NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON PROPOSED NEW YORK STATE TAX SHELTER LEGISLATION

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I. INTRODUCTION

The New York State Bar Association submits this report to comment on Senate Bill 6500 (the "Bill"), that is now pending before the New York Legislature. Generally, the Bill requires taxpayers to disclose participation in certain federal reportable transactions, as well as other transactions that are deemed by the New York Commissioner of Taxation and Finance (the "Commissioner") to present the potential for tax avoidance. The Bill also imposes list maintenance and registration requirements, sanctions (including failure to disclose and accuracy related penalties) and a retroactive effective date.

Senate Bill 6500, which was proposed by the New York Department of Taxation and Finance (the "Department"), is the most recent step in New York's developing effort to combat abusive tax shelters. As stated in the Department's Memorandum in Support of the Bill:

> The problem of tax shelter abuse has become a matter of national importance. The federal government is actively investigating the legality of many known tax shelters and maintains a list of problem shelters. The states, most recently California, have begun to seriously identify and attack abusive tax shelter schemes. New York should also play a leading role in leveling the playing field for all taxpayers by bringing abusive schemes to light, attacking them and restoring confidence and fairness to the tax laws. This bill would authorize the Department of Taxation and Finance to identify participants in and require disclosure of commonly known transactions that are abusive or have the potential to be abusive. This bill would give New York the tools needed to join the federal government and other states in removing the incentive to engage in abusive tax shelter transactions.[2]

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[1] This Report was prepared by the Multistate Tax Matters Committee of the Tax Section of the New York State Bar Association. The Principal authors were Robert E. Brown, Paul R. Comeau, Alice A. Joseffer, Carolyn Joy Lee, Diann Smith and Jack Trachtenberg. Helpful comments were received from Kimberly S. Blanchard, Peter H. Blessing, Peter Canellos, Peter L. Faber, Patrick C. Gallagher, Maria T. Jones, Robert J. Levinsohn, Erika W. Nijenhuis, Arthur R. Rosen, David Sachs, Michael L. Schler and Lewis Steinberg.

[2] *See* S.6500, Memo in Support, p. 2.

Prior to the Bill's proposal, the Department had other measures to combat abusive tax shelters. In 2003, the Department established the Tax Shelter Unit, which has been devising methods and procedures to identify and audit tax shelter promoters and participants.[3] New York has also partnered with the Internal Revenue Service (the "IRS") and thirty-four other states to share information regarding these transactions.[4]

The Tax Section commends these efforts. As we have stated in the past, tax-abusive transactions "diminish . . . revenues and undermine the public trust that is essential to our system of self-assessed taxes."[5] Accordingly, the Tax Section generally supports the Bills' imposition of disclosure requirements and penalties as appropriate and useful tools for deterring and combating tax shelter activity.

With respect to specific provisions of the Bill, however, the Tax Section has several comments, concerns and recommendations. Among other things, the Tax Section is concerned that the Bill's broad grant of administrative power to the Department and the Commissioner, free from the normal review under the State's Administrative Procedure Act, could weaken the law's focus and lead to an inappropriately broad and unintended imposition of penalties. We also have reservations regarding the Bill's nexus standards for triggering the disclosure and list maintenance requirements, as well as its retroactive application. Finally, the Tax Section believes that the Bill's deterrent mechanisms could be simplified so as to reduce the burden on the taxpayers and the State, and that New York should consider adopting, as part of the Bill, a limited amnesty program.

II. SUMMARY OF THE BILL

The Bill contains the following six primary provisions:

1. Disclosure of Federal Reportable Transactions. Every taxpayer or other person required to disclose their participation in a reportable transaction to the IRS under Section 6011 of the Internal Revenue Code of 1986, as amended, (the "Code") would be required to attach a duplicate of the federal disclosure statement to the taxpayer's New York return or report,

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[3] *See* "New Compliance Initiatives", EMPIRE STATE TAX NEWS (Fall 2003), available at http://www.tax.state.ny.us/Statistics/ESTN/fall_2003/Compliance.htm.

[4] *See* "IRS and States Announce Partnership to Target Abusive Tax Avoidance Transactions", available at http://www.irs.gov/newsroom/article/0,,id=112866,00.html.

