



Securities Industry Association

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September 4, 2001

John Angell
Majority Staff Director

Kolan L. Davis
Republican Staff Director

Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Sirs:

The Securities Industry Association ("SIA")¹ would like to thank Chairman Baucus and Ranking Member Grassley for the opportunity to provide comments relating to the bipartisan Tax Shelter Staff Discussion Draft dated August 3, 2001 (the "Discussion Draft"). Consistent with our responses to the Preliminary Staff Discussion Draft dated May 24, 2000 and the Revised Staff Discussion Draft dated October 5, 2000, our current comments focus primarily on the proposed penalty increases that would affect our firms in their capacities as financial intermediaries and financial advisors assisting clients with capital markets transactions.

We would like to note, however, that the definition of "tax shelter" incorporated in the Discussion Draft that triggers serious penalties is very broad, and much broader than the definition of an "abusive tax shelter device" that

¹ The Securities Industry Association brings together the shared interests of nearly 700 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 80-million investors directly and indirectly through corporate, thrift, and pension plans. In the year 2000, the industry generated \$314 billion of revenue directly in the U.S. economy and an additional \$110 billion overseas. Securities firms employ approximately 770,000 individuals in the U.S. (More information about SIA is available on its home page: <http://www.sia.com>.)

triggers serious penalties under the draft of October 5, 2000.² This is problematic for taxpayers and advisors alike, as it results in the potential application of large penalties to routine and nonabusive cases. Such penalties cannot be avoided through disclosure or listing as the Discussion Draft suggests, for where the operant definition covers a broad range of routine transactions, such disclosure or listing is not practicable.

For the reasons set forth below, SIA strongly urges the Finance Committee to coordinate closely with the Treasury Department to evaluate the regulatory responses to tax shelter activity before proceeding to additional legislation on this topic. This should allow for the development of effective responses to tax abuse that minimize unnecessary compliance costs and business uncertainties.

The penalty for failure to maintain lists of investors should not be increased at this time. SIA's principal concern with the Discussion Draft relates to the proposal to dramatically increase the penalty for failure to maintain lists of investors as required under section 6112 of the Code. Current temporary Treasury regulations implementing the statutory list-keeping requirements remain sweeping in scope, arguably imposing new listing requirements with respect to many normal capital markets transactions. Under these regulations, a securities dealer must maintain a list of investors and compile detailed information with respect to almost every transaction that "has been structured to produce federal income tax benefits that constitute an important part of the intended results of the transaction." "Tax benefits" are defined, for this purpose, to include any "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 consequence that may reduce a taxpayer's Federal income tax liability by affecting the timing, character, or source of any item of income, gain, deduction, loss or credit." Since tax consequences are typically important to significant business transactions, this language is so broad that it arguably imposes list-keeping requirements with respect to most transactions the structure of which was affected in some way by input from tax professionals.

Under the Discussion Draft, the proposed increase in the list-keeping penalty also would apply without regard to whether the tax treatment of the transaction was correct as a matter of law. The failure to inquire into the proper treatment of a transaction, combined with the broad reach of the temporary regulations, would make the proposed penalty increase particularly pernicious in practical effect. It is easy to imagine the penalty being asserted on audit by an IRS agent in technically correct yet inappropriate circumstances.

² The term "tax shelter" would include for this purpose "any entity, plan, arrangement, or transaction if a significant purpose of such entity, plan, arrangement, or transaction is the avoidance or evasion of Federal income tax."

SIA has been working with the Treasury Department since the original temporary regulations were promulgated to assist in the development of effective rules that do not unnecessarily impact day-to-day business activities of securities dealers. We are forwarding with this comment letter copies of our submissions to Treasury dated June 13, 2000 and June 14, 2001 containing several specific recommendations for more appropriately targeting the list-keeping requirements. As you know, on August 2, 2001, Treasury issued new temporary regulations narrowing certain aspects of the list-keeping requirements. While these revisions improved the rules in important respects, they left in place the broad language quoted above and other troublesome aspects of the regulations, with the result that the list-keeping requirements continue to extend to routine business transactions.

