions.

- Only 64 listed transactions were disclosed. Listed transactions are transactions that previously have been identified by the IRS in published guidance as tax avoidance transactions. Based on other information, the Treasury Department and the IRS have reason to believe that a far greater number of listed transactions were undertaken.
- The remaining 208 disclosures were for transactions that satisfy a multi-factor test designed to identify transactions that have at least two of five characteristics common to tax avoidance transactions (the 2-of-5 filter test). Two types of transactions, however, account for 159 of these disclosures. The Treasury Department and the IRS believe that taxpayers and promoters are manipulating the requirements and exceptions to the 2-of-5 filter test to avoid disclosure.

The small amount of disclosure was disappointing. From the information the Treasury Department and the IRS have seen, this disclosure is a small segment of the universe of transactions that should have been disclosed. A number of factors have led to insufficient disclosure, registration, and list-keeping.

First, the rules in Sections 6011, 6111, and 6112 of the Code do not contain a consistent definition of a transaction that must be disclosed and registered, and for which investor lists must be maintained. While this situation is due, in part, to differing statutory requirements, it also reflects the desire, when these rules were drafted, to exclude legitimate business transactions and minimize taxpayer administrative burden. The result, unfortunately, is a set of elegantly constructed, but complicated, rules. 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.

Second, the rules and regulations under Section 6011, 6111, and 6112 contain a number of exceptions intended to ensure that the rules are narrowly tailored. For instance, the disclosure requirements contain an exception for transactions for which there is a generally accepted understanding that the taxpayer's intended tax treatment is properly allowable. Another disclosure exception is for transactions that the IRS has "no reasonable basis" to challenge.

The Treasury Department believes that many taxpayers and promoters have read the exceptions broadly to cover virtually everything and interpreted the filters in the 2-of-5 filter test narrowly to cover virtually nothing. While some interpretations are good faith interpretations of the rules, others are attempts to assure taxpayers that they can engage in tax avoidance transactions without appropriate disclosure. The Treasury

Department's enforcement initiative will eliminate any confusion about the obligation to disclose questionable transactions to the IRS.

Third, the penalties for the failure to comply with the existing enforcement regime may be insufficient to deter efforts to avoid IRS scrutiny. For example, there currently is no penalty on a taxpayer for failure to disclose a transaction subject to the disclosure requirements (although nondisclosure may be a factor in determining if an accuracy-related penalty applies to any underpayment). The Treasury Department's enforcement initiative will create a new and significant penalty on taxpayers who fail to disclose transactions, and will increase significantly the penalty imposed on promoters who delay in providing investor lists to the IRS. Corporations also will be required to disclose publicly to their shareholder penalties that they incur for undisclosed listed transactions. Finally, the Government will be authorized to seek injunctions against promoters who repeatedly disregard the registration and list-keeping rules.

Finally, many taxpayers and promoters believe that they can disregard the rules and avoid detection. As described below, the IRS already is taking steps to increase its detection of tax avoidance transactions, and these proposals will significantly enhance the IRS' ongoing efforts.

Ongoing Efforts to Combat Abusive Tax Avoidance Transactions and Their Promoters

The Treasury Department and the IRS recently have taken a number of important, additional steps to combat abusive tax practices. The Treasury Department and the IRS are committed to making sure that the necessary time, effort, and resources are committed to this important issue.

Taxpayer Initiatives

- Encouraged Voluntary Disclosure – IRS Announcement 2002-2, which was issued last December, gives taxpayers an incentive to disclose questionable transactions and other items that may have resulted in an underpayment. Under the Announcement, if a taxpayer discloses a questionable transaction before April 23, 2002, the IRS will waive the accuracy-related penalty if additional tax ultimately is due. In order to obtain this relief, a taxpayer must disclose all relevant information about the transaction, including the identity of any promoter. The IRS already has received almost 150 disclosures and expects many additional disclosures in the coming weeks. The IRS will use the information it receives to pursue promoters, identify taxpayers that have not disclosed reportable transactions, and evaluate the new types of transactions that are identified.
- Issued Penalty Guidelines – Along with the disclosure initiative, the IRS issued penalty guidelines for tax avoidance transactions, including guidelines for the coordination of penalty consideration with the IRS' Office of Tax Shelter Analysis. These guidelines will ensure that penalties are impartially, fairly, and consistently considered in all tax avoidance transaction cases.

- Evaluated Additional Transactions – The Treasury Department and the IRS recently issued Notice 2002-21, which warns that the IRS will challenge transactions using a loan assumption agreement to claim an inflated basis in assets, Notice 2002-18, which announces the Government's intention to promulgate regulations preventing the duplication of losses by a consolidated group, and Notice 2001-45, which warns that the IRS will challenge transactions improperly shifting basis from one party to another. In addition, the Treasury Department and the IRS recently promulgated final regulations on hedging transactions that prevent employers from deferring tax on income from investments used to fund deferred executive compensation. Other transactions currently are under review. The Treasury Department and the IRS recognize the critical need to expedite the process for reviewing questionable transactions and are working to meet this objective.
- Made Additional Resources Available to Address Abusive Tax Avoidance Transactions – Recent published guidance in areas that have consumed significant IRS audit resources, such as accounting method and timing issues, will allow the IRS to devote more of its audit resources to tax avoidance transactions.
- Developed a Mandatory IDR for LMSB Cases – The IRS' Large and Midsize Business Division (LMSB) has developed an information document request (IDR) that will be used for all LMSB audits beginning in April 2002. This mandatory IDR will request information regarding all listed transactions.
- Increased Coordination with the Department of Justice – In order to coordinate the Government's efforts against abusive tax avoidance practices and conserve resources, the Treasury Department and the IRS have increased their coordination with the Department of Justice on tax avoidance transaction cases.
- Entered into Tax Information Exchange Agreements (TIEAs) - The Treasury Department has mounted a concerted effort to enter into agreements covering the exchange of tax information with significant foreign financial centers where the possibility of hiding income or assets poses a serious problem. Agreements recently have been reached with three key offshore financial centers – the Cayman Islands, Antigua and Barbuda, and The Bahamas.

Promoter Initiatives

The IRS is vigorously pursuing actions against the promoters of corporate and individual tax avoidance transactions. The IRS' objectives are to curb the most egregious promoters, penalize non-compliance, and obtain investor lists that will allow the IRS to target and examine those taxpayers who have engaged in potential tax avoidance transactions.

The IRS has contacted some 30 promoters of tax avoidance transactions in connection with their marketing activities.