[5] *See* New York State Bar Association Report #1019, Report on Tax Shelter Legislation.

and the taxpayer would also have to furnish any other disclosure information required by the Commissioner.[6]

2. Disclosure of New York Reportable Transactions. Every taxpayer or other person who participates in a "New York reportable transaction" would be required to disclose their participation on their return or report, in a form prescribed by the Commissioner. The Bill authorizes the Commissioner to determine what types of transactions are New York reportable transactions. Article 2 of the State Administrative Procedure Act ("SAPA") would not apply to the Commissioner's determination of what constitutes a reportable transaction or to his publication thereof.[7]

3. Registration Requirement. Every person required to register a tax shelter under Code Section 6011 would be obligated to file with New York a duplicate of the registration application filed with the IRS within 60 days after the date required for filing with the IRS, if (a) the person is organized, doing business or deriving income in New York, or (b) any investor in the tax shelter is a New York taxpayer.[8]

4. List Maintenance Requirement. Every person who is required to maintain a list of persons who were sold an interest in a potentially abusive tax shelter under Code Section 6112 would be obligated to maintain a duplicate of the list, and furnish a copy of the list to the Commissioner within 20 days after written request, if (a) the person is organized, doing business or deriving income in New York State, or (b) any investor required to be included on the list is a New York taxpayer.[9]

5. Sanctions. Penalties for substantial understatement would be doubled (from 10% to 20% of the taxes due) for any understatement that is attributable to a transaction that is required to be disclosed under 1. or 2. above.[10] The Commissioner is authorized to waive such penalties on a showing by the taxpayer that there was reasonable cause for the understatement, and that the taxpayer acted in good faith. Reasonable cause cannot, however, be based merely on the taxpayer's disclosure of participation in the reportable transaction.[11] The Bill would also impose a $10,000 penalty for each failure by the taxpayer to comply with any of

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6 Proposed NY Tax Law §24(A).

7 Proposed NY Tax Law §24(A).

8 Proposed NY Tax Law §24(B).

9 Proposed NY Tax Law §24(C).

10 NY Tax Law §685(p) and §1085(k), as the Bill would amend them.

11 NY Tax Law §685(p) and §1085(k), as the Bill would amend them.

the foregoing disclosure, registration and list maintenance requirements, unless the taxpayer can show that the failure was due to reasonable cause and not willful neglect.[12]

6. Retroactive Effective Date. The provisions of the Bill would take effect upon passage, and would apply to taxable years beginning on or after January 1, 2004.

III. COMMENTS AND RECOMMENDATIONS

A. The Bill's Failure to Adequately Define New York "Reportable Transactions" Combined With Its Waiver of the State's Administrative Procedure Act Could Lead to an Unfair and Overbroad Assertion of Penalties.

Proposed N.Y. Tax Law § 24(A) defines a New York reportable transaction as any transaction that is designated by the Commissioner to have a potential for tax avoidance:

> A New York reportable transaction is a transaction that is the same as or substantially similar to one of the types of transactions that the Commissioner has determined to have the potential for tax avoidance.

In other words, a New York reportable transaction is any transaction that the Commissioner says is a reportable transaction. There are no statutory parameters to constrain the Commissioner's decision, or any legislative directives that the Department promulgate regulations to provide a framework for how reportable transactions should be identified. Moreover, there is no legislative history to guide the Department as to the Legislature's intent regarding what types of transactions constitute abusive tax shelters. Rather, the Commissioner is seemingly granted unfettered discretion.

In fact, Section 1 of the Bill provides that "[t]he provisions of article two of the state administrative procedure act shall not apply to the determination of a New York reportable transactions by the commissioner or the publication of such determination." Typically, SAPA governs an administrative agency's rule making procedures, and provides an opportunity for public comment on an administrative action. Under the Bill, the Commissioner's determination of what constitutes a reportable transaction would be made without having to follow the formal regulation procedures. Instead, the Bill would permit the Commissioner to list a reportable transaction "by notice, regulation or other form of published guidance." No period of public comment would be required.

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[12] Proposed NY Tax Law §685(x) and §1085(p).

The Bill's waiver of these public comment and regulation adoption procedures is an extraordinary measure, and appears to create the potential for unfairness. In fact, when the Legislature adopted SAPA, it declared that the legislation was necessary to ensure that administrative agencies acted in conformity with sound standards and equitable practices so as to protect the public interest:

> Legislative Intent. The legislature hereby finds and declares that the administrative rulemaking, adjudicatory and licensing process among the agencies of state government are inconsistent, lack uniformity and create misunderstanding by the public. In order to provide the people with simple, uniform administrative procedures, an administrative procedure act is hereby enacted. This act guarantees that the actions of administrative agencies conform with sound standards developed in this state and nation since their founding through constitutional, statutory and case law. It insures that equitable practices will be provided to meet the public interest.[13]

The Tax Section appreciates the Department's need for flexibility in responding to tax shelter developments and other "emergency" situations. Nonetheless, we are concerned that the potential negative consequences of granting the Commissioner such unilateral listing authority outweighs the benefits. Specifically, in light of the serious consequences that attend classifying a transaction as a reportable transactions (i.e., the potential application of considerable non-disclosure penalties and increased substantial understatement penalties), we believe that the grant of unregulated discretion to the Commissioner is unwise in that it could result in the overbroad assertion of penalties. This could occur not only as a result of the specific transactions listed by the Commissioner, but also because taxpayers would be required to disclose any transaction that is "substantially similar" to those designated by the Commissioner, even if (apparently), the transaction is "substantially similar" to a transaction that becomes listed *after* disclosure was initially required.[14] Accordingly, we do not believe that the Commissioner's listing authority should be free from review and public comment altogether.

