IRS Abuse of Anti-Tax-Shelter Tools

By Steven J. Mopsick

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The IRS is using one of its biggest anti-tax-shelter weapons — IRC section 6700 — to “shoot first and aim later” by accusing legitimate businesses of fraud before their first meeting with a revenue agent. The IRS does not consider a section 6700 investigation an audit but rather an opportunity to “just take a look” and see if a taxpayer is engaged in an activity the Service might want to put out of business.

A section 6700 investigation is commenced by the IRS sending a menacing letter advising the recipient of the agency’s review of “your tax shelter promotion” despite that the underlying transactions may have never made the IRS hit list of “reportable” or “listed” transactions, or that the businesses involved have obtained sound legal opinion letters that pass muster even under the new strict requirements of Circular 230.

The “section 6700 letters” threaten to put the targeted taxpayers out of business by imposing onerous penalties, contacting their clients with “prefiling” letters warning them not to claim the tax benefits to which they may be legitimately entitled, and even threatening to refer them to the Justice Department for injunctions to make sure they stay out of business for good.

Congress added section 6700 to the code as part of the Tax Equity and Fiscal Responsibility Act of 1982, which empowered the IRS to fight the generation of tax shelter promotions that was sweeping the country in the 1970s and early 1980s. Section 6700 provides for the assessment of a monetary penalty against any person who organizes or sells “a plan or arrangement . . . and makes . . . a statement with respect to the allowability of any [tax benefit] which the person knows or has reason to know is false or fraudulent.” (Emphasis added.) Section 7408, a companion section, authorizes the government to enjoin any conduct that is subject to the penalties under section 6700. The legislative history makes it clear that those sections were targeted at clearly abusive transactions such as mail-order ministries, family trust arrangements, and the son-of-BOSS schemes that are currently making tax news headlines.

Shortly after section 6700 was enacted, the IRS put in place internal controls that required the Examination Division to present its evidence of suspected abusive activity to a local section 6700 committee made up of representatives of the Criminal Investigation Division (CID), the Collection Division, Appeals, and most importantly, District Counsel. Under the new procedures, the committee had to give its approval before an investigation was commenced. The presence of District Counsel was to ensure that Examination personnel were on the right track and that it was likely they would develop evidence that would allow the government to sustain its formidable burden of proving that the principals and sales people involved were willfully mistating the tax benefits of the arrangement under scrutiny. What is troublesome is that the IRS recently dropped the requirement that Exam present a proposed investigation to the section 6700 committee. The Examination function of the Small Business/Self-Employed Division is no longer required to get Counsel approval to commence an investigation. Counsel is immediately assigned to assist the agent in an advisory capacity, and it appears as though Counsel must still approve the assertion of the penalty at the conclusion of the investigation, but by that time enough damage may have been done to the taxpayer’s business that Counsel rejection of the penalty proposal would be moot.

Tax practitioners are finding that their clients are receiving notices of section 6700 investigations in areas where it is clear the IRS should be following normal audit procedures. Under normal audit procedures, the Internal Revenue Manual prescribes strict procedures concerning the commencement of a fraud investigation. The revenue agent must first discover “firm indications of fraud” as part of the audit process. If the manager agrees, a report is sent through proper channels to CID. CID then has a

See Rev. Proc. 2005-26, Doc 2005-7334, 2005 TNT 68-10. Taxpayers are required under section 6011, and the regulations thereunder, to disclose some information regarding each listed transaction in which the taxpayer has participated, as defined in reg. section 1.6011-4(c)(3). Generally, if a taxpayer is required to disclose information regarding the transaction, the taxpayer must complete Form 8886, “Reportable Transaction Disclosure Statement,” for each listed transaction and attach the Form 8886 to the taxpayer’s return for each year in which the taxpayer participated in the listed transaction. See reg. section 1.6011-4(e). A copy of the disclosure statement must also be sent to the Office of Tax Shelter Analysis when a disclosure statement is first filed by the taxpayer. See reg. sections 1.6011-4(d) and (e). The Form 8886 must provide the information requested and be completed in accordance with the instructions to the form. See reg. section 1.6011-4(d).


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brief period to determine if it has any interest in developing the case for possible criminal charges. Only after CID advises Examination that it is not interested in the matter is Examination free to develop the case for possible civil fraud or negligence penalties.

In a normal civil fraud case, the revenue agent will develop the facts, and there is usually “give and take” between the agent and the taxpayer in which documents are exchanged, and there is an opportunity for the taxpayer to meet with the agent and present legal arguments. If the case is “unagreed,” the IRS will issue a 30-day letter and the taxpayer has an opportunity to present a “protest letter” to either the agent’s manager or to Appeals.