- "Soft Letters" – The IRS has requested, through so-called "soft letters," information from these promoters. These letters request investor lists as well as

information regarding compliance with the registration requirements under Section 6111. A number of promoters already have provided the IRS with a significant amount of information, including investor lists.

- Summonses – The IRS, in cooperation with the Department of Justice, is using summonses to force reluctant promoters to provide investor lists and other materials related to their promotion of tax avoidance transactions. These summonses already are proving to be a valuable tool, and additional summonses are being prepared. The IRS and the Department of Justice will seek to enforce all summonses in court, if necessary.

- Penalty Audits – The IRS has begun more than a dozen promoter penalty audits and expects to begin additional audits in the coming weeks.

The IRS also has intensified its enforcement efforts against promoters of abusive tax avoidance transactions and scams directed primarily at individuals and small businesses. These schemes include claims that the federal income tax is unconstitutional, claims that individuals are citizens of the States and therefore not subject to federal income tax, claims that U.S. citizens are not subject to U.S. income tax because of Section 861 of the Code (so-called "Zero Tax" schemes), and credit claims for slavery reparations. The Treasury Department believes that these schemes are especially pernicious because the individuals targeted by promoters often have a limited understanding of their legal duties and obligations. Recent and ongoing actions include:

- Injunctions Granted – The Department of Justice has obtained injunctions against six promoters of abusive tax avoidance schemes, including a preliminary injunction that was issued on February 20, 2002.
- Pending Cases – The Department of Justice has filed an additional eight actions against promoters of abusive tax avoidance schemes.
- Future Cases – The IRS has referred a number of additional promoter cases to the Department of Justice in order to initiate legal action against these promoters.

In addition, the IRS is pursuing a major initiative against promoters of abusive offshore trust schemes. These schemes use banks located in offshore financial centers to help U.S. individuals hide income while at the same time allowing these individuals to access their offshore money in the U.S. by using credit cards issued by the offshore banks. The IRS believes that thousands of individuals are using these schemes to evade tax. In addition to an extensive publicity campaign to educate the public about the dangers of these schemes, the IRS is working to shut them down.

- Summonses to Financial Networks – Summonses have been issued to two financial networks to obtain transaction information that will allow the IRS to identify individuals who are using credit cards issued by foreign banks to evade tax.

- Summonses to Vendors – Although information obtained from the financial networks may identify accounts, these schemes are set up so that the financial

networks often do not have information identifying specific persons. Summonses will be issued to vendors expected to have identification information for credit card transactions. The IRS expects to identify individuals through these vendor summonses.

- IRS Audits - The IRS will initiate audits of individuals who are identified as participants in these schemes. If an identified individual is already under audit, this information will be provided to the auditor.
- Criminal Prosecution – The IRS and the Department of Justice will initiate, where appropriate, criminal proceedings against individuals who have violated the criminal laws by participating in these schemes.

Aggressive enforcement and continuous taxpayer education will continue to be keys to the Government's efforts to close down the tax schemes being marketed to individuals and small businesses. For the more sophisticated tax avoidance transactions, increased transparency, supported by stiffer penalties, is needed.

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The Treasury Department's enforcement proposals are divided into administrative actions and legislative proposals. These proposals, collectively, will enhance and expand the efforts to combat abusive tax avoidance transactions.

THE TREASURY DEPARTMENT'S ADMINISTRATIVE ACTIONS

1. **Expand the Disclosure Rules to Cover Partnerships, S Corporations, Trusts, and Some Individuals** – The Treasury Department and the IRS will amend the regulations under Section 6011 of the Code to require partnerships, S corporations, trusts and individual taxpayers to disclose "reportable transactions," as described in Administrative Action No. 3, below. This requirement, however, will not affect individuals unless they engage in specifically identified tax avoidance transactions or in other transactions resulting in a significant reduction of tax liability.

    Reason for Proposal: *Under current law, only corporate taxpayers are required to disclose reportable transactions on a tax return. The Treasury Department believes that potentially abusive tax avoidance transactions are increasingly being used by high net-worth individuals. Individuals, for example, have used transactions modeled after those described in Notice 2000-44 (the so-called "Son of Boss" transaction) and Notice 2001-45 (basis-shifting transaction) to avoid paying income tax. In addition, potentially abusive transactions by both corporations and individuals often employ partnerships and trusts to achieve unintended tax results. The Treasury Department believes that individuals, partnerships, S corporations, and trusts should be required to disclose questionable transactions. While this will*

result in some duplicative reporting, the duplicative reporting will ensure disclosure and also may deter improper transactions.

2. **Centralize the Receipt and Review of Disclosures by Partnerships, S Corporations, Trusts, and Individuals** – Disclosures of transactions must be submitted as part of a taxpayer's return. The IRS currently requires that copies of corporate taxpayer disclosures be sent to a single location so that the IRS' Office of Tax Shelter Analysis can coordinate their review. This centralized filing requirement for disclosures will be expanded to disclosures required for partnerships, S corporations, trusts, and individuals and will permit the expeditious review of all disclosures.

   Reason for Proposal: *The Treasury Department believes that the review of all disclosures, whether by corporations, individuals, partnerships, S corporations, or trusts must be centralized and coordinated. The coordinated review of these disclosures will allow the Treasury Department and the IRS to identify trends and new types of transactions and will ensure the consistent evaluation of disclosed transactions. Moreover, the certainty of review that will result from centralized disclosure should serve to deter improper transactions.*

3. **Expand and Unify the Definition of a "Reportable Transaction" for Return Disclosure, Registration and List-Maintenance Purposes** – The Treasury Department and the IRS will amend the regulations under Sections 6011, 6111, and 6112 of the Code to establish a single definition of the types of transactions (reportable transactions) that must be disclosed by taxpayers and registered by promoters, and for which lists of investors must be maintained by promoters.[1]

   The current regulations under Section 6011 require taxpayers to disclose (i) listed transactions (i.e., tax avoidance transactions identified by the IRS in published guidance), subject to a minimum tax effect requirement; and (ii) transactions that satisfy the 2-of-5 filter test, subject to a number of exceptions. The current regulations under Section 6111 requiring registration of confidential corporate tax shelters and the current regulations under Section 6112 requiring list maintenance use different standards than those in the Section 6011 regulations, but each set of regulations has exceptions similar to those in the Section 6011 regulations.

   The IRS' identification of listed transactions under current regulations has played an important role in compelling disclosure of transactions, discouraging future participation in these transactions, and guiding IRS audits in the field. Listed

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[1] Certain legislative changes will be required to allow for the full conformity of the definition of a reportable transaction for purposes of Sections 6011, 6111, and 6112 of the Code. See Legislative Proposal No. 8, below

transactions will remain an important part of the definition of a reportable transaction.

