



Securities Industry Association

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Dear Sir/Madam:

Thank you for meeting with us recently to discuss our concerns relating to the substantial overbreadth of the temporary regulations under section 6112 of the Internal Revenue Code (and by cross-reference, the regulations under section 6111 of the Code). I hope that our frank discussion of how securities firms are operating under the new requirements was helpful. We encourage refinements to the regulations that would result in them affecting far fewer common business transactions while at the same time ensuring that tax administrators can obtain the information envisioned concerning investors in tax-problematic transactions.

In follow-up to our meeting, we would like to briefly summarize and clarify a few of the points that we discussed with you and that we believe are the most critical to the effective operation of the list-keeping rules. (Please refer to our submission dated June 13, 2000 (copy attached) for further details concerning the specific recommendations outlined below for more effectively targeting the list-keeping requirements.)

1. IRS should explicitly state the intended use of investor lists. We strongly believe, as an initial matter, that both auditors and those subject to the list-keeping requirements should be put on notice of how the IRS intends to make use of investor lists. As a basic matter of fairness, those charged with keeping investor lists and the IRS agents auditing them should share the same

conception of what the rules are, and are not, intended to accomplish. Only in this way can predictable and even-handed administration of the rules be assured.

2. Penalties for failure to keep investor lists should not be increased at this time. We are very concerned that there are pending legislative proposals that would dramatically increase the penalty for failure to keep required investor lists. As we discussed with you, any action by Congress to increase this penalty at this time would penalize activities involving *absolutely no wrongdoing*, because the list-keeping requirements of the temporary regulations currently can be read to extend to a wide range of normal capital market transactions that constitute the day-to-day business activities of securities firms. While a substantial penalty could be justified with respect to a failure to keep a list of investors with respect to transactions that are not within the tax laws, or with respect to transactions that the IRS has explicitly listed, securities firms should not face the risk of severe penalties with respect to normal business transactions. To the extent they do, they will be forced to incur substantial compliance costs of no benefit to tax administrators and will likely face unjustified problems on audit. SIA has been working with Congress to urge caution on penalty changes and will continue to do so.

In a recent speech before the Tax Executives Institute, Assistant Secretary Weinberger stressed the importance of evaluating and refining the regulatory responses to corporate tax shelters before proceeding to additional legislation on the topic, in order to avoid regulatory and legislative measures working at cross purposes. We hope that Treasury will coordinate closely with the congressional tax-writing committees to address tax abuses in an effective manner that minimizes unnecessary compliance costs and business uncertainties.

3. Revised Treasury regulations should narrow and significantly alter the reach of the list-keeping requirements. We believe that the temporary regulations need substantial revisions to better target the transactions that are of concern to tax administrators without impacting legitimate transactions. While we did not discuss all of these ideas during our meeting, SIA has several suggestions that we believe, if adopted, would greatly improve the regulations. While some of the recommendations outlined here would narrow the scope of the regulations, others would clarify, expand or redirect the focus of the regulations. (Please refer to SIA's submission dated June 13, 2000 for more detail concerning these recommendations.)

- Eliminate the so-called "catch-all" provision in the regulations. The regulations require a securities dealer to list "every transaction that has been structured to produce tax benefits that constitute an important part of the intended results of the transaction", where "tax benefits" is defined to include "all deductions, exclusions from gross income, nonrecognition of gain, tax credits, adjustments (or the absence of adjustments) to the basis

of property, and any other tax consequences that may reduce the taxpayer's Federal income tax liability by affecting the timing, character, or source of any item of income, gain, deduction, loss, or credit." Tax consequences are typically important to significant business transactions. This language is so broad that it arguably captures most significant financial transactions the structure of which was affected in some way as a result of input from tax professionals. As indicated below, there are other, much more targeted means of reaching transactions of concern to tax administrators.

- Narrow the economic substance test for non-financing transactions. We do not think the requirement that a transaction be listed if it does not have a reasonably expected pre-tax profit should apply to business transactions where there is no net equity invested in the contract and therefore no expectation of a pre-tax profit *per se*, such as hedging transactions, mergers, acquisitions, restructurings and non-hedging long positions in interest rate swaps, equity swaps, commodity swaps, futures contracts, forward contracts, option contracts and other financial instruments. We do not think it advisable to address this problem with an exception, however, since the exception would engulf the rule. Rather, we recommend that the profit test apply only to transactions where (i) a taxpayer pays some significant amount to "invest in" a transaction and (ii) the investment does not meaningfully change the investor's risk/reward profile but rather resembles a relatively risk-free investment producing passive investment income.
 - o Such a limitation would be entirely consistent with the thrust of the regulations under section 6112, which plainly envision an "investment" in a tax shelter that is "organized" by a promoter and which therefore require the promoter of the tax shelter to maintain a list containing such information as "who purchased interests" in the tax shelter, "how much they invested" in the tax shelter and what tax benefits they thought they were getting in exchange for their investments. Such requests for information only make sense in the context of an investment in a tax shelter, and indeed they can only be rationally complied with in the context of such an investment. More important, a listing requirement that compares the anticipated pre-tax profit from the investment with the anticipated tax benefits from the investment only makes sense in the context of an investment and cannot be rationally applied to mergers, financings, hedging transactions, restructurings and a vast array of other financial transactions that are not investments at all.
 - o Likewise, we do not see how or why a profit test should be applied to an investment - - such as a naked purchase of volatile stocks - - that radically changes the investor's economic profile. One cannot

"measure" the anticipated profit from such an investment, nor does the lack of "measurable" profit suggest a motivation to avoid taxes.

