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SUMMARY:
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In this viewpoint, Prof. Johnson responds to Tax Analysts' request for comments on the IRS's recent shelter settlement initiative. This is the first of what we hope will be many "invitational" viewpoint sections in which we will ask practitioners, academics, and others who have contributed to Tax Notes to provide timely commentary on current issues in federal taxation.

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By **Calvin** H. **Johnson**

The IRS has just announced a tax shelter initiative in which it has offered to settle a broad range of abusive tax shelter cases with a reduced penalty./1/ For the most serious abuses, in group 1 of the announcement, the IRS has offered to reduce the penalty to half of the maximum penalty -- that is, to no more than 20 percent -- and also to allow the deduction of all out-of-pocket costs, including promoter and lawyer fees. The taxpayer would give up deductions for the counterfeit losses that did not really happen.

The initiative in effect puts a 20 percent cap on penalties. For the taxpayer who plays things strictly by the numbers, the cap will mean that the odds favor even tax

shelters that do not have a realistic possibility of success on the merits. The environment, with a 20 percent cap on penalties, will nurture an infestation of shelters with too little merit and make worse those wounds to our nation's tax base.

Group 1 of the announcement is a series of loss generators in which the promoter sells a large counterfeit tax deduction -- as large as $ 100 million -- that the purchasing taxpayer expects to use to erase taxable income received from some other source. Loss generators have to be fake losses; that is, you need to report the $ 100 million tax loss to the government without losing it, because it is never rational to lose the $ 100 million just to deduct it. The technical bases for the claimed losses vary, but there are recurring patterns. One pattern is to unzip a straddle: The shelter buys offsetting positions that result in both a gain and a loss at the $ 100 million level. But by various tricky schemes, the positions are disattached and only the loss leg is shown on any tax return./2/ Another pattern is to overstate the economic detriment of a liability, again at the $ 100 million level./3/ A third pattern is to reduce the value of the taxpayer's asset without reducing the taxpayer's basis, because, for various reasons, the reduction in real economic value in question does not ordinarily reduce basis./4/ The shelters have the common trait that the claimed mega-loss did not happen. They are all permanent errors, never fixed by basis adjustments. They have all been identified as listed or potentially abusive shelters. Those shelters are massive assaults on our nation's tax base, at a time when deficits are soaring and the war debts must be paid.

I think it is now the law that loss generators do not work. Section 165 of the 1954 code allows a deduction only for losses that the taxpayer has really suffered. The tax regulations under section 165 have long provided that deductions are allowable only when the taxpayer has sustained a bona fide loss as determined by its "substance and not mere form."/5/ The courts must examine "whether the substance of those transactions was consistent with their form," because a transaction that is "devoid of economic substance . . . simply is not recognized for federal taxation purposes."/6/ The absence of a bona fide loss is fatal to the claim. The fake loss is permanent, moreover, so it is a perfectly appropriate occasion for the commissioner to announce that the taxpayer's accounting does not reflect income and then to fix it, as Congress has allowed./7/ The IRS needs to broadcast loud and clear that if you have not lost $ 100 million, do not claim it on your

[*930]

tax return. If that rule is in doubt, the IRS needs to litigate until it is settled beyond dispute that artificial losses may not be claimed. Or the IRS needs to lose a $ 100 million case and take it to Congress so that Congress can clarify that counterfeit losses are not recognized for tax from the effective date of the 1954 code./8/

Settling tax shelter cases before ACM Partnership is firmly established and before loss generators are dead is premature. A violation of ACM Partnership -- which simply restated that losses without economic substance are not recognized -- needs to be a clear and serious offense for all participants before the IRS can quit. Indeed, it may ultimately be possible to control those mega- shelters only if the criminal sanction is brought to bear on loss generators.