Under new regulations, the 2-of-5 filter test will be replaced by clearer rules that will be easier for taxpayers and their advisors to apply and the IRS to administer. In addition, the minimum tax effect requirement for listed transactions and the exceptions to the 2-of-5 filter test (including exceptions for transactions for which there is a generally accepted understanding that the taxpayer's intended tax treatment is properly allowable, and the exception for transactions that the IRS has "no reasonable basis" to challenge) will be eliminated.

These rules will have the effect of broadening the scope of transactions required to be registered with and reported to the IRS. The IRS will have the ability to issue published guidance to narrow the requirements as appropriate. In addition, the IRS will establish expedited procedures permitting taxpayers (and particularly those taxpayers who enter into multiple transactions of the same type) to seek a determination from the IRS that their transactions are not reportable transactions.

Under this proposal, a reportable transaction will be defined as a transaction (including a series of related transactions) falling into any of the following categories:

- Listed Transactions – Any transaction specifically identified by the IRS in published guidance as a tax avoidance transaction without regard to the size of the tax savings.

- Loss Transactions – Any transaction resulting in, or that is expected to result in, a loss under Section 165 of the Code of at least:

  - For corporate taxpayers – $10 million in any single year, or $20 million in any combination of years.
  - For partnerships and S corporations – $10 million in any combination of years.
  - For trusts – $2 million in any single year or $4 million in any combination of years, whether or not any losses flow through to one or more beneficiaries.
  - For individual taxpayers – $2 million in any single year, or $4 million in any combination of years.

- Transactions with Brief Asset Holding Periods – Any transaction resulting in a tax credit (including a foreign tax credit) if the underlying asset giving rise to the credit was held by the taxpayer for less than 45 days. This definition will be limited to transactions resulting in tax credits exceeding $250,000.

- Significant Book-Tax Differences – Any book-tax difference of at least $10 million, subject to specific exceptions for book-tax differences that are not indicative of potentially abusive tax avoidance practices, such as depreciation, depletion, amortization, bad-debt reserves, state and local taxes, and employee compensation.

- Transactions that are Marketed under Conditions of Confidentiality and that Provide Minimum Tax Benefits – Any transaction promoted under conditions of confidentiality, if the transaction results in, or is expected to result in (i) a reduction in taxable income of an individual, partnership, S corporation, or trust of at least $250,000, or (ii) a reduction in taxable income of any corporate taxpayer of at least $500,000. Conditions of confidentiality do not include the fact that a taxpayer's financial information is subject to restrictions on disclosure.

Under this proposal, this same definition of a reportable transaction will be used to identify those transactions that must be registered by promoters under Section 6111 and for which lists must be maintained pursuant to Section 6112 of the Code. The exceptions to disclosure also will be eliminated for purposes of promoter registration and list maintenance.

The Treasury Department recognizes that this definition of a reportable transaction potentially will cover many transactions that may not be abusive tax avoidance transactions. This definition, however, will enable the Treasury Department and the IRS to accomplish two important objectives. First, this definition will give the Treasury Department and the IRS the information needed to evaluate promptly potentially questionable transactions. Equally important, this definition will allow the Treasury Department and the IRS to identify problems and anomalies with existing rules and regulations for which statutory or regulatory changes should be considered.

> Reason for Proposal: *Taxpayers and promoters are interpreting the requirements in the current rules narrowly and reading the exceptions liberally. The Treasury Department believes that a clear and consistent rule for disclosure, registration, and list-maintenance will ensure that the IRS has more than one source of information about a reportable transaction. The IRS must have the ability to move quickly from a promoter registration to the promoter's investor list in order to identify non-disclosing taxpayers. Similarly, the IRS must be able to move quickly from a taxpayer disclosure of a reportable transaction to a promoter who might have failed to register the transaction, and from the promoter's investor list to non-disclosing taxpayers. This web of disclosure will increase the likelihood that taxpayers who fail to disclose and promoters who fail to register will be identified.*

4. **Clarify the Definition of a Listed Transaction** – Under current law, a "listed transaction" includes any transaction that is the same or "substantially similar" to a transaction identified by the IRS in published guidance as a tax avoidance transaction. The Treasury Department and the IRS will amend the regulations under Section 6011 of the Code to clarify that a listed transaction includes any transaction designed to produce the same or similar type of tax result using the same, or similar, tax strategy. For example, a transaction that relies on Sections 318 and 302 to shift basis from one person to another in a factual situation similar to the one in IRS Notice 2001-45 would be a listed transaction.

   Reason for Proposal: Some taxpayers and promoters have applied the "substantially similar" standard in an overly narrow manner to avoid disclosure. Some taxpayers and promoters, for example, have made subtle and insignificant changes to a listed transaction in order to claim that their transaction is not subject to disclosure. Others have taken the position that their transaction is not substantially similar to a listed transaction because they have an opinion concluding that the transaction is proper. The Treasury Department believes that these interpretations are improper. The change to the definition of a listed transaction is intended to halt these practices.

5. **Impose Strict Liability for Accuracy-Related Penalties for Reportable Transactions that are not Disclosed** – Under current law, taxpayers may claim a defense to the accuracy-related penalty, even for an undisclosed reportable transaction resulting in an underpayment, based on an opinion regarding the tax consequences of the transaction. The Treasury Department and the IRS will amend the regulations under Sections 6662 and 6664 of the Code to provide two similar, but distinct, rules for reportable transactions that are not disclosed. These amended regulations generally will provide that the defenses to the penalty under Sections 6662(d)(2)(B) and (C) and 6664(c) are not available in these cases.

   For listed transactions that are not disclosed, the amended regulations will provide that (i) a taxpayer cannot rely on, among other things, an opinion as a defense to the imposition of the accuracy-related penalty under Section 6662 if the transaction results in an underpayment and (ii) that any underpayment resulting from the transaction will be treated as an underpayment attributable to negligence or the disregard of rules or regulations for purposes of Section 6662. In other words, the increased accuracy-related penalty of 25%, in addition to the $200,000 failure to disclose penalty,[2] will apply regardless of the amount of the underpayment.

   For other reportable transactions (i.e., non-listed transactions) that are not disclosed, the amended regulations will provide that a taxpayer cannot rely on, among other things, an opinion as a defense to the imposition of the accuracy-related penalty

[2] See Legislative Proposal No. 1, below.

under Section 6662 if the transaction results in an underpayment. Whether any resulting underpayment is attributable to negligence or the disregard of rules or regulations will depend on the facts.

