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## **THE GREAT TAX SETTLEMENT: A PROPOSAL TO CONGRESS**

by

**NICHOLAS J. CREME\***

### **INTRODUCTION**

This article proposes that a national congressional settlement offer, The Great Tax Settlement, be made to all taxpayers in tax shelter cases. The settlement would require the taxpayers involved to pay 50% of their tax deficiencies as calculated by the Internal Revenue Service (Service), plus interest, but without any penalties.

This proposal, if enacted:

- Raises billions of dollars almost immediately;
- Collects billions of dollars that would never be collected;
- Collects billions of additional dollars from increased audits of non-shelter returns;
- Reduces the federal deficit;
- Ends millions of tax cases;
- Frees the Tax Court from its unmanageable case backlog;
- Is consistent with the Service's own existing tax policy; and
- Is fair to millions of taxpayers who invested in shelters based on the advice of lawyers, accountants and tax advisors.

This proposal, if enacted, would result in the immediate collection of billions of dollars. Although unlikely, the Service could eventually collect most of this revenue through current means, either upon settlement of the cases under existing settlement policy or upon successful litigation of the cases. However, collection in either event would not be for several years. Settlement of controverted cases now, as a result of a settlement proposal that is equitable to both the Government and the taxpayers and that is nationally publicized, would accelerate rapidly the collection of tax revenue that otherwise will be lost. Early settlement would also free Service agents to audit non-tax shelter returns once again, generating billions of dollars in tax revenues that have been lost because the Service has devoted much of its staff to tax shelter cases. Congress must also find ways to raise revenue now, to meet the Gramm-Rudman-Hollings deficit reduction law targets, solve the \$18 billion gap between the Reagan Administration's and Congress' proposed budgets, and reduce this nation's debtor status. This proposal is the solution.

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This proposal would eliminate millions of tax cases from the administrative quagmire that has already engulfed millions of taxpayers, most of the Service's personnel, almost the entire United States Tax Court, and which may one day engulf all United States Federal Courts of Appeals.

This proposal is consistent with the Service's own existing tax policy. For several years the Service has offered across-the-board settlements to taxpayers in *all* pre-1981 tax shelter cases permitting the taxpayer to deduct his cash investment with no penalties imposed. On April 16, 1987, the Service announced for cases concerning pre-June 23, 1981 commodities straddles that the Service will concede to taxpayers all losses claimed by dealers on regulated exchange trades, will allow 30% of the losses claimed by investors on regulated exchange trades and 20% of the losses claimed by investors in off-the-market cases. Since 1980, tax shelters have been settled on a case-by-case basis. The settlements, if offered, have generally permitted the taxpayers to deduct their cash investments and imposed some, but not all, of the proposed penalties.

On April 16, 1987, the Service announced that it would make national settlement offers for pre-1982 shelters. Whether to make offers for post-1982 shelters is still being considered by the Service. Thus, the Service itself recognizes that settlement of *all* tax shelter cases is appropriate. Nevertheless, the Service's current settlement policy has fallen short of eliminating the formidable backlog of tax shelter cases. The current policy is simply not attractive enough to many investors to induce settlement. A congressionally mandated settlement offer, however, with its attendant publicity and more generous terms, should cause many taxpayers, who would not otherwise do so, to settle their cases. If taxpayers do not settle these cases now, the interest charges will exceed the tax ultimately found due. With interest on taxes being nondeductible, many taxpayers will never be able to pay the tax bill. Those taxpayers who lose their tax cases will be forced to hide their assets to avoid collection, thereby swamping the Service's collection division with cases. Billions in revenues will be lost. A congressional settlement offer is the only hope.

This proposal is fair. Millions of taxpayers relied on written legal opinions from counsel, or advice from their accountants or tax advisors before making their tax shelter investments. They had no knowledge that the Service would challenge most tax shelter investments or that Congress would impose retroactive penalties. Many of the investors caught up in the tax shelter net are middle income taxpayers; shelters have not been sold just to the wealthy. This proposal is also fair to the Government because it eliminates the Government's litigation expense and risk of losing the tax shelter cases. The Service has lost the equipment leasing test case and the pre-1981 dealer straddle cases. Consequently, billions of tax dollars have been lost that would have been collected if the congressional settlement offer had been in effect.

Last year, Congress considered tax amnesty for taxpayers who failed to

file returns. The amnesty would have allowed taxpayers to settle by paying their unpaid taxes without penalties and without the threat of criminal prosecution. Tax experts believed the amnesty proposal created greater problems than it solved, eroded taxpayer belief in the system, and would only have collected a few billion dollars in lost tax revenues. By comparison, the Great Tax Settlement proposal only affects taxpayers who filed returns and did not commit evasion, claimed deductions and credits on the advice of their tax advisors, believed they were acting within the tax laws, and could possibly otherwise win their tax cases in court.

