

TREASURY PROPOSALS TO CURB ABUSIVE TAX AVOIDANCE TRANSACTIONS

“The complexity of our tax code has created opportunities for abuse. These proposals will help us find and stop unscrupulous promoters who are marketing questionable transactions to taxpayers.”

Treasury Secretary Paul O'Neill

THE ABUSIVE TAX AVOIDANCE TRANSACTION PROBLEM: SYMPTOM OF A LARGER PROBLEM

- 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 structured to take advantage of a complex tax code to obtain tax benefits that Congress did not intend.
- The ability of taxpayers to engage in these kinds of transactions is one more reason why our complex tax system must be re-evaluated and simplified, so that the opportunities for abusive tax practices that currently exist are eliminated.
- These transactions must be curbed because they violate Congress' intent, harm the public fisc and erode the public's sense of fairness.
- To address this problem, the system must include clearer rules, more transparency and stiffer penalties. Together, the initiatives will change the risk/reward ratio for taxpayers who wish to play the audit lottery and fail to follow the law.

THE IMPORTANCE OF TRANSPARENCY AND VIGOROUS ENFORCEMENT

- The current rules for disclosing, registering, and maintaining customer lists for tax shelter transactions differ, which creates complexity. In addition, the disclosure regulations set forth a series of filters and exceptions that taxpayers are parsing to avoid disclosure. As a result, registrations and disclosures to date have been disappointing.
- Transparency – that is, ensuring that questionable transactions are disclosed and subjected to IRS review – is critical to the Government's ability to address abusive tax avoidance practices.
- Clear rules mandating transparency and vigorous enforcement are essential to curbing abusive tax avoidance transactions. Treasury believes that the existing enforcement regime must be expanded and enhanced to ensure transparency.
- This means more than just new rules; it means more action. Treasury and the IRS have intensified enforcement efforts against promoters of abusive tax practices.

NEW BROADER DISCLOSURE REQUIREMENTS AND ENHANCED PENALTIES NEEDED

- Treasury will seek legislation that will impose new penalties and enhance existing penalties for a taxpayer's or promoter's failure to comply with enhanced rules.
- Treasury is undertaking a series of administrative actions that strengthen and improve the rules for disclosing and registering transactions and the maintenance of customer lists for tax avoidance transactions.
- Under these new proposals, Treasury will create a single set of rules, that leaves no room for interpretation, to apply to disclosure, registration, and maintenance of customer lists. A single set of rules should create a better enforcement system that increases the certainty of IRS detection of failure to disclose, failure to register, and failure to maintain customer lists, and thus will deter tax shelter activities.

TREASURY'S LEGISLATIVE PROPOSALS

✓ **Impose a Penalty on the Failure to Disclose Reportable Transactions**

Without a penalty, taxpayers have less incentive to disclose. Significant new penalties will apply to the failure to disclose reportable transactions. No penalty currently exists.

✓ **Increase the Penalty on Promoters for Failure to Register a Reportable Transaction**

A significant penalty should be imposed on a promoter for the failure to register a reportable transaction.

✓ **Require Corporate Taxpayers to Disclose to Shareholders any Penalties for Failing to Disclose "Listed" Transactions or Participating in Undisclosed "Listed" Tax Avoidance Transactions**

Corporate taxpayers should disclose to their shareholders that they have been penalized for failing to disclose or for participating in undisclosed tax avoidance transactions that have been listed by the IRS.

✓ **Increase the Penalty for the Failure to Turn Over Investor Lists in a Timely Fashion**

Legislation is necessary to encourage promoters to respond more quickly to IRS requests for investor lists.

✓ **Permit Injunction Actions against Promoters who Repeatedly Disregard the Registration and List-Maintenance Requirements**

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 violated these rules in the future. The threat of an injunction will enable Treasury and the IRS to curb the most egregious behavior by promoters.

✓ **Impose a Penalty for the 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 the "Report of Foreign Bank and Financial Accounts" (Form TD F 90-22.1).

✓ **Increase the Penalty for Frivolous Return Positions**

Treasury, 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.

✓ **Amend the Promoter Registration Rules**

This will expand the types of transactions promoters will be required to register with the IRS.

✓ **Confirm Treasury and the IRS' Ability to Expand the Number of Promoters and Advisors Required to Register Reportable Transactions and Maintain Investor Lists**

Broadening the list of promoters and advisors required to register transactions and keep lists will help the IRS more easily identify the taxpayers participating in abusive tax avoidance transactions.

✓ **Curb Improper Use of Foreign Tax Credits**

To prevent taxpayers from improperly obtaining foreign tax credits, Treasury 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.

✓ **Curb Abusive Income-Separation Transactions**

To prevent "income-separation" transactions that are structured to create immediate tax losses or to convert current ordinary income into deferred capital gain, Treasury will seek legislation to prevent the separation for tax purposes of an asset from its income stream.

TREASURY'S ADMINISTRATIVE ACTIONS

✓ **Require Partnerships, S Corporations, Trusts and High-Income Individuals to Disclose Reportable Transactions**

Disclosure should not be limited to corporations—everyone should be required to disclose potentially abusive transactions.

✓ **Centralize the Receipt and Review of Disclosures by Partnerships, S Corporations, Trusts and High-Income Individuals**

This will give the IRS an early warning mechanism to identify potentially abusive transactions. It also facilitates the process of identifying potentially abusive transactions if all the documents are in one location.

✓ **Establish a Consistent Definition of a “Reportable Transaction” for Return Disclosure, Registration and List-Maintenance Purposes**

A single set of rules reduces complexity and should apply on a clear bright line basis that leaves no room for interpretation and is not based on subjective inquiries.

✓ **Clarify the Definition of a Listed Transaction**

Clarifying the definition of a listed transaction will improve disclosure.

✓ **Impose Strict Liability for Failure to Disclose a Reportable Transaction**

To encourage taxpayers to disclose reportable transactions, a strict liability penalty should be imposed on a taxpayer who fails to disclose a reportable transaction and is found liable for an understatement of tax.

✓ **Impose Strict Liability for Failure to Disclose a Position**

A strict liability penalty should be imposed on a taxpayer who fails to disclose that it has disregarded a regulation and is found liable for an understatement of tax.

✓ **Broaden the Range of Persons who Are Required to Register Reportable Transactions and Maintain Lists of Investors**

Broadening the list of promoters and advisors required to register transactions and keep lists will help the IRS more easily identify the taxpayers participating in abusive tax avoidance transactions.

✓ **Establish Standards for Opinions in Circular 230**

Because taxpayers often rely on opinions in deciding whether to participate in a tax avoidance transaction, and because some practitioners are rendering legal opinions that fall short of appropriate minimum standards, it is necessary to clarify the standards for opinions and impose strict standards on promoters who provide opinions to facilitate abusive tax avoidance transactions.

✓ **Provide a Consistent Form for Return Disclosures**

A standard form will ensure that all relevant information is provided to the IRS.

✓ **Establish Procedures for Early Examinations of Potential Tax Avoidance Transactions**

This process will allow the IRS to quickly identify, evaluate, and shut down abusive tax avoidance transactions.

✓ **Target Abusive Tax Avoidance Schemes**

The IRS will re-deploy resources to identify and shut down abusive tax avoidance transactions. Resolution of issues such as capitalization and the R & E credit, which the IRS has indicated consumes nearly 40% of the audit resources in the IRS Large & Mid-Size Business Division, will free up resources for better use—such as targeting abusive tax avoidance schemes.