> Reason for Proposal: *The Treasury Department believes that many reportable transactions are not being disclosed. Promoters are advising taxpayers to disregard the disclosure requirements on grounds that an opinion will be sufficient to avoid accuracy-related penalties even if a listed transaction is identified during audit and results in an underpayment. The Treasury Department believes there should not be defenses to the accuracy-related penalties in cases where a reportable transaction is not disclosed. In the case of a listed transaction, there should be strict liability regardless of the amount of the understatement.*

6. **Impose Strict Liability for Accuracy-Related Penalties for Transactions Based on the Invalidity of a Regulation that are not Disclosed** – Some promoters are advising taxpayers to participate in certain tax avoidance transactions based on opinions that conclude that a contrary regulation is invalid. The Treasury Department and the IRS will amend the regulations under Sections 6662 and 6664 of the Code to provide that a taxpayer cannot rely on an opinion as a defense to the imposition of the accuracy-related penalty under Section 6662 for any underpayment attributable to the disregard of rules or regulations if the underlying transaction or item (whether or not a "tax shelter" as defined by Section 6662) was not adequately disclosed. The defenses to the penalty under Sections 6662(d)(2)(B) and 6664(c) would not be available in these cases.

> Reason for Proposal: *Taxpayers and promoters should not be permitted to rely on opinions – rendered for penalty protection – that conclude that one or more regulations are invalid unless the taxpayer discloses that its position is based on the invalidity of a regulation. Although the Treasury Department believes that such opinions currently are insufficient to establish a defense to the penalty, some promoters nevertheless are encouraging participation in (and nondisclosure of) transactions based on such opinions. The Treasury Department believes that this practice is improper for all transactions regardless of whether they are reportable transactions.*

7. **Broaden the Range of Persons who are Required to Register Reportable Transactions and Maintain Lists of Investors** – The Treasury Department and the IRS will amend the regulations under Sections 6111 and 6112 of the Code to clarify that all parties materially involved with a reportable transaction must register a transaction and maintain lists of investors. Material participation will be measured by the fees received, or expected to be received, as a result of the transaction or a series of related transactions (e.g., fees in excess of $250,000 for corporate transactions, or in excess of $100,000 for individual transactions). In addition, a material participant may include a return preparer if the return preparer or an affiliate was materially involved with the transaction.

   In order to avoid unnecessary burden, the Treasury Department and the IRS will allow otherwise obligated persons to agree to have a single person register a transaction on behalf of a group of promoters and advisors so long as the registration identifies all of the promoters and advisors subject to the agreement. The IRS would not be precluded from imposing a penalty on any obligated party otherwise required to register a transaction if the transaction is not registered. A promoter or advisor always will have the option of registering a transaction on its own. Each promoter or advisor, however, will be required to maintain its own list of investors. Clarifying legislation to coordinate the language in Section 6111 and 6112 may be requested. See Legislative Proposal No. 9, below.

   Reason for Proposal: The IRS is dealing with many situations where promoters have not registered transactions or maintained lists of investors. Some promoters, for example, have argued that they are merely "advisors" or "return preparers" (and not an organizer or seller) for a transaction and therefore are not subject to the registration and list-maintenance requirements. In other instances, the promoting parties use or create a separate entity that they claim promotes the transactions. Afterwards, this separate entity ceases doing business, and there is no registration or investor list. The Treasury Department believes that these practices are improper.

8. **Establish Standards for Opinions in Circular 230** – Circular 230 provides standards and ethical rules for practice before the IRS. In January 2001, the Treasury Department and the IRS issued proposed amendments to Circular 230 that would establish new rules and standards for opinions that are used to support tax avoidance transactions. These amendments reflect Treasury's concern that many of these opinions were being written to promote a transaction without reaching a firm conclusion about the validity of the transaction, were inadequately discussing important legal issues, were reaching inconsistent conclusions on issues, or were based on questionable factual assumptions. The Treasury Department believes that practitioners have a duty to the integrity of the tax system as well to their clients, and in the case of opinions used to promote or support tax avoidance transactions, a high degree of diligence and analysis is appropriate.

The Treasury Department and the IRS are evaluating these proposed amendments in light of the extensive comments received from the major tax professional organizations and will issue revised proposed regulations shortly. In addition, the Treasury Department and the IRS will finalize other proposed amendments to Circular 230 that were issued in January 2001.

> Reason for Proposal: *Taxpayers participating in tax avoidance transactions often rely on opinions by tax professionals that the transactions are legitimate and proper. Many taxpayers will not participate in these transactions without opinions, either as a basis for participating in a transaction or as protection from penalties. Some tax professionals are rendering opinions that fall short of the minimum standards that the Treasury Department believes are appropriate. This proposal will address this problem by establishing minimum standards for these types of opinions.*

9. **Provide a Consistent Form for Return Disclosures** – The IRS will issue a disclosure form, to be submitted by taxpayers as part of their returns and to the IRS' Office of Tax Shelter Analysis, that will clearly identify the information required to be disclosed for reportable transactions. These forms will require taxpayers to disclose information relevant to the IRS' evaluation of a transaction – e.g., a description of the transaction, its participants (including tax-indifferent parties), its principal tax benefits, and the promoter.

> Reason for Proposal: *Although existing rules require that certain information be included as part of a disclosure, the Treasury Department believes that a standard form will ensure that the disclosures are made and that all relevant information is provided to the IRS.*

10. **Establish Procedures for Early Examinations of Potential Tax Avoidance Transactions** – The IRS will establish procedures for the early examination of potential tax avoidance transactions while allowing, if necessary, for the examination of other issues at a later time. This process will allow the IRS to quickly identify, evaluate, and shut down abusive tax avoidance transactions.

> Reason for Proposal: *Although existing rules under Section 7605 of the Code permit the early examination of a particular issue, the Treasury Department and the IRS believe that these procedures should be clarified to emphasize the availability of an early examination of potential tax avoidance transactions. This action will ensure that the IRS will be able to act quickly on disclosures and registrations of reportable transactions, while allowing for the examination of other issues as part of the regular audit process.*

11. **Target Abusive Tax Avoidance Schemes** – The IRS will re-deploy resources to identify and shut down abusive tax avoidance schemes. For example, the IRS' Small Business/Self Employed Division (SBSE) is finalizing the establishment of a centralized organization charged with developing leads on these schemes. As part of this effort, SBSE will establish a dedicated network of at least one examination group/collection group team in each of the 16 SBSE areas to work on abusive tax scheme cases; establish a new executive position to focus solely on abusive tax schemes, money laundering and fraud; implement additional monitoring of the Internet and other media outlets where abusive tax schemes often are advertised; increase efforts to educate the public about why these schemes are illegal; and increase efforts to shut down promoters.