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[13] N.Y. State A.P.A. § 100 (McKinney 2004).

[14] For federal purposes, taxpayers must disclose, on their next return, any transaction that becomes listed after the taxpayer initially filed his or her return, but only if the statute of limitations for the originally filed return is still open. A similar rule at the state level could be problematic. For instance, it is not clear whether a taxpayer would be required to file a state return for a subsequently listed transaction if he or she was not otherwise obligated to file a return (e.g., because the taxpayer is no longer a resident in New York and otherwise has no New York source income).

Moreover, we suggest that it is in the Department's own interests to allow for some period of public comment, at least initially, in the transaction listing process. Often, the private sector will recognize problems that regulatory agencies may not. In the absence of such input, listings could be made that are under-inclusive, thereby failing to require the disclosure of abusive conduct that the Department may wish to identify. Conversely, the listings could be over-inclusive. This could result in an overly-burdensome array of compliance and filings requirements for both the taxpayers and the Department.

To balance the Department's need for flexibility in listing transactions with the desirability of some review and comment mechanism, the Tax Section recommends the following:

- Either the SAPA requirements should be retained, or the Legislature should direct the Department to initially promulgate regulations, in accordance with SAPA, that govern the Commissioner's discretion to list transactions. Similar to the regime adopted at the federal level, these regulations would guide the Commissioner's discretion by defining what constitutes a reportable transaction. The opportunity for public comment is important to help ensure the implementation of more effective and efficient rules and regulations, and could even occur after an "emergency" notice has been issued. If changes are later made to the transaction listed, such changes should be retroactive to the date of the original notice (though retroactivity should not apply to the extent the listed transaction, as amended, is broader than the one initially promulgated under the "emergency" notice).

- The Bill should include definitional parameters for determining generally what constitutes a New York reportable transaction.

B. The Bill's Imposition of List Maintenance and Registration Requirements on Individuals Whose Only Contact With the State Is a Relationship to a Tax Shelter in Which One or More Investors Is a "New York Taxpayer" Is Overly Stringent.

Proposed N.Y. Tax Law § 24(B) and § 24(C) require various persons to maintain lists and register transactions if any investor in the relevant transaction is a "New York taxpayer." Each failure to satisfy these obligations carries a potential penalty of $10,000.

We initially question whether it is appropriate for New York to require a person to make filings, or to impose such substantial penalties for failure to do so, where the sole contact the person has with New York is his or her relationship to a tax shelter in which one or more investors is a "New York taxpayer." We also note the term "New York taxpayer" is not defined by the Bill. Does it include any person who pays any New York tax, including sales or cigarette

taxes? Is it limited to those who pay income or franchise taxes? This is left open. Moreover, irrespective of the definition, the status of an investor as a "New York taxpayer" may not even be known to such person. A promoter may not, for example, know whether an individual resident in State X will at some point in the relevant year derive income from New York sources that requires the filing of a New York nonresident return; may not know that a particular corporation files as part of a New York combined group; and may not know or be able to identify the ultimate taxpayers where the investor is a pass-through entity. Certainly, it is not unreasonable to impose filing and record-keeping requirements on persons who knowingly direct their activities at the New York market. It is not, however, appropriate to enact a statute that purports to obligate and penalize persons whose connection to New York is extremely remote.

Based on the above, the Tax Section recommends the following:

- The Bill should not impose the list maintenance and registration requirements on a promoter merely because an investor in the promoter's tax shelter is a New York taxpayer unless the promoter "knows or has reason to know" that the investor is a New York taxpayer.

- The Bill should require promoters to take reasonable steps to determine whether any investor is a New York taxpayer. A list of factors (e.g., whether the promoter required its investors to submit a list of states in which income tax returns were filed) should be developed (either in the Bill or in regulations) to help determine whether a promoter had reason to know that a particular investor was a New York taxpayer.

- Absent actual knowledge that an investor is a New York taxpayer, a promoter should not be subject to penalties if such reasonable measures are taken.

