ETHICAL IMPLICATIONS FOR INDIVIDUAL TAXPAYERS INVESTING IN ILLEGAL U.S. TAX SHELTERS

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INTRODUCTION

In addition to the federal losses mentioned in the Abstract, the Multistate Tax Commission estimated the losses to the states from these tax shelters at more than $12 billion for 2001 alone. This Subcommittee Report examined the development of mass-marketed generic tax shelter products sold to multiple clients using prominent accounting firms, banks, lawyers and investment firms. By 2003, dubious tax shelter sales were no longer the sole province of shady fly-by-night companies which had prospered in the 1980's. By the late 1990's tax shelter sales had become a big business assigned to talented individuals at the top of their fields and able to draw upon the vast resources and reputations of the country's largest accounting firms, law firms and investment firms[1]. The Senate Subcommittee Report then described the commitment made by the accounting firms to end their involvement with abusive tax shelters. This paper will look at the group hardly mentioned in the Senate Subcommittee Report but which perhaps was the main beneficiary of the tax shelters, namely, the individual investors in these illegal tax shelters.

While it is not illegal to sell or invest in an abusive tax shelter, it is illegal to not comply with the various reporting requirements if you are the seller and it is likewise illegal to knowingly claim on a tax return a deduction or loss which is not sustainable. The vast majority of the Senate Subcommittee's time was spent reviewing the tax shelter promoters' actions. An interesting threshold question is why the Senate Subcommittee ignored, for the most part, the taxpayers who profited from these shelters by investing in them and thus understating their tax liabilities.

Tax Years Ending Before Enactment of American Jobs Creation Act of 2004

Prior to October 23, 2004 the IRS was pretty much limited to the accuracy related negligence and fraud penalties of the Code. Noncorporate taxpayers generally could avoid all or part of the penalties by showing they acted in good faith and there was (1) reasonable cause and (2) substantial authority for the understatement. Substantial authority generally meant that the likelihood that the taxpayer's position on the return was correct was greater than 50%.[2] In the Senate Subcommittee Report it was disclosed that many of the professional firms' tax opinion letters were couched in terms of the taxpayer being able to prevail more than 50% of the time if the IRS contested the taxpayer's position with respect to the tax shelter deduction or loss claimed. Indeed, KPMG told its tax professionals to tell clients worried about IRS penalties:

"The opinion letters that we issue should get you out of any penalties. However, the Service could try to argue that KPMG is the promoter of the strategy and therefore the opinions are biased and try and assert penalties. We believe there is a very low risk of this result. If you desire additional assurance, there is at least one outside law firm in NYC that will issue a co-opinion. The cost ranges between $25-$40k"[3].

Case law, however, has been clear for some time that taxpayers are not permitted to rely for penalty protection on a tax opinion from a promoter of a product when that promoter had a direct financial interest in the deduction or loss claimed[4]. The common belief amongst the tax shelter promoters (although not one professional which testified before the Senate Subcommittee admitted to that particular role) was that the tax opinion of a large, well respected accounting firm should insulate the taxpayer from any negligence or fraud penalties which might be asserted by the IRS, especially when combined with an opinion from a similarly large, well respected law firm. Tax law is very complicated and taxpayers have historically escaped the negligence and fraud penalties when their understatement of a tax liability was based on the opinion of an unbiased, skilled expert in the tax field.

The question becomes, was it reasonable for the taxpayer to rely on the expert opinion of a well respected accounting firm or law firm that the deductions or losses claimed would more likely than not be sustained upon IRS audit? This implies a “facts and circumstances test” with respect to each taxpayer claiming tax shelter benefits. Should the software developer who knows nothing about tax law escape the negligence penalty while the tax law expert who personally invested in the tax shelter be hit with the 20% penalty? Furthermore, if this reliance was reasonable at the time the individual’s return was filed, did it become unreasonable subsequent to filing when the taxpayer discovered that said “expert opinion positions” were being disallowed for other taxpayers? Penalties are determined on the basis of positions reflected on an original return and on the basis of the taxpayer’s knowledge and conduct with respect to those return positions as of the date of the filing of the original return[5]. If the taxpayer’s reliance was justified at the time of filing, then negligence and fraud penalties can not be assessed when the taxpayer subsequently learns her position with respect to tax shelter related items of deductions and losses was incorrect. The Senate Subcommittee hearings generated such outrage, Congress reacted by tightening up and increasing the certainty of the penalty provisions applicable to abusive tax shelter positions on individual and corporate returns[6].