    Reason for Proposal: Many abusive tax avoidance schemes that are targeted at individuals and small businesses are marketed through a number of different mass media outlets. The Treasury Department believes that increased monitoring of these media outlets, as well as increased publicity about the dangers of these schemes, will help curb these tax avoidance schemes.

THE TREASURY DEPARTMENT'S LEGISLATIVE PROPOSALS

1. **Impose a Penalty for the Failure to Disclose Reportable Transactions** – The Treasury Department will seek legislation that would:

    - Impose a penalty on corporate taxpayers for each failure to disclose a listed transaction equal to the sum of (i) $200,000 and (ii) 5% of any underpayment resulting from the listed transaction.
    - Impose a penalty of $50,000 on corporate taxpayers for each failure to disclose a reportable transaction (other than a listed transaction).
    - Impose a penalty of $200,000 on partnerships, S corporations, and trusts for each failure to disclose a listed transaction, and $50,000 for each failure to disclose other reportable transactions.
    - Impose a penalty on individual taxpayers for each failure to disclose a listed transaction equal to the sum of (i) $100,000 and (ii) 5% of any underpayment resulting from the listed transaction.
    - Impose a penalty of $10,000 on individual taxpayers for each failure to disclose a reportable transaction (other than a listed transaction).

    The portion of this proposed penalty that is dependent on the amount of any underpayment will be incorporated as an increase to the existing accuracy-related penalty under Section 6662. The disclosure penalty for listed transactions will not be waivable.

    Reason for Proposal: Although the failure to disclose a transaction is a factor in determining whether an accuracy-related penalty should be imposed, current law does not impose a penalty

for the mere failure to disclose a reportable transaction on a return. The Treasury Department believes that nondisclosure should be subject to a separate sanction because it undermines the IRS' ability to evaluate questionable transactions.

2. **Require Public Disclosure by Corporate Taxpayers of Penalties for the Failure to Disclose Listed Transactions and Accuracy-Related Penalties Resulting from an Undisclosed Listed Transaction** – The Treasury Department will seek legislation requiring corporate taxpayers to disclose, in their filings with the Securities and Exchange Commission, any penalty for the failure to disclose a listed transaction and any accuracy-related penalty resulting from an undisclosed listed transaction.

   Reason for Proposal: The Treasury Department believes that a corporation should be required to disclose to its shareholders the corporation's participation in a listed transaction if the corporation incurs any penalties as a result of not disclosing the transaction to the IRS.

3. **Expand and Increase the Penalty for a Promoter's Failure to Register a Reportable Transaction** – The Treasury Department will seek legislation that would amend Section 6707 of the Code, which provides for the penalty on promoters for the failure to register a transaction under Section 6111. The amendment would:

   - Impose, for listed transactions, a penalty equal to the greater of 50% of the fees paid to the promoter or $200,000. This penalty would be increased to 75% for the intentional failure to register a transaction or the intentional failure to provide complete or true information as part of a registration.
   - Impose, for the failure to register all other reportable transactions, a penalty of $50,000.

   Reason for Proposal: The Treasury Department believes that a significant penalty should be imposed on the failure to register a reportable transaction.

4. **Increase the Penalty for a Promoter's Failure to Timely Turn Over Investor Lists** – The Treasury Department will seek legislation that would replace the existing penalty in Section 6708 of the Code for a promoter's failure to maintain lists of investors in a reportable transaction. Under the Treasury Department's proposal, the penalty would be changed so that if a promoter fails to provide the IRS with a list of investors within 20 business days after receipt of the IRS' written request, the promoter would be subject to a penalty of $10,000 for each additional business day that the requested information is not provided. This penalty would be imposed for each investor list that a promoter fails to maintain or delays in providing to the IRS. The IRS would have the discretion to extend the deadline or waive all or a portion of the penalty for good cause shown.

Reason for Proposal: Too many promoters are using delaying tactics to avoid turning over investor lists. The Treasury Department believes that the penalty statute must be structured to sanction this type of behavior.

5. **Permit Injunction Actions against Promoters who Repeatedly Disregard the Registration and List-Maintenance Requirements** – The Treasury Department will seek legislation to amend Section 7408 of the Code to allow the Government to enjoin promoters after the repeated disregard of the rules requiring the registration of reportable transactions under Section 6111 of the Code and the maintenance of investor lists under Section 6112 of the Code. An injunction would place a promoter under court order to abide by the registration and list-maintenance requirements. The promoter then would be in contempt of court if it violates these rules in the future.

    Reason for Proposal: One of the persistent problems faced by the Treasury Department and the IRS is the fact that some promoters are ignoring the rules even in the face of penalties. The Treasury Department believes that the threat of an injunction will enable the Treasury Department and the IRS to curb the most egregious behavior by promoters.

6. **Impose a Penalty for the Failure to Report an Interest in a Foreign Financial Account** – The Treasury Department will seek legislation that will impose, in addition to existing criminal penalties, a civil penalty of $5,000 for the failure to comply with the rules and regulations requiring the reporting of information requested on the "Report of Foreign Bank and Financial Accounts" (Form TD F 90-22.1). The IRS would have the ability to waive the penalty, in whole or in part, if the taxpayer paid all U.S. tax due with respect to the taxpayer's foreign accounts and the taxpayer demonstrates that the failure to file this form was due to reasonable cause.

    Reason for Proposal: The Treasury Department believes that many taxpayers are not filing Forms TD F 90-22.1 even though they have an obligation to do so. Because many tax avoidance transactions involve foreign financial accounts, information about a taxpayer's interest in a foreign financial account will enhance the IRS' ability to identify participants in tax avoidance transactions.

7. **Increase the Penalty for Frivolous Return Positions** – The Treasury Department, in its 2003 fiscal year budget, has proposed to increase the penalty for frivolous tax returns from $500 to $5,000. This amendment would further deter individual taxpayers from taking positions that have no basis in law or fact, such as claims that the Federal income tax is unconstitutional and claims for slavery reparations. The

IRS would publish, at least annually, a listing of positions, arguments, requests, and proposals deemed frivolous for purposes of the statute.

