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Advertising Material

HRO Alert

TAX SHELTER PENALTIES AND THE HIPPOCRATIC OATH

The Internal Revenue Service (IRS) recently announced that tax fraud in the medical and healthcare professions continued to be an area of emphasis by the Service, particularly as it involves doctors, dentists, and chiropractors who have participated in “abusive tax avoidance transactions.” Federal convictions of medical professionals who have committed income tax evasion, filing false income tax returns, and criminal tax fraud are up, and the IRS continues to publicize these convictions on its website and in the press. For medical professionals who are lucky to have escaped a criminal conviction, incarceration, or the loss of a medical license, the IRS can still impose significant civil penalties to a tax liability which can more than double the tax at issue. Penalties which uniquely apply to tax shelters will be imposed to all taxpayers, however, not just to professionals in the medical profession.

It’s no secret to tax practitioners that the IRS has stepped-up enforcement of individuals who are involved in the investment in, and the promotion of, tax shelters. The federal and state penalties for participating in a tax shelter have gotten increasingly stringent in the past few years, even where taxpayers participated in an investment strategy which was blessed by a competent tax professional with a written tax opinion letter. Many penalties cannot be abated in negotiated settlements with the IRS because the IRS has committed to make an example of those involved in tax shelters. The bottom line is that tax shelters are bad, and the federal and state tax penalties that apply to them are even worse.

In the past few years, the IRS has found itself confronted with the proliferation of abusive tax avoidance transactions which were marketed nationwide to a large number of taxpayers, including many medical and healthcare professionals. Medical professionals were particularly vulnerable because they had little time to focus on their finances. Practitioners who have represented taxpayers involved in tax shelter products understand too well that the IRS has moved from a mindset of “customer service” to an era of increased enforcement. The IRS has an arsenal of penalties which apply to taxpayers involved in abusive tax avoidance transactions. Many of these penalties cannot be abated, even by the most seasoned tax litigators. Taxpayers should be aware of the federal and state tax penalties which will be imposed for participation in a structured tax transaction, which the IRS and state taxing agencies find abusive.

The IRS can find a transaction to be abusive on one of three categories: (1) a listed transaction; (2) a reportable transaction; and (3) a transaction of interest.

A “listed transaction” is a “reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction of Section 6011.” A “reportable transaction” is defined as “any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under Section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion.” The IRS has also identified certain “transactions of interest” which are neither reportable nor listed transactions. Transactions of interest are designated by the IRS as tax transactions which have the potential for abuse, but lack sufficient information to determine whether the transaction should be identified specifically as a tax avoidance transaction. The IRS may take one or more future actions, including designating the transaction as a listed transaction, or including it in a new category of reportable transaction.

When the IRS labels a transaction as “listed,” it reflects the IRS litigating position with respect to the tax treatment of that transaction. It is not a judicial determination of the transaction, but the IRS’s determination that the transaction is abusive. The IRS has been known to de-list transactions on its website upon a finding that there were fewer abusive transactions of its kind than originally anticipated. The problem with the IRS’s determination that a transaction is listed is that the IRS usually makes this determination years after a taxpayer has entered into the transaction and has filed a tax return. Often the listing of a transaction is retroactive to years before a taxpayer entered into a transaction. The IRS’s assertion that a transaction is “listed” or “reportable” is not judicially determined until the transaction at issue has been found by a court to be a tax shelter in another similarly situated taxpayer’s case.

Once the transaction is listed, taxpayers and their counsel will encounter an IRS with stepped-up enforcement tactics. If a return is selected for audit, the IRS will likely assert increased reportable or listed transaction penalties, all which will be applied if the IRS finds the transaction at issue to be substantially similar to a listed or reportable transaction. For example, if the IRS believes a taxpayer's transaction is a listed transaction, the IRS can assert a 25% penalty for failure to timely pay the tax, a 20% accuracy related penalty, a 30% penalty for an understatement with respect to a reportable transaction, and a $100,000 per transaction penalty for failure to include a reportable transaction information statement with a return. This means that a taxpayer who faces, for example, an increase in tax of $100,000 for one tax year could potentially face an additional $175,000 in penalties for his participation in a listed transaction!

Under the Code, the IRS can impose an accuracy related penalty on an understatement of tax attributable to a reportable transaction which is equal to 20% of the amount of the reportable transaction understatement. The penalty increases to 30% if the IRS finds that the taxpayer was required to disclose the transaction on the taxpayer's return. While taxpayers in years prior to the new tax shelter penalty regime faced negligence penalties for their underpayments of tax, taxpayers involved in listed and reportable transactions now face heightened penalties. There is an implicit presumption in the language of the Code that listed and reportable transactions will result in some imposition of increased penalties for participating in such transactions.

New legislation has extended the statute of limitations for assessing a tax for a taxpayer's failure to disclose a listed transaction. Under the new legislation, the statute of limitations is extended another year from the earlier of the dates when the IRS is informed of the transaction (presumably from the taxpayer) or the date which the tax shelter promoter provides a list of the investors to the IRS. In other words, though a normal statute of limitations to assess a tax is typically three years from the date the return was filed, if the taxpayer was involved in a tax shelter, and he or she has not informed the IRS of his or her participation in the shelter (or the promoter has not identified the taxpayer to the IRS), the statute of limitations could conceivably go on indefinitely until one year after the IRS is advised of the transaction. The crux of this new statute is that the IRS can assert an increase in tax and penalties at any time upon discovering a taxpayer's involvement in the listed or reportable transaction, if the taxpayer has not affirmatively informed the IRS of the transaction at issue.

Many states have increased penalties which would be applicable to taxpayers involved in listed and reportable transactions. Many states' tax shelter penalty statutes do mirror the federal tax penalties to a large extent. Generally, California follows the tax shelter penalties which apply to listed and reportable transactions at the federal level. For investors who participate in tax shelters, California has a few penalties which are unique to California and which are not imposed by the IRS. For example, California has a unique "interest based only penalty" which applies to any taxpayer who has a deficiency in state tax and who failed to properly disclose the transaction on a return. The interest based only penalty is equal to 100% of the interest payable on the underpayment of tax from the original due date of the return to the date of the notice of propose assessment.

California also imposes a 40% non-economic substance penalty for an understatement of tax attributable to any transaction which lacks "economic substance." Only the Chief Counsel of the Franchise Tax Board (FTB) can rescind this onerous penalty once the penalty has been assessed. Strikingly, the non-economic substance penalty statute specifically precludes any judicial review of the FTB's failure to abate the penalty. Thus, once the FTB has assessed this penalty, there is little a California taxpayer can do to request abatement of the penalty.

The new state and IRS tax shelter penalty regime is serious and should be noted to those who are invested in, or who are contemplating participating in, a questionable tax strategy. The penalty consequences are dire if the IRS finds that the transaction at issue is listed, reportable, or generally lacks economic substance. Medical professionals should have their tax investment strategies reviewed by competent tax professionals who are familiar with the Code and the federal and state penalties which could be implicated. IRS and state taxing officials have touted their success in collecting tax liabilities and penalties in connection with so-called abusive tax shelters. The imposition of such penalties comes at a high price and, accordingly, investors should beware and should seek competent tax professionals to assist in advising whether a tax investment is sound or advisable.

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