This proposal is the right solution. Most investments are now economically motivated rather than tax motivated because of recent congressional action, especially the Tax Reform Act of 1986, and the efforts of the Service. The goal to eliminate abusive tax shelters has been achieved. Now is the time to substantially reduce the administrative burden facing the Service and the courts, accelerate the recovery of billions of lost tax dollars for the United States, and ease the tax conscience of millions of taxpayers. The Great Tax Settlement achieves these results.

## I. THE FACTS

Tens of billions of dollars have been invested in tax shelters since 1970.<sup>1</sup> Internal Revenue Service Commissioner Roscoe Egger,<sup>2</sup> reacting to the growing threat to the tax system, initiated a Service enforcement program in the early 1980s to crackdown on tax shelters. In 1973, the Service examined a mere 400 tax shelter returns. By December 31, 1985, 413,665 shelter returns (presumably partnership returns, each with many investors) were under examination, demanding involvement of most of the Service's audit force. By the same time, the Service's appeals division had 31,072 cases, and over 30,000 cases were docketed in the Tax Court.<sup>3</sup> The total inventory of tax shelters undergoing Service examination has thus grown from 400 to over 426,000 by 1986 — an increase of over 1,000%.<sup>4</sup> This substantial increase of the tax shelter return inventory over the last 13 years seriously impaired the ability of the Service to manage its audit load. Audit coverage has decreased from 5% of all individual income tax returns in the mid-1960s to 2.11% in 1979, then to

<sup>1</sup>See Joint Committee on Taxation, *Tax Reform Proposals: Tax Shelters and Minimum Tax (JSC-34-85)*, August 7, 1985. For example, in 1984 taxpayers invested approximately \$8.25 billion in publicly held tax-favored investments, of which approximately \$3.9 billion were pure "shelter" investments. It is estimated that an additional \$10.5 billion was invested in 1984 in "private placement" partnership investments, all of which were shelter oriented investments. Thus, in 1984 alone, taxpayers invested over \$14 billion in tax shelters. Similar numbers are reported for 1983, and were slightly less in 1982.

<sup>2</sup>See Remarks of Roscoe L. Egger, Jr., Commissioner of the Internal Revenue Service, Before the International Association of Financial Planning, Washington, D.C., I.R.S. News Release IR-85-56 (June 4, 1985). See also, Statement of Roscoe L. Egger, Commissioner of the Internal Revenue Service, Before the House Ways and Means Subcommittee on Oversight, September 28, 1982, IR-82-111 (Sept. 28, 1982).

<sup>3</sup>Ruwe, *IRS Settlement Policy and Other Matters*, FIFTH ANN. INST., LEGAL TIMES, BUSINESS & LAW, INC. (Fordham University School of Law, March 21, 1986).

<sup>4</sup>I.R.S. News Release IR-87-56.

1.27% in 1984, and finally to 1.10% in 1986. In 1979, 1,844,986 individual income tax returns were examined. By 1984, the number had declined to 1,215,927, while the number of return examination staff positions increased by approximately 1,000 persons. In 1984, as a result of Service audits, approximately \$4.38 billion in additional taxes and penalties were assessed. In addition, 114,323 shelter returns were closed after examination in 1984, with additional taxes and penalties of \$2.2 billion assessed.<sup>5</sup> Although the Service proposed nearly \$8.2 billion in additional taxes and penalties between October 1982 and December 1985, 91% of these assessments, or \$7.4 billion, were contested.<sup>6</sup> These audits and taxes mostly relate to pre-1981 tax shelters. The Service did not begin auditing most 1981 and 1982 tax shelters until 1985 and 1986 and the Service has not yet begun auditing 1983-1985 tax shelters.

The tax shelter problem has also "handcuffed" the Tax Court in its ability to manage its docket. At the end of 1979, the Tax Court had 27,910 cases pending. In 1981, in response to the growing burden attributable to tax shelter litigation, three additional judges were appointed to the Tax Court.<sup>7</sup> Congress enacted penalties on tax shelter investments, increased the interest rate on tax shelter deficiencies, and made interest nondeductible after a phase-in period.<sup>8</sup> These actions have increased the dollars at stake and thus have caused more taxpayers to litigate their cases. The Tax Court also doubled its rate of disposing of cases between 1979 and 1984.<sup>9</sup> Notwithstanding these efforts, the backlog of docketed cases rose to approximately 64,000 by the end of 1984 and to 83,000 by the end of 1986.<sup>10</sup> Of that number, over 40,000 of the docketed cases were tax shelter cases.

Cases docketed in the Tax Court are only the tip of the iceberg. Most tax shelter cases are held in suspense at the Service audit level awaiting the outcome of the "test" cases that are docketed with the Tax Court. Of the additional 426,000 shelter cases currently under audit, those that are not settled or held in suspense will be added to the Tax Court docket, completely paralyzing the judicial process.<sup>11</sup> In March, 1985, the Tax Court sought \$1.862 million in additional funding for fiscal year 1986 from Congress in order to finance the hiring of new employees and process the expanding backlog of shelter cases.<sup>12</sup>

<sup>5</sup>Facts and figures derived from 1984 IRS COMM'R & CHIEF COUNSEL ANN. REP. 12, 13-14, 42-45, 60-61, 73.

