TAXPAYER'S LEGAL AND ETHICAL OBLIGATIONS TO AMEND RETURNS CONTAINING ABUSIVE TAX SHELTER DEDUCTIONS

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LEGAL OBLIGATIONS TO AMEND

In February 2005 the U.S. Senate Permanent Subcommittee on Investigations issued a report on the "Role of Professional Firms in the U.S. Tax Shelter Industry"[i]. This Report documented the loss of federal tax revenues to the U.S. Treasury from tax shelters in the amount of $85 billion from 1993 through 2003. In addition to these federal losses, the Multistate Tax Commission estimated the losses to the states from these tax shelters at more than $12 billion for 2001 alone. Total damage to the U.S. and state treasuries from taxes that should have been paid but were not paid due to taxpayers investing in abusive tax shelters exceeded $100 billion. The Senate Subcommittee report was highly critical of three of the big four accounting firms for peddling tax shelters the IRS determined to be abusive after these tax shelters started appearing on taxpayers' returns.

It is interesting to note the Senate Subcommittee did not call any taxpayers who had invested in these abusive tax shelters to testify. The Subcommittee's main targets were the tax shelter promoters (accounting and law firms) and the banks that financed the tax shelters. Several emails from the tax shelter promoters became part of the Subcommittee record in which these promoters relied on their professional status as "experts" to insulate the taxpayers from any negligence or fraud penalties in the event the IRS disallowed the transactions.

There is a long history of case law which supports that position, namely, taxpayers can not be charged with negligence or fraud if they relied on expert opinion and that reliance was reasonable under the circumstances. In essence, the sales pitch to taxpayers to invest in these tax shelters was, to the effect, "you have nothing to lose. Buy the tax shelter product and the worse case scenario is that if the IRS disallows the tax shelter deduction, you will be right back where you started from, owing taxes and interest but no penalties." For certain high income taxpayers the economics from such an investment in a tax shelter made the investment a very sound, profitable investment.

Prior to the American Jobs Creation Act of 2004, individual taxpayers were often times immune to imposition of the 20% accuracy related penalty that is attributable to a substantial understatement of income tax[ii] if they had (a) relied on substantial authority for the position taken on the return and (b) they had reasonably believed at the time the return was filed that the position taken was more likely than not the proper treatment of the item.

Very recent case law[iii] would seem to suggest taxpayers may not be liable for most penalties for understatements of tax due to disallowed losses claimed through investments in disallowed tax shelters. Most tax shelters in the recent tax shelter controversy provided tax opinions from reputable law firms and, many times, reputable accounting firms.

> “The amount of the understatement . . . shall be reduced by that portion of the understatement which is attributable to . . . the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment.”[iv]

In *Klamath v. U.S.* (see footnote #3 below) the government asserted four accuracy related penalties against taxpayers which the court rejected because of taxpayers’ reasonable reliance on expert tax opinion regarding the “more likely than not” position for claimed tax shelter losses.

To better grasp the what constitutes “substantial authority” and “reasonable belief” we have looked at current case law interpreting these issues. Furthermore, we looked at the “perjury declaration termination” principles developed before the tax shelter controversy arose and to see how the IRS is applying it to the tax shelter cases. This is a very new topic which we think is interesting and perhaps controversial. In most cases, taxpayers should be able to rely on their expert’s opinion on complicated tax law matters to avoid all penalties. Indeed, information obtained subsequent to filing an original return which was unavailable at the time the return was filed should not impose any further legal obligation on the taxpayer to amend her return.

ETHICAL OBLIGATIONS TO AMEND

The legality of an action, however, does not guarantee that the action is morally right. It is a mistake to see law as sufficient to establish the moral standards that should guide the taxpayer. If it was determined that those tax shelters purchased under the advice of the experts are illegal and the taxpayers received preferential tax treatment, should they amend, prior to notice of audit to correct the error?

Taxpayers have an ethical responsibility to file the amendment. Morality serves to restrain our purely self-interested desires. Having a moral principle involves having a desire to follow the principle for its own sake – just because it is the right thing.

The fact that a taxpayer is not obligated under the law to file a tax amendment will not change the fact that he/she is doing something morally wrong. The trait of integrity should be the virtue of every individual. All principles, duties and rules of ethics must be expressed in the moral life of all of us. The law is to present the minimum ethical standards to prevent us from committing an action that could lead to a penalty (financial or physical) but ethics should be a lot more than that. Ethics is a way of life.

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[i] MISC-LEG-DOC, 2005ARD 031-5, United States Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations Report: The Role of Professional Firms in the U.S. Tax Shelter Industry, February 14, 2005
[ii] Code Sec. 6662(a)
[iii] *Klamath Strategic Investment Fund, LLC v. United States*, 5:04-CV-278 (E.D.Tex 2007)(#278)
[iv] § 6662(d)(2)(B)(i).