While the proper targeting of the list-keeping requirements so clearly remains a “work in progress,” SIA believes it would be unfair and unwise to move forward on legislation containing huge penalty increases that could be asserted inappropriately (and unpredictably) by the IRS with respect to transactions that should not concern tax administrators. Doing so would impose substantial costs and business disruptions on the securities industry and its taxpayer-clients without adequate assurances that tax administrators would obtain benefits justifying the costs. Securities dealers and their taxpayer-clients would be subjected to increased frictions with the IRS with respect to many complex but wholly appropriate transactions. Securities firms also would be forced to incur unnecessary and nontrivial record compilation and retention costs with respect to a wide range of transactions. For affected transactions, the regulations require not only a list of investors, but also a full description of the structure of the transaction, a full description of the associated tax consequences, copies of all relevant offering documents, materials and distributions, and a list of all offerees. It is difficult and costly to organize and maintain this information to meet tax specifications in addition to business needs.

Any increase in the penalty for failure to maintain investor lists should incorporate a “two-tiered” approach. If it is determined that an increase in the penalty for failure to maintain a list of investors is desirable, SIA recommends that a two-tiered penalty be adopted in recognition of the uncertain scope of the current list-keeping requirements. Under this approach, a large penalty would be reserved for cases in which the requirements are clear, such as failures relating to transactions that have been clearly identified by Treasury and the IRS to be of concern.³

The proposed promoter penalties are redundant. The Discussion Draft would amend section 6701 of the Code to impose a penalty on a securities dealer equal to 50% of the gross income derived from assisting in the organization of an entity, plan or arrangement (where one of the significant

³ See IRS Notice 2001-51.

purposes of the structure is to avoid tax) if the dealer is involved in a representation that a purported tax treatment will more likely than not prevail and a court concludes that the representation was unreasonable. It would also amend section 6700 of the Code to impose a penalty equal to 50% of the gross income derived from the organization of an entity, plan or arrangement if the dealer makes a statement regarding its tax consequences that it knows, or has reason to know, is false. Finally, it would amend section 6708 of the Code to impose a penalty equal to 50% of the gross income derived from assisting in the organization of an entity, plan or arrangement and failing to list it as required by regulations. There is no coordination between these three penalty proposals, and presumably there is no intent to impose a penalty of 150% of gross income on a securities dealer with respect to its involvement in a single transaction. The Discussion Draft should be clarified to address penalty interactions (as it already does with respect to the penalties for failure to register under section 6707 and for failure to list under section 6708).

The tax base of the proposed promoter penalties needs to be clarified. Typically, securities dealers provide a broad range of financial services relating to financial market access. Structuring a financial transaction to deal with the relevant regulatory, tax, accounting, and other issues is generally complementary to the main purpose of financial intermediation, which is to assist in raising funds and to advise on large financial transactions. Tax-related structuring is thus a relatively minor and incidental component of a large business transaction. Absent clarification, each of the 50% penalties described above could theoretically be imposed on all of the gross income derived by a securities dealer from its provision of financial services with respect to a large business transaction, even though tax planning played a relatively small role. Suppose, for example, that a \$10 million fee for assisting in a large corporate merger was increased by \$200,000 to compensate for tax planning designed to defer some of the gain that would otherwise arise from the transaction. It seems clear that the penalty in this hypothetical should be limited to \$100,000 and that securities firms should not face a far greater penalty than other advisors for assisting with the relevant tax structure.

The newly increased penalty for making a false statement concerning tax consequences should be substantially narrowed. The newly increased penalty under section 6700 of the Code would apply to any tax-related statement made in connection with any transaction, tax shelter or otherwise. It would apply, moreover, to statements that are unintentionally false, if the securities dealer “has reason to know” better. If, for example, a securities dealer mistakenly tells the purchasers of interests in a trust that the original issue discount rules apply to debt held by the trust, the dealer could be liable for a penalty equal to 50% of its gross income from the underwriting. We assume that this literal reading goes well beyond what is intended, since it bears no relation to tax shelters. SIA recommends that this penalty be limited to statements that are made in connection with a tax shelter and that result in a significant understatement of federal income tax liability.

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Thank you for your consideration of our views. We hope that you will continue to involve SIA and others in the process of analyzing these issues. Please do not hesitate to contact one of us, or call Patti McClanahan, SIA's Vice President and Director of Tax Policy (202-326-5324), if we can be of assistance with respect to any aspect of your ongoing work.

Sincerely,

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Chair, SIA Committee on Federal
Taxation of the Securities Industry
Securities Industry Association

Marc E. Lackritz
President
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cc: Russ Sullivan
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