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Viewpoint

Tax Shelters

OOPS! There You Go Again! (Options Obliterated but Principle Survives)

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Blip ..., blip .... That sound you hear is the plug being pulled on one of the favorite techniques of dissembling by the Internal Revenue Service in its retroactive prosecution of tax shelters.

Of course you would rarely hear the popular press report about this abuse of process by the service.

Unfortunately, the American Institute of Certified Public Accountants was also missing in action in the retroactive debate. Reorganization and their own internal leadership problems have silenced an organization that used to hold the service accountable when they overstepped their bounds.

There may indeed be valid economic substance issues for "tax shelter" transactions similar to the *Long Term Capital Management* case[1] (a trial I attended in New Haven, Conn.). However, that concept is not law and it has been hotly debated whether it can or should be codified.

But finally someone stood up to the service and their Machiavellian ways; a judge in the Eastern District of Texas has fortified taxpayers to challenge unjust interpretative retroactive regulations.

'Klamath' Ruling

In *Klamath Strategic Investment Fund LLC*, the judge said it is not wrong for the service to challenge a transaction just as it is not wrong for a taxpayer to conduct a transaction if there is no rule against it. The judge merely brought common sense to a technique that should not be allowed. A regulatory body (the service) cannot call transactions illegal three years before that body sets the ground rules and before they have been adjudicated illegal or have been legislatively prescribed.

I have no idea how BOSS (bond option sales strategy), Son of BOSS, COBRA (currency options bring reward alternatives), CARDS (custom adjustable rate debt structure), BLIP (bond linked issue premium structure), or any other hodgepodge of acronym transactions work.[2] However, if I was confronted with one back then, I probably would have advised against it because I could not explain it.

But I do understand the injustice of retroactivity.

Form over substance and substance over form arguments have always been with us. Section 1031 like-kind exchanges are a good example of the former. Disguised partnership sales are a good example of the latter. Fair fights between the taxpayer and the service have always occurred in these areas. However, when retroactivity in enforcement is allowed, then no taxpayer transaction is safe. Anything can be undone based on mere whims of the person in charge.

The press has certainly been the friend of the service here, whipping up a frenzy of class envy and tales of lost revenue. But every tax code deduction rule result in lost revenue, does it not? Is that bad? That is for legislators to decide and not administrative agencies whose mission is to disallow deductions.

The frenzy of envy has resulted in one of the most onerous procedures I have ever seen in an IRS audit situation. The service, in reaction to the "tax shelter" transactions, has apparently advised all agents who deal in the Large and Mid-Sized Business (LMSB) Division that every taxpayer must answer "listed transaction" questions.

My sources say this is required even if there is not one scintilla of evidence that the "listed transactions" were ever conducted by the taxpayer. Currently the questions number 31 and run six pages. Buried in each questions is a code cite, revenue ruling, or case to which the service refers.

Cost of Compliance

I have determined that in 31 questions, there were 93 citations. I estimated that in two hours of research per citation (a low estimate I believe) a taxpayer would incur 186 hours of professional time at a minimum to just understand the question. At $200 per hour, I have calculated the minimum cost to just answer the "listed transaction" questions to be $40,000.

Now to those of you who say "Who cares? The big sophisticated companies in LMSB can handle those fees," I caution that entry into the club of LMSB starts at $10 million in assets. I ask what small business can absorb a $40,000 fee just to answer questions that do not apply?

Worse yet, it appears that the IRS agents who are handing out the "listed transactions" information documents requests (IDRs) do not even understand the questions they are asking.

It challenges credulity in objective rulemaking when every 10 years abuse cycles back into the system. Back then the accounting profession fought over the use of mandatory financial status audit questions at the beginning of each audit. Similar to the listed transactions mandate these questions were required to be answered at the beginning of the audit. As chairman of the AICPA small business taxation committee at the time, I fought this misplaced initiative by the service, which resulted in the enactment of tax code Section 7602(e). It states:

> The Secretary shall not use financial status or economic reality examination techniques to determine the existence of unreported income of any taxpayer unless the Secretary has a reasonable indication that there is a likelihood of such unreported income.

Similarly new Section 7602(f) might now read:

> The Secretary shall not ask listed transactions questions of taxpayers unless the Secretary has a reasonable indication that there is a likelihood of such listed transaction.

OOPS--there you go again.

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[1] *Long Term Capital Holdings v. United States*, D. Conn. Aug. 27, 2004

[2] See *The Ethics Conundrum*, Tax Analysts, a Tax Notes publication, 7/28/04.