<sup>6</sup>Tax Administration: IRS' Backlog of Tax Returns with Tax Shelter Issues Awaiting Settlement, GAO/GGD-86-140.

<sup>7</sup>Joint Committee on Taxation, *supra* note 1.

<sup>8</sup>I.R.C. § 6659 (30% overvaluation penalty); § 6661 (25% substantial understatement of tax liability penalty); § 6621(d) (interest rate for tax shelter deficiencies is 120% of normal Treasury interest rate imposed on tax deficiencies); § 6653(a)(2) (50% penalty on interest where negligence is found); § 6601(e)(2)(B) (interest on penalties); § 163(h) (disallowance of deduction for personal interest).

<sup>9</sup>Joint Committee on Taxation, *supra* note 1.

<sup>10</sup>In 1984, there were 40,514 new cases filed in the Tax Court.

<sup>11</sup>It is estimated by the Service's Midwest Regional Counsel that the shelters under audit could generate another 100,000 in docketed cases in the Tax Court.

<sup>12</sup>Remarks of Chief Judge Howard A. Dawson, Jr., United States Tax Court, to the House Appropriations Subcommittee, March 27, 1985, Daily Tax Rep. (BNA) No. 60, p. G-2 (March 28, 1985).

Adoption of The Great Tax Settlement would enable cutbacks in judicial funding as more cases are settled, further assisting Congress in achieving its goal of reducing the federal deficit.

Furthermore, the Service is not guaranteed victory in the 40,000 docketed tax shelter cases. In fact, the Service lost the equipment leasing test case and has conceded total victory for taxpayers in the pre-June 23, 1981 dealer commodity straddle cases.<sup>13</sup>

The indirect impact of the tax shelter problem, although disguised and difficult to verify quantitatively, is perhaps even more significant. The growing public perception that the Service has turned most of its staff over to tax shelter audits leaving no agents to audit non-shelter returns may be one reason for the widespread decline in voluntary compliance. Experience dictates that a mere 1% reduction in voluntary compliance translates into approximately \$5 billion in lost tax revenues. Since 1974, voluntary compliance has declined from 84% to a projected 81.6% for fiscal year 1986.<sup>14</sup>

## II. CURRENT SERVICE ENFORCEMENT PROGRAMS

In 1982, the Service implemented its tax shelter settlement plan. Under the so-called "out-of-pocket" settlement plan, a national policy was established by the Service whereby *all* pre-1981 tax shelter investors are offered settlement of their proposed tax bills.<sup>15</sup> The settlement offer permits deductions for the taxpayer's actual out-of-pocket investment without any penalties. Thus, a taxpayer who invested \$25,000 in a tax shelter but claimed \$100,000 in deductions (the typical 4-1 write-off tax shelter) may settle his pre-1981 case if he agrees to a deduction for only the \$25,000 invested. His tax bill would be for the tax owed on the disallowed \$75,000 in claimed deductions — a twenty-five cents on a dollar settlement offer. This policy demonstrates the Service's desire to settle all tax shelter cases irrespective of the merits of the particular tax shelter involved. Some taxpayers have accepted the settlement after weighing the risks and expense of litigation, since they will owe the full proposed deficiency without any deduction for their cash investment if they litigate and lose. However, many taxpayers have refused this settlement and it is the Service's policy that once the full cash settlement offer is rejected by a taxpayer the full cash settlement offer will never be made again.<sup>16</sup>

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<sup>13</sup>*Thomas v. Comm'r*, 84 T.C. 412 (1985) (equipment leasing) and I.R.S. News Release IR-87-57 (straddle settlement).

<sup>14</sup>Commissioner Egger Speaks Out in Favor of Tax Reform Plan, Fed. Taxes Rep. Bull. (P-H) No. 27, p. 60,473 (June 13, 1985).

<sup>15</sup>Internal Revenue Service Policy Statement P-4-64 was approved in August, 1982, authorizing the "out-of-pocket" settlement approach. See, Statement of Roscoe L. Egger, Commissioner of Internal Revenue Service, Before the House Ways and Means Subcommittee on Oversight, September 28, 1982.

<sup>16</sup>The Service usually makes a second offer for only 75% of cash invested; then 50% of cash invested. If the case is set for trial, no further settlement offer is made.

Post-1980 cases carry potential penalties that are not present in pre-1981 cases. For the last five years, in post-1980 cases, taxpayers have been offered settlements on a case-by-case basis; no national settlement policy had been formulated. A deduction for cash investment usually is permitted, but not all of the proposed penalties are forgiven. The imposition of some penalties in the settlement offers has lead many more taxpayers to reject the offers. Finally, on April 16, 1987 the Service announced in IR-87-56 that it was formulating national offers for pre-1983 tax shelters. However, it will be several months before those offers will be made. Settlement of post-1982 cases will still be done on a case-