It is also a mistake to allow a deduction for out-of-pocket transaction costs in these shelters. All of them have a strongly negative expected value in absence of tax. The underlying assets have volatility histories and ascertainable values that allow proof of the negative expected value in a world without tax. You have to expect to pay real money to buy a $ 100 million bogus tax deduction, and the fees paid

always drop the expected pretax value into the strongly negative range. Thus the shelterers are not investing in a real pretax transaction but are buying tax losses. The payments are substitutes in lieu of payments of federal tax; they happen only in the tax world and not in the real pretax world. Because federal taxes are not deductible, the familiar "in lieu of" test/9/ means that payments in lieu of taxes are not deductible either.

In tax shelter cases, the purchasers have to be presumed to be completely amoral. The premise of the shelter, often restated, is that there is no patriotic duty to pay a dime more tax than you can get away with. It is hopelessly innocent to assume that the shelter investors feel some kind of greater duty to God, to country, or to the rule of law. No trick is too dirty or too sneaky if it works. Shelter investors play the straight percentages and only that. Promoters push investors to the edge of the straight percentages because that is how they make their money. Standard ethical business norms now say that if your accountant or lawyer will sell you a shelter, you can buy it. And if investors are there to buy it, then promoters shall arise to invent them. For both promoters and investors, moreover, it matters not at all what the law says, but rather what settlement you can get from the government in the worst case.

On the straight percentages, massive, abusive counterfeit shelters will survive and thrive under the settlement initiative. Let's look at the odds. A taxpayer who pays his due tax, without a shelter, pays 100 percent of tax (t). To justify buying a shelter, the expected cost of the shelter must be less than 100% * t. With the shelter, the purchaser has some percentage chance (x%) of paying no tax and thus (1-x%) of having to pay the tax plus the maximum 20 percent penalty for 120 percent of t. The shelter's value, before fees, is x% of 0*t + (1-x%) * (120% t).

Fees and transaction costs must be paid to the promoters and lawyers, assume at f% of tax avoided. With the deduction allowed under the settlement initiative, the after-tax cost of fees in a 35 percent tax bracket is (1-35%)*f%*t.

The break-even point by the straight percentages in the decision as to whether to pay tax or buy the shelter is described by the following equation:

(1A) Pay tax = expected value from shelter (1B) 100% t = x% * 0 + (1-x%) * (120% t) + (1-35%) * f% * t.

From (1B), it follows that an amoral investor will buy a shelter if the chance of success is greater than x% where

(1C) x% = (20% + 65% * f%) divided by 120%

Chart 1 graphs (1C) and x%, the required chance of success for the investor to buy the shelter, for a range of fees charged:

Required Chance of Success

[Image Omitted]

With a 20 percent cap on penalties, the investor does not need a very big chance of the shelter's success to make the shelter look attractive. With low fees as a percentage of tax saved, a shelter becomes rational on the straight percentages if there is just above a one-sixth chance of success in evading tax. With deductible fees of 30 percent of the tax the promoter is erasing for you, there needs to be a 33 percent chance of success.

The graph makes it look like greater fees will force shelters to be more reliable to be attractive. Overall, however, fees have more effect in subsidizing than in

restraining shelters. Fees operate not only as a disincentive for the shelterer but also as an incentive to the promoter to invent more shelters and learn how to hide
[*931]
them better from the IRS. Shelter promoters are increasing their chances of avoiding tax not just with a smarter product but also with sneakier tricks camouflaging the shelter to avoid clear IRS perceptions of the issues.

Even with fees in the 30 percent of tax avoided range, the law, with the 20 percent cap on penalties means that shelters we need to condemn would go forward for an amoral investor. A fine definition of an abusive shelter is one that is below professional standards. Circular 230 requires that a promoter must have a one-third chance of success of the merits to meet professional standards./10/ But shelters that do not meet the one-third chance standards are perfectly rational under a 20 percent penalty cap. Indeed, a shelter might have a snowball's chance of succeeding on the merits and still come into the acceptable range if the shelters can be made to avoid detection or are made so complicated that no outsider can understand the shelter enough to second-guess the promoter. Ideally, we should be forcing amoral investors to obey the law -- that is, to invest only if it is more likely than not that the shelter will work on the merits. For large shelters, we might well ask investors to aim even higher than that. The 20 percent penalty, in any event, is not enforcing the level of compliance that we need.