> <u>Reason for Proposal</u>: *The IRS has been faced with a significant number of individuals who are filing returns based on frivolous arguments or who are seeking to hinder tax administration by filing returns that are patently incorrect. The IRS must address such frivolous arguments through statutorily mandated procedures, which result in delay and additional administrative burden and expense. The Treasury Department believes that enhanced penalties will deter egregious taxpayer behavior and enable the IRS to utilize its resources more efficiently.*

8. **<u>Permit a Single Definition of a Reportable Transaction for Disclosure, Registration, and List-Maintenance Requirements</u>** – The Treasury Department will seek legislation amending the statutory definition of a transaction that must be registered under Section 6111 of the Code (currently, a "tax shelter" as defined in Section 6111(c) and (d)) using the existing definition under section 6112(b)(2) – <u>i.e.</u>, "any entity, investment plan or arrangement or other plan or arrangement which of a type which the Secretary determines by regulations as having a potential for tax avoidance or evasion." Among other things, this would eliminate the "conditions of confidentiality" requirement in Section 6111(d). In addition, the registration requirements under Section 6111 would be expanded to cover transactions entered into by individuals, partnerships, S corporations, and trusts.

> <u>Reason for Proposal</u>: *This proposal will allow for regulations that will establish a single definition of a "reportable transaction" for purposes of disclosure, registration and list maintenance. <u>See</u> Administrative Action No. 3, above.*

9. **<u>Confirm the Treasury Department and the IRS' Ability to Expand the Number of Persons Required to Register Reportable Transactions and Maintain Investor Lists</u>** – The Treasury Department will seek legislation confirming that the registration requirements under Section 6111 of the Code and the list-maintenance requirements of Section 6112 apply to all organizers and sellers of a reportable transaction, including persons who assist such persons, and confirming the Treasury Department and the IRS' authority to impose conditions on agreements among promoting parties to have only one person (on behalf of a group of promoters) register a reportable transaction and maintain lists of investors. <u>See</u> Administrative Action No. 7, above.

<u>SUBSTANTIVE LAW CHANGES TO CURB ABUSES</u>

1. **<u>Expand Section 901(k)</u>** – The Treasury Department will seek legislation that will amend Section 901(k) of the Code to cover income streams other than dividends (which already are covered by the statute) that are subject to foreign withholding

taxes. Other income streams that may be subject to foreign withholding taxes include interest and royalties. The amendment would require a minimum holding period for the underlying property generating the income and deny foreign tax credits with respect to any withheld foreign taxes if the minimum holding period is not satisfied.

> *Reason for Proposal: The Treasury Department is concerned that the recent appellate decisions in Compaq and IES may cause taxpayers to renew their efforts to trade in foreign tax credits to reduce their U.S. tax liability. While Section 901(k) of the Code already addresses the specific type of transaction at issue in these cases, this section should be expanded to cover other similar transactions.*

2. **Address Income-Separation Transactions** – The Treasury Department will seek legislation to curb "income-separation" transactions that are structured to create immediate tax losses or to convert current ordinary income into deferred capital gain. These transactions are similar to the bond-stripping transactions that were prohibited by Section 1286 of the Code and preferred stock-stripping transactions that were prohibited by Section 305(e).

> *Reason for Proposal: Subsequent to the enactment of Section 1286, which applies only to bonds, and Section 305(e), which applies only to preferred stock, taxpayers have been engaging in essentially identical transactions using similar assets – i.e., assets providing for relatively stable, periodic income and with substantial future value. Although the IRS is pursuing these transactions under existing tax principles, legislation is needed to create a more comprehensive, consistent tax regime.*

In a common form of these types of transactions, a taxpayer acquires shares in a money-market mutual fund, which provide for a periodic income stream and which have a constant redemption value (e.g., $1 per share). The taxpayer separates the right to receive the income stream over a specific period (e.g., 15 years) from the right to the underlying shares at the end of that period. When the future right to the shares is sold, the parties claim that under the technical rules (i) the taxpayer has a large tax loss on the sale of the future right to the shares (this is accomplished through the allocation of the entire tax basis solely to the future right to the shares), and (ii) the buyer, rather than recognizing ordinary income periodically as the future right to the shares increases in value over time, claims that it is entitled to defer income until a future sale, at which time the buyer will claim that its income is capital gain. Other types of assets used in these income-stripping transactions include leases and service contracts.

The Treasury Department will propose legislation that will treat an income-separation transaction as a secured borrowing, not a separation of ownership. Debt

characterization will ensure that the parties' ongoing tax treatment from the transaction clearly reflects income.

SENATE FINANCE COMMITTEE
Testimony Statement of B. John Williams
Chief Counsel, Internal Revenue Service
March 21, 2002

INTRODUCTION

Mr. Chairman, Senator Grassley, Members of the Finance Committee, I appreciate the opportunity to speak before you today about corporate tax shelters. The issue is a high priority in the Office of Chief Counsel as well as in the Internal Revenue Service and the Department of Treasury. I would like to speak today about some of the problems we face in dealing with these transactions and about the measures the Office of Chief Counsel plans to take to address those problems. At my confirmation hearing in November, I made two points which you urged me to follow up on: (1) the IRS must use available tools more effectively to gather information and increase compliance; and (2) the IRS must use that information in a more effective and timely manner. As the Office of Chief Counsel brings its resources to bear on the tax shelter issue, the measures we are taking will reflect this dual objective.

The Committee also requested subsequent to that hearing a written report detailing the IRS's current approach to the tax shelter problem and any proposals to improve compliance and enforcement in this area. At the time, last November, I committed to provide that report by March 31, 2002. With the delay in my confirmation, however, and given the nature and scope of the request, I find it is necessary to ask for an extension. I hope that the Committee will consider my testimony today to constitute an interim report. I will follow up with a more formal written report on May 31. I appreciate your understanding in this matter.

ISSUES AND RESPONSES

I believe there are three major issues faced by the IRS in dealing with tax shelters. First, determining whether certain transactions are "abusive" is a difficult call and does not lend itself to fast answers. Second, the IRS has fallen behind the marketplace in identifying and addressing abusive transactions. Finally, the disclosure, registration and list maintenance rules have produced limited results. All three issues, and the ways in which we solve them, are interrelated. I am pleased to report to you that the IRS, the Office of Chief Counsel and the Treasury Department are taking steps to address them.

Determining what is "Abusive"

Perhaps the most important and difficult issue is the question of what constitutes an "abusive" transaction. Some transactions are indisputably "abusive" - these tax

shelters are based on misstatements of law or outright fraud. They are shams in fact, and the government's response to them requires no complex policy calls. The tax shelters we are discussing today, however, are sophisticated transactions based on technical arguments, and it is less clear when they are truly "abusive." Some transactions may be technically sound and are therefore not necessarily "abusive," even though the government may not like them. Shutting them down may require a change in law either by amending regulations or new legislation. Other transactions take advantage of ambiguities or gaps in the tax law, or they interpret current law in a manner not previously contemplated by the government. These transactions often may seem to work on their face, but they lack economic reality or do not adhere to long-standing tax principles. These latter transactions are "abusive." The facts and circumstances of specific transactions must be examined to distinguish apparently technically sound transactions from "abusive" ones that do not work under current law.