Tax Years Ending After Enactment of American Jobs Creation Act of 2004

Because disclosure is so vital to combating abusive tax avoidance transactions, the Committee Reports for this Act indicate Congress believed that taxpayers should be subject to a strict liability penalty on an understatement of tax that is attributable to a non-disclosed tax shelter position. Furthermore, in order to deter taxpayers from entering into tax avoidance transactions, Congress believed that a more meaningful (but not a strict liability) accuracy-related penalty should apply to such transactions even when disclosed[7]. The provision modified the present-law accuracy-related penalty by replacing the rules applicable to tax shelters. The penalty rate and defenses available to avoid the new penalty vary depending on whether the transaction was adequately disclosed. If the transaction is disclosed on the taxpayer’s return a 20-percent accuracy-related penalty is imposed on any understatement attributable to a disallowed tax shelter. The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment. The new law makes it very clear that for a disclosed transaction penalty waiver the taxpayer can, but does not have to rely on a totally disinterested tax opinion letter. If the transaction is not disclosed on the taxpayer’s return, the strengthened reasonable cause exception is not available (i.e., a strict-liability penalty applies), and the taxpayer is subject to an increased penalty rate equal to 30 % of the understatement. The clear intent of the new penalty provisions, at least with respect to individual taxpayers, is to make the excuse of the tax opinion letter more difficult to apply in disclosed transactions and, secondly, in undisclosed transactions totally unavailable.

Qualified Amended Return Filing Rules

Taxpayers, who have taken tax shelter positions on their original returns in the belief they were complying with what the law permitted (at least according to the expert's tax opinion) have a window of opportunity to amend their original return and not be assessed an accuracy penalty. These individuals are taxpayers who have claimed benefits from abusive shelters and want to change their position in an amended return once they have realized the error on their original return have a new safe harbor available if they correct the original return before being notified of an audit by the IRS. These new qualified amended return provisions encourage voluntary compliance with tax laws by permitting taxpayers to avoid accuracy-related penalties by filing an amended return before the IRS begins an investigation of the taxpayer or the promoter of a transaction in which the taxpayer participated. The IRS has issued proposed and temporary regulations[8] identifying circumstances that end the period within which a taxpayer may file an amended return that constitutes a qualified amended return. The IRS has been concerned, however, that the existing rules may have been encouraging taxpayers to delay filing amended returns until after the IRS has taken steps to identify the taxpayers as participants in potentially abusive transactions. To discourage this attitude, the IRS has announced that an amended return filed after April 30, 2004 in which the taxpayer sought to retract an earlier tax shelter position would no longer insulate the taxpayer from the accuracy related penalties discussed above.

Conclusion

This paper has attempted show the impact on individual taxpayers of the choices they now face. Taxpayers who have claimed benefits from illegal tax shelters prior to the effective date of the Jobs Act can sit back and wait for the IRS to find them and then plead "innocence" because of the tax opinion letters stating the outcome was more likely than not that the tax shelter position would be sustained. If and when they are found by the IRS they can probably escape the 20% accuracy related penalty. While these taxpayers might well have the law on their side with respect to the application of the accuracy penalty for these prior years, is it ethical to not voluntarily amend those earlier years when the "innocent" taxpayer realizes the positions claimed with respect to the tax shelter, were incorrect?

For tax years ending after the effective date of the Jobs Act, reliance on a tax expert opinion will become more problematic even if the transaction is disclosed, and if the transaction is not disclosed, then such reliance on expert opinion is not applicable and the penalty becomes a 30% strict liability penalty.

1 Ibid, Part IV
2 Code Sec. 6662(d)
3 Ibid, footnote #163, SC2-Appropriate Answers for Frequently Asked Shareholder Questions, included in an SC2 information packet dated 7/19/00, Bates KPMG 0013393.
4 At least three appellate courts, the Sixth Circuit in Illes v. Commr., 982 F.2d 163 (1992), the Second Circuit in Goldman v. Commr., 39 F.3d 402 (1994) and the Third Circuit in Neonatology Assocs. v. Commr., 299 F.3d 221 (2002) have held that taxpayers cannot reasonably rely on professional advice from an advisor with a financial interest in a product.
5 Broadhead v. Commr, 14 TCM 1284 (1955).
6 Code Sec. 6664
7 COM-RPT, 2005FED ¶39,654B.99, Committee Reports on P.L. 108-357 (American Jobs Creation Act of 2004)
8 NEWS-FEDERAL, 2005TAXDAY, (Mar. 02, 2005), Item #I.1, Temporary and Proposed Regulations Modify Qualified Amended Return Filing Rules (T.D. 9186; NPRM REG-122847-04)