The terrible state of affairs is not the IRS's fault. Taxpayers come in with a war chest of $ 1 million per shelter to spend on defense lawyers. When you are facing litigation against opponents with that large a defense fund, there are hazards of litigation. Still, the 20 percent cap is not an occasion for self-congratulations or happy talk. An environment of 20 percent maximum penalty allows very ugly abusive shelters to arise and prosper. This settlement initiative will induce -- not end -- those festering wounds to our tax base.

FOOTNOTES

/1/ Announcement 2005-80, 2005-46 IRB 1, Doc 2005- 21864, 2005 TNT 208-11 (Oct. 27, 2005).

/2/ Notice 2003-81, 2003-2 C.B. 1223, Doc 2003- 25811, 2003 TNT 234-4 (offsetting positions in euros); Notice 2003-54, 2003-1 C.B. 363, Doc 2003-16790, 2003 TNT 137-8 (ownership of common trust fund timed so the tax-exempt entity owns the trust during the gain leg, and the investor gets the tax loss leg).

/3/ Notice 2002-21, 2002-1 C.B. 730, Doc 2002- 6738, 2002 TNT 53-7 (BOSS-like transaction claiming immediate basis for long distant principal payment on zero coupon bond).

/4/ Notice 99-59, 1999-2 C.B. 761, Doc 1999-38713, 1999 TNT 237-1 (son-of-BOSS: basis not reduced by future payments assumed but not considered liabilities reducing basis); Notice 2003-55, 2003-2 C.B. 395, Doc 2003-17125, 2003 TNT 140-17 (lease strips: value but not basis reduced by rent assigned to other parties).

/5/ Treas. reg. section 1.165-1(b)(1960); see Cottage Savings Association v. Commissioner, 499 U.S. 554, 567-68 (1991) (relying on the rule).

/6/ ACM Partnership v. Commissioner, 157 F.3d 231, 245-46, Doc 98-31128, 98 TNT 202-7 (1998) (emphasis added).

/7/ Section 446(b) (giving the commissioner authority to require that accounting reflect income). For applications, see, e.g., Hillsboro National Bank v. Commissioner, 460 U.S. 370, 395, 402 (1983) (corporate taxpayer loses the deduction for cattle feed not consumed, in what would otherwise be tax-free liquidation, because permanent deduction of feed not yet lost is "unwarranted"); Commissioner v. Kluckenberg, 309 F.2d 202 (9th Cir. 1962) (cash method of accounting for completed contracts anticipated that all income that has been earned will eventually be taxable to the individual who earned it regardless of the accounting method involved, and cash method does not reflect income and is not permissible under section 446(b) when it leads to permanent avoidance of tax); Palmer v. Commissioner, 267 F.2d 434 (9th Cir. 1959) (completed contract method of accounting for major construction contracts failed to reflect income under section 446(b) standard when construction company contributed the contracts to the corporation under section 351 and would have avoided taxable income permanently).

/8/ See, e.g., Marvin Chirelstein and Lawrence Zelenak, "A Note on Tax Shelters," 2005 Columb. L. Rev. 1939 (October 2005), http://www.ssrn.com/abstract=745385 (recommending Congress prohibit noneconomic losses or give Treasury authority to do so retroactively).

/9/ See, e.g., Raytheon Production Co. v. United States, 144 F.2d 110 (1944), cert. denied, 323 U.S. 779.

/10/ Treas. reg. section 1.6694-2(b)(1), as amended by Treasury Decision 8382 (Dec. 12, 1991).

END OF FOOTNOTES