Identification of Tax Shelters

This Committee's work over the past couple of years has shown that it is not easy to define the difference between legitimate tax planning and "abusive" transactions that do not work under current law. While not easy to define, transactions that are abusive can be recognized, if spotted. For this reason, the best tool we have in dealing with them is early identification. There are two ways to identify these transactions. First, the IRS may identify transactions through the examination process. Second, taxpayers and promoters are required to disclose or register questionable transactions. Identifying questionable transactions early could permit the IRS to gather information and issue guidance, in some cases even before the transactions show up on tax returns. Notifying the public of the IRS's position with respect to current transactions coupled with a vigorous enforcement of the disclosure, registration and list maintenance requirements should discourage taxpayers from playing the audit lottery and participating in abusive transactions.

Although early identification is critical to stemming the tide of abusive transactions, the IRS has had difficulties identifying and responding to these transactions in a timely manner. Too often the IRS is behind the marketplace. The IRS's lack of timeliness is caused by several factors, some of which may be out of the government's control. First, the typical examination function of the IRS is not positioned to scrutinize a transaction until several years after it has been marketed. Second, many abusive transactions are difficult to identify on a tax return. Third, once transactions are identified, there has been a disconnect between revenue agents, field counsel and technical counsel in the National Office that has resulted in significant time delays.

One major conclusion I have reached is that the IRS must rely upon disclosure and registration to gain any chance of addressing questionable transactions early. Current disclosure and registration roles are complicated and need to be simplified and harmonized. Changes in these rules announced yesterday by Treasury should, in my view, increase IRS access to necessary information and permit an adequate factual

and legal analysis of questionable transactions even while they are being marketed. I will address these issues later in my testimony.

Internal Coordination - Tax Shelter Tax Forces

Organizationally, the IRS and the Chief Counsel's office are positioned to eliminate the disconnect between the various functions. Larry Langdon and I have discussed this issue and have developed some solutions. Historically, abusive transactions that are identified in the field must make their way up the line from agent to field counsel to technical counsel in the National Office, resulting in extensive delays. After National Office counsel review the problematic transactions, too often there has been inadequate follow up in factual investigation of these transactions by agents and field counsel. Within the Chief Counsel's office, inadequate coordination of review of potential issues among the technical and operating divisions has contributed to significant delay.

Issuing guidance requires IRS operating units to work together with Counsel field and technical experts to consider these transactions, including preparing analysis for joint review by the Office of Chief Counsel and Treasury. Traditionally these units have worked sequentially, requiring extended amounts of time. To address this problem of internal delays, the Office of Chief Counsel and the Large and Mid-Size Business Division ("LMSB") have agreed to implement transaction-specific task forces. The task forces would be formed for specific transactions or a group of transactions, and would include attorneys from the appropriate operating divisions of Chief Counsel, attorneys from the technical divisions of Chief Counsel, the Department of Treasury, and the Office of Tax Shelter Analysis. In addition, revenue agents would be assigned to each task force. Being dedicated to the task force would reduce the distraction of other obligations that detract from a focus on these issues.

Use of such task forces should allow us to distinguish between sound and problematical transactions, determine the kind of guidance necessary and permit both follow-up on the transaction and prompt issuance of public guidance. Decisions on whether to issue a Notice alerting taxpayers that the IRS will challenge a transaction will be made jointly and early. The hope is that we will become aware of these transactions even before they are reported on a tax return and be able to address them early in their promotion. Public guidance, if needed, can be issued promptly. The task forces will achieve consistency through the system, coordinating the efforts of the National Office, the field attorneys, the revenue agents and Appeals. Furthermore, cross-checking of issues identified in the field with disclosure and registration becomes easier. This means a higher likelihood that taxpayers who have invested in questionable transactions will be identified and subject to examinations.

The process will start with a review of registered transactions by the Office of Tax Shelter Analysis ("OTSA") working with Chief Counsel's LMSB division. As new transactions are identified, a preliminary determination will be made as to which

transactions warrant referral to a task force. A task force will comprise members from OTSA, the appropriate Division Counsel (LMSB, the Small Business and Self-Employed Division ("SBSE"), or the Tax Exempt and Government Entities Division ("TEGE")), and the appropriate technical divisions. This composition ensures that technical expertise will be available from the start. The task force will decide whether to recommend (1) factual investigation of the transaction, (2) further inquiry of the promoter, and/or (3) issuance of public guidance. Revenue agents who will be a part of the task force will conduct any factual investigation with assistance of division counsel. If further information is needed (e.g., list of investors) from the promoter, it will be requested. Treasury attorneys will be asked to join the task force if it is determined that public guidance should be considered.

The Committee may be aware that on Monday the IRS published Notice 2002-21, which targets transactions involving the use of a loan assumption agreement to claim an inflated basis in assets. This Notice was the product of a task force I formed shortly after my arrival at the IRS a couple months ago. The task force included attorneys from my office, the technical divisions of Chief Counsel, LMSB, and Treasury. The group worked together to quickly analyze the transaction and issue the Notice. The use of transaction-specific task forces such as this should greatly increase the timeliness of the IRS's response to abusive transactions and should go a long way towards fixing the problems of internal communication and coordination.

Public Identification - Published Guidance

The published guidance program is an important tool in the tax shelter area that can be used to increase disclosure and compliance. Because our federal tax system is based on self-assessment, the IRS has a responsibility to assist taxpayers in determining what works and what does not. The current level of published guidance is unacceptable to the Commissioner and to the public. According to a study performed in the course of considering how to redesign the IRS, in 1998, the IRS published merely 15% of the number of revenue rulings published in 1979. Furthermore, in 1979, 97% of these rulings dealt with substantive issues; in 1998, this number dwindled to 38%.

The IRS must respond to transactions more quickly. Our delays mean more taxpayers will enter into these transactions. While abusive transactions will be challenged upon audit even where they have not yet been addressed by public guidance, informing the public that we are aware of such transactions will encourage disclosure and should often discourage participation in abusive transactions. Showing that we are aware of transactions currently in the market, and of who has invested in them, should also reduce taxpayers' incentive to play the audit lottery. Our commitment to serving the public demands that we announce early our views on new transactions that do not work, and our views on those that do.