- The Bill should provide a clear definition of what constitutes a "New York taxpayer."

C. The Bill's Retroactive Effective Date May Be Overly Burdensome to Taxpayers.

The Bill states that the proposed legislation is effective immediately, and will apply to taxable years beginning on or after January 1, 2004. We suggest that the Bill's blanket effective date be replaced with tailored effective dates that correlate with the specific disclosure provisions of the Bill:

- Where all that is required is the provision to New York of a copy of a federal disclosure, it is reasonable to impose such a requirement with

respect to tax returns filed after the effective date of the legislation, even if the transaction requiring disclosure was entered into in a prior tax year.

- Where a promoter must disclose merely because an investor is a "New York taxpayer" (and the promoter is not otherwise linked to New York), the Bill should limit its disclosure requirements to transactions entered into after the date of enactment (or perhaps after the date the Bill was introduced), because the promoter cannot be expected to have taken "reasonable steps" with respect to prior transactions to identify whether any investors are New York taxpayers as recommended in III.B above.

- Proposed N.Y. Tax Law § 24(B) requires registration of a tax shelter in New York within sixty days after federal registration. An alternative effective date should be offered to allow for compliance in the case of closed transactions. Persons who are required to register during a tax year beginning on or after January 1, 2004 need adequate time following enactment of this legislation to identify those federally filed transactions for which New York filings will now be required. For example, if a promoter filed a federal disclosure on February 1, 2004, it is impossible to file a New York disclosure within 60 days of that date. We suggest that the Bill require New York registration to be completed by the later of sixty days after federal registration was required and sixty days after the Bill's enactment date.

D. The Bill Should Adopt a Limited Amnesty Program Similar to That Provided in Other States' Tax Shelter Legislation

Several other states are currently considering adoption of tax shelter disclosure legislation and one state, California, has already implemented such legislation.

California's legislation includes a Voluntary Disclosure Initiative and Illinois's proposal would allow taxpayers to either choose disclosure with no appeal rights (in which case all penalties would be abated) or disclosure with appeal rights (in which case only the new penalties would be abated). It appears that approximately 60% of the participants in the California program retained their appeal rights and anecdotal evidence suggests that the vast majority of the participants involved federal tax shelter issues rather than issues unique to California. The federal government has frequently provided a limited form of amnesty for specific transactions that have recently become listed. Both the state and the federal programs are useful in quickly bringing taxpayers into compliance and limiting the future audit workload of the tax authority.

We suggest that New York adopt a similar program as part of its Bill. While we are aware that the Department is currently conforming to the federal Son-of-Boss program, it is

unclear whether similar programs exist for other tax shelter transactions. A recent press release indicated that taxpayers could disclose other shelters and be spared the penalties, but no official policy has been adopted.[15] Defining the full scope of the disclosure program in the Bill will help ensure that benefits of such a program (for both the State and its taxpayers) are fully taken advantage of.

E. We Encourage New York to Work With Other States to Address Shelters on a Uniform Basis.

Many states have continued to enact substantive legislation to eliminate perceived tax code loopholes and curtail unintentional legislative ambiguities creating tax avoidance opportunities contrary to legislative intent. Such specific substantive revisions continue to be the focus of considerable legislative activity throughout the states. The Multistate Tax Commission (the "MTC"), a state compact organization, has also been actively studying the abusive tax shelter problem. One of its initiatives, the Tax Compliance Initiative, has included a subgroup specifically tasked with the review and implementation of programs intended to reduce the use of abusive tax shelters. This subgroup, headed up by Gerald Goldberg of the California FTB, has recently released a comprehensive discussion of the current state specific tax shelter problems and a variety of proposed solutions. The MTC, along with participation from New York and the Federation of Tax Administrators, is also working on a database through which states can share information on newly discovered tax sheltering techniques and, potentially, taxpayer specific information to aid multistate audits of such shelter participants.

We believe there is a need for uniformity and coordination between the states as these reporting provisions become more commonplace. New York is to be commended for narrowly tailoring its proposal to existing federal reporting rules which will significantly decrease the compliance burden on taxpayers. A particular concern, however, occurs for state specific listed transactions. We strongly encourage New York and other states to coordinate the procedural reporting rules so that similar rules apply in each adopting state and to avoid differing substantive definitions for similar terms or transactions. States might wish to consider participating in a national registry, accessible by all states, which would permit a promoter to register a transaction in a single, central location. The goal should be state to state uniformity to the greatest extent possible given the differing tax regimes of the various states.

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[15] *See* "New York State Cracks Down on 'Son of Boss" Tax Abuse," available at http://www.nystax.com/press/2004/sonofboss.htm (May 21, 2004).