- o The regulations should also clarify that the discounting rule involves discounting the anticipated profit from the transaction (as reduced by transaction costs and other expenses) to present value.
- Replace the economic substance test for financing transactions with rules focused on tax-indifferent parties. The financing test in the regulations, as currently drafted, applies somewhat haphazardly to certain routine financing and refinancings. Moreover, it does not deal with the broader problem that the step-down preferred transaction raises - - namely, the use of a tax-indifferent party to create tax benefits for a taxable person. We recommend replacing this test with a broader requirement (based on one of the tax shelter "indicators" proposed by the staff of the Joint Committee on Taxation) that an arrangement or transaction be listed if it (i) results in U.S. taxable income to a tax-indifferent participant (if the tax-indifferent participant were fully subject to U.S. tax) that is materially in excess of economic income to the tax-indifferent participant, (ii) permits a corporate participant to characterize items of income, gain, loss, deduction or credit in a more favorable manner than it otherwise could have without the involvement of the tax-indifferent participant, or (iii) results in a noneconomic increase, creation, multiplication or shifting of basis for the benefit of the corporate participant, and results in the recognition of income or gain that is not subject to federal income tax because the tax consequences are borne by the tax-indifferent party. This requirement would pick up not only financing transactions involving "enhanced" interest deductions but also many potentially abusive transactions that are not financing transactions (e.g., Colgate, lease stripping transactions, "LILO" transactions and transactions involving distributions from charitable remainder trusts.)
- Expand the list-keeping requirements to transactions in which promoter's fees are contingent upon the realization of tax benefits. It is routine for the *business parties* to a financial transaction to compensate each other for certain tax consequences of the transaction, such as depreciation deductions, tax credits, withholding taxes, dividends-received deductions and additional income taxes. It is unusual, however, for a person who merely promotes or helps structure a transaction to charge fees that are contingent upon the realization of tax consequences (or that may be rebated if such consequences fail to materialize.) We recommend that the presence of such contingent fees trigger an automatic requirement to list investors.
- Clarify the "no reasonable basis" exception. Many practitioners, consistent with public statements made by some IRS officials, believe that

the “no reasonable basis” exception from the listing requirement is available in cases where the IRS (if the IRS were a taxpayer) would not have a “reasonable basis” for asserting its position, within the meaning of section 6662 of the Code. We recommend that this interpretation be explicitly endorsed in revised regulations. This is a familiar standard and one that would appropriately limit list-keeping requirements to transactions judged to be aggressive.

- Provide an exception for “execution only” transactions. We recommend that rules be included in revised regulations to clarify that securities dealers are not required to keep lists with respect to transactions that they routinely execute based on instructions of others but play no role in structuring. For example, securities dealers are often asked to serve as counterparties to interest rate or equity swaps, consistent with their market role. Such dealers cannot be expected to determine whether their counterparties are motivated by inappropriate tax objectives, nor will they have the means to do so. (This issue was not raised in our June, 2000 submission.)
- Provide an exception for public transactions. Because the IRS is already aware of transactions described in public SEC filings, we believe these transactions should be excepted from the list-keeping requirements.

We believe that the above changes would best implement the listing requirements by focusing on the most problematic transactions. As information is obtained by tax administrators through the audit process and as a result of transactions now being done on a nonconfidential basis, the rules can and should evolve to reflect the experience gained.

4. A compliance safe-harbor should be provided. We believe that a securities dealer should be considered to have complied with the list-keeping requirements if it produces all required information within a reasonable period of time following an IRS request for a list of investors in a specified type of transaction. Securities firms need some assurance that there is a “safety net” in case their reasonable judgments concerning data compilation are not the same as those of tax administrators. Further, if all requested information is promptly provided, there is no harm to tax administration caused by providing this type of safe harbor.

Thank you for your consideration of our views. Please do not hesitate to contact Patti McClanahan, SIA’s Vice President and Director of Tax Policy (202-326-5324), if you have any questions or think it would be valuable to meet again

to discuss any aspect of your efforts to address corporate tax shelters. We look forward to working with you to arrive at rules that limit participation in corporate tax shelters while minimizing unnecessary compliance costs.

Sincerely,

Saul M. Rosen
Chair, SIA Committee on the
Federal Taxation of the Securities Industry

Cc: The Honorable Mark Weinberger
Assistant Secretary (Tax Policy)