Some transactions that raise concerns are technically sound under current law. Our willingness to issue guidance addressing the transactions that work should

encourage promoters and taxpayers to come to us with transactions that they believe are technically sound. If promoters and taxpayers know that the IRS is not simply a nay-sayer, they should be more interested in talking to us about transactions and financial instruments currently being developed. As a result, the IRS would be better informed of current transactions, and would be able to recommend necessary changes to the law, whether administrative or legislative, more quickly.

Issuing guidance quickly on transactions that are abusive requires us to develop our principal position and announce it early rather than attempting to refine all the possible arguments that might apply. Too often published guidance is delayed while we attempt to formulate the perfect solution to all potential problems. We should focus instead on developing excellent advice that covers the general issues; more specific problems can be addressed in later guidance. The Office of Tax Policy and the Office of Chief Counsel are committed to early and joint policy review to increase the level of published guidance. Joint efforts should allow us to remain on top of current transactions.

Disclosure and Registration - Administrative Proposals

Becoming current with the market must be a top priority. If the IRS must rely only on information from examinations to identify transactions, however, internal efforts to respond as quickly as possible will have little effect. Even in the best of circumstances, large corporate returns generally are not filed until nine months after the close of the tax year, and examination is not completed until several years after that. This means the IRS may not become aware of the transaction until several years after it has been marketed and taxpayers have entered into it.

Thus, the IRS is not always able to identify abusive transactions promptly through return examination and often must rely upon disclosure and registration to catch transactions. The limited results under these rules has hampered the IRS's ability to identify transactions currently in the market. The rules are complicated, and they can be construed very narrowly, while exceptions can be construed very broadly. Many taxpayers are construing them in such a way that the taxpayers are able to conclude that the rules do not apply to their particular transaction. Thus we need disclosure, registration and list maintenance requirements that are simpler, broader and more integrated with the application of the section 6662 penalties.

Treasury, the IRS and the Office of Chief Counsel have worked together to develop administrative and legislative changes that will address these problems. A primary goal of these proposals is to provide clearer rules, without exceptions and loopholes, that will be easier for taxpayers and their advisors to understand and easier for the IRS to administer and enforce. First, our proposals would broaden the range of persons who are required to register reportable transactions and maintain lists of investors. Promoters have not complied with these rules in the past because they have argued that they are not an organizer or seller of the tax shelter and thus do not have a

reporting obligation. The proposals would also require individual taxpayers, partnerships and trusts, not just corporations, to disclose their participation in reportable transactions. Additionally, receipt of these disclosures would be centralized at one location, as are corporate disclosures, to provide for coordinated review by OTSA. These changes thus should cover a large number of promoters and taxpayers who have participated in reportable transactions, and it should expose a larger number of transactions currently in the market.

The proposals also would amend the rules under sections 6011, 6111 and 6112 of the Internal Revenue Code to establish a consistent definition of a "reportable" transaction for disclosure, registration and list maintenance purposes. Because taxpayers and promoters are reading the exceptions in the current rules liberally and interpreting the requirements narrowly, a clear and consistent rule is needed. This would ensure that the IRS has multiple sources of information about a reportable transaction and gives the IRS the ability to move quickly between the various forms of information. For example, if a taxpayer fails to disclose a reportable transaction, the IRS would be able to move quickly from a registration to an investor list in order to identify that taxpayer and other non-disclosing taxpayers.

The proposals would clarify the definition of "listed transaction." Taxpayers have applied the "substantially similar" standard narrowly to conclude that disclosure is not required. The regulations would be amended to provide that the term "substantially similar" includes any transaction that is designed 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. This change should prevent more taxpayers from avoiding disclosure. The proposals also would discourage taxpayers from participating in transactions based on the invalidity of a regulation without disclosure. Reliance on opinions asserting that a regulation is invalid will not be a defense to the accuracy-related penalties unless proper disclosure is made. Finally, the administrative proposals would apply the accuracy-related penalties under section 6662 if a listed transaction is not disclosed and results in an underpayment.

Disclosure and Registration - Enforcement Activities

These changes to the disclosure, registration and list maintenance rules combined with focused task forces should result in broader identification, quicker public guidance, and better compliance. I have committed to the IRS the support of the Office of Chief Counsel in obtaining the information it needs to determine whether taxpayers and promoters are in compliance with these rules. The IRS has authority under current law to investigate the adequacy of disclosure statements by seeking information from both promoters and investors. Promoters are required to register tax shelters with the IRS and maintain a list of investors in the transactions. Furthermore, any person who claims a deduction, credit or other tax benefit by reason of a "reportable" transaction must disclose the transaction on their return. The IRS is exercising its authority under the Internal Revenue Code to determine whether taxpayers are in compliance with

these registration and disclosure requirements. The IRS is gathering this information through the use of Information Document Requests (IDRs) and summonses to promoters. I have personally committed to the Commissioner and to the Division Commissioners (LMSB, SBSE, TEGE) whatever support is needed to pursue these matters.

Under this authority, the IRS has requested information from 30 promoters thus far to determine whether they have complied with the registration and list maintenance requirements. Our attempts to remain current with the market, however, are hampered by these promoters' failure to cooperate. Many of these letters were issued over eighteen months ago, and the promoters still have yet to provide us with any information. Specifically on these current matters, I have instructed Chief Counsel attorneys to issue summonses for the information we have requested and to pursue enforcement vigorously. Two summonses have already been issued, but more must follow. Once the information is gathered, we will be prepared to act quickly upon that information if further investigation or published guidance is warranted.

We are presently seeking legislation that would allow the government to seek injunctive relief against promoters who repeatedly disregard the registration and list maintenance requirements. Some promoters are blatantly ignoring the rules regardless of the penalties they face. An injunction would place a promoter in a public proceeding under court order to comply with the rules. Failure to comply in the future would place the promoter in contempt of court. Even the threat of such an injunction (and the associated publicity) should be enough to end noncompliance.

CONCLUSION

The Office of Chief Counsel is committed to supporting the IRS in its efforts to address tax shelters and to remain current with respect to transactions occurring in the marketplace. We will assist in identifying and analyzing transactions to determine whether published guidance or legislative changes are needed. When needed, we will provide published guidance in a timely manner. We will help the IRS gather the information it needs to determine whether promoters and taxpayers are in compliance with disclosure, registration and list maintenance rules, and we will work with the IRS in processing the information it receives. This commitment should help resolve the issues faced by the IRS in dealing with tax shelters.

Thank you, Mr. Chairman, for giving me the opportunity to speak today. I will gladly answer any questions the Committee may have.