If the taxpayer chooses to follow the protest route, there is an opportunity to settle the case before the proposed deficiency must be paid. Appeals will take a hard look at the case and determine the relative “hazards of litigation” of the parties. If the appeals officer determines, for example, that the government will be unable to sustain its burden of proving fraud in the Tax Court, the taxpayer will be offered a chance to settle the case. In fraud cases, the government will often offer to drop the fraud penalty entirely or offer to substitute the negligence penalty instead. If no agreement can be reached at the Appeals level, the taxpayer will then be sent a notice of deficiency, after which the taxpayer will have 90 days to file a petition with the Tax Court. Again, there is no requirement that the proposed deficiency be paid at that point. Once a petition is filed, Area Counsel gets involved, which provides yet another round of prepayment settlement opportunities, including a chance to meet with Appeals yet again if new facts are developed. An Appeals meeting, even after the case becomes docketed in the Tax Court, will almost always lead to settlement when the case becomes docketed in the Tax Court.

Contrast the normal procedures with a section 6700 case. The audit letter invites the taxpayer to a conference. Although the IRM implies that only one conference is allowed, most agents are flexible and understand that more than one conference may be necessary as in a normal audit. The IRM states that the agent and the Area Counsel attorney “will jointly determine” if the penalty and the prefilling notification letters are appropriate. Query whether in practice under the new regime the taxpayer has an opportunity to settle with Appeals yet again if new facts are developed. An Appeals meeting, even after the case becomes docketed in the Tax Court, will almost always lead to settlement when the case becomes docketed in the Tax Court.

The Area Director must approve the assertion of the penalty. That is usually a “rubber stamp action” in most cases. But unlike the deficiency procedures, once the penalty is proposed it is assessed shortly thereafter. Once

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4The Examination Tax Shelter Handbook explains the goals and objectives of the section 6700 Program. See IRM Part 20, Chapter 1, Penalty Handbook, Section 6, Preparer/Promoter Penalties.
5IRM 20.1.6.5.2.
included in the employee’s withholding and payment of employment taxes.\textsuperscript{7}

Whether amounts are paid under an accountable plan is governed by section 62, which generally defines adjusted gross income as gross income minus specified (“above-the-line”) deductions. Section 62(a)(2)(A) allows an employee an above-the-line deduction for expenses paid by the employee in connection with his performance of services as an employee, under a reimbursement or other expense allowance arrangement with the employer. Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of section 62(a)(2)(A) if (1) the arrangement does not require the employee to substantiate the expenses covered by the arrangement or (2) the arrangement provides the employee with the right to retain any amount in excess of the substantiated expenses covered. Under reg. section 1.62-2(c)(1), a reimbursement or other expense allowance arrangement satisfies the requirements of section 62(c) if it meets the three requirements in paragraphs (d), (e), and (f) of reg. section 1.62-2: business connection, substantiation, and returning amounts in excess of expenses.

If an arrangement meets the three requirements, all amounts paid under the arrangement are treated as paid under an accountable plan.\textsuperscript{8} The regulations further provide that if an arrangement does not satisfy one or more of the three requirements, all amounts paid under the arrangement are paid under a “nonaccountable plan.” Amounts paid under a nonaccountable plan are included in the employee’s gross income, must be reported to the employee on Form W-2, and are subject to withholding and payment of employment taxes.\textsuperscript{9}

The legislative history under section 62(c)\textsuperscript{10} is brief but makes it clear that Congress sought, in part, to address a potential abuse of the “2 percent floor” rule\textsuperscript{11} and also to ensure that otherwise allowable employee business expenses are deductible above the line as reimbursed expenses as long as they are incurred under an arrangement that requires the employee to substantiate the expenses to the person providing the reimbursement. To be deductible above the line the expenses must be either actually substantiated or be “deemed substantiated” under the rules relating to per diem and other fixed arrangements.\textsuperscript{12}

It is also important to note that the addition of section 62(c) to the code also had the effect of leveling the playing field between Schedule C self-employed tradesmen, who are able to deduct all of their tool expenses, and Form 1040-filing employee craftsmen, who cannot do so because they are not in business for themselves and must satisfy the 2 percent floor before they can deduct anything at all.

Under legitimate tool reimbursement plans in place today, employers use various methods to determine the amount paid as reimbursement for tools. Under some arrangements, employees are periodically interviewed, often by third-party plan administrators, and are required to provide receipts and detailed inventories of their tools. The plan administrator determines, through that interview process and other substantiation, whether an employee’s tool expenses had been previously reimbursed by past employers or depreciated by the employee. From that information, a reimbursable basis is determined. An hourly rate may be computed for each employee and adjusted up or down as the employee disposables or acquires new tools. Most responsible plans provide that the employee must return to the employer any amount in excess of the substantiated expenses covered under the arrangement. The plan may provide that the employee may be reimbursed up to his basis in his tools. The reimbursements are paid based on the hours worked by the employee.

The IRS Attack on Tool Reimbursement Plans

The IRS fired its first warning shot at tool reimbursement arrangements in July 2000 when it announced unequivocally in a coordinated issue paper (CIP) that “amounts paid to motor vehicle service technicians as tool reimbursements will not meet the accountable plan requirements.”\textsuperscript{13} Rather than provide industry guidance on how an employer can meet the accountable plan rules and regulations, the CIP simply assumed that the arrangements described above were nothing more than tax-avoidance schemes designed to avoid employment and income taxes by disguising wages as reimbursements. Despite the fact that those arrangements are directly correlated with, or based exclusively on, the actual tool expenses paid by the service technician, the CIP, apparently because the IRS was ignorant of industry standards, concluded that tool reimbursements are paid regardless of the actual expenses incurred and that they have no logical connection to those expenses.

The IRS’s Inconsistent Positions

What is most troubling about the IRS position is that it took two years after publication of the antitools CIP, in a

\textsuperscript{7}Reg. sections 1.62-2(c)(4), 31.3121(a)-3, 31.3306(b)-2, 31.3401(a)-4, and 1.6041-3(h)(1).

\textsuperscript{8}Reg. section 1.62-2(c)(2)(i).

\textsuperscript{9}Reg. sections 1.62-2(c)(5), 31.3121(a)-3(b)(2), 31.3306(b)-2(b)(2), and 31.3401(a)-4(b)(2).

\textsuperscript{10}The accountable plan rules were added to the code as part of the Family Support Act of 1988, P.L. 100-485, section 702(a).

\textsuperscript{11}The “2 percent floor” rule was enacted as part of the Tax Reform Act of 1986. Deductions for unreimbursed employee business expenses and other miscellaneous itemized deductions generally are allowable only to itemizers, and only to the extent that the total of those deductions exceeds 2 percent of the taxpayer’s AGI. Sections 62(a)(2)(A) and 67.


180-degree turn, the IRS published a revenue procedure that generously allowed favorable tools expense reimbursement relief to oil and gas pipeline construction industry rig-welder employees. The revenue procedure sets out the procedures for substantiation and simply gave the rig welders a “ballpark” figure of $13 per hour as the nontaxable reimbursement amount. Yet the facts in the revenue procedure are indistinguishable from the tool reimbursement plans described above. In both cases, the tool technicians and rig welders are employees and not Schedule C self-employed filers. As a condition of employment, both are required to provide their welding rigs and tools in performing services as employees. It is presumed that the rig welders have purchased their rigs before performing services for a particular employer and also that the rig welders have used those rigs in the performance of services for other employers. That presents a direct conflict with the antitools CIP, which takes the rigid position that the business connection element of the accountable plans rules is breached if an employee were to be reimbursed for an expense incurred before employment.

Notwithstanding the IRS’s attempt to write the accountable plan rules out of the code in the antitools CIP, in the rig welders’ revenue procedure the IRS easily declared a “deemed substantiation” ballpark figure of $13 per hour as a nontaxable above-the-line reimbursement for the rig welders’ employee business expenses. Query whether that deemed substantiation rule unfairly rewards employees whose expenses are less than $13 per hour and penalizes those who can substantiate expenses in excess of that amount.

In October 2005 the IRS published Rev. Rul. 2005-52, which disapproved an arrangement under which an employer used a projection to determine an employee’s total annual tool expenses and the total number of hours the employee is expected to work during the year that would require the use of tools to convert the employee’s estimated annual tool expenses into an hourly rate for the tool allowance. The IRS concluded that such an arrangement would not satisfy the substantiation requirement of a valid accountable plan. But whether the IRS is correct is a genuine question of law. The arrangement described in Rev. Rul. 2005-52 is not a tax shelter. It has never been a listed or reportable transaction.

Nevertheless, tool plan administrators all across the country are receiving section 6700 tax shelter investigation letters. The IRS should instead be following normal examination procedures with either the purchaser of a tool plan, the plan administrator, or the author of the plan. It is disingenuous for the IRS to argue that a regular audit of a tool plan seller’s Form 1040 or Form 1120 is not the proper venue for the Service to examine the bona fides of a plan. Presumably, the seller of a tool reimbursement plan is reflecting income from the sale of the plan on a Form 1040 or Form 1120. Selling a tool plan that involves a substantiation arrangement based on a reasonable interpretation of the law is not fraudulent or illegal conduct even if that interpretation differs from the position taken in a revenue ruling.

The proper venue for an examination of a tool reimbursement plan is the return on which a taxpayer reflects the tax benefits allowable under an accountable plan: a Form 941 employer’s quarterly tax return, a Form 940 unemployment (FUTA) tax return, or the Form 1040 of an employee who is excluding the reimbursement amount.

Conclusion

The IRS’s section 6700 program has the potential to destroy legitimate businesses, especially when the Service uses prefiling notification letters to contact a taxpayer’s client base or when a penalty is asserted and the only remedy is a costly refund suit in U.S. district court. A section 6700 investigation is a heavy hammer. The IRS should exercise some restraint and use it only in the most egregious cases. When it is clear that a party is engaging in the sale of a product that is clearly abusive, the section 6700 arsenal is appropriate. It should not be a substitute for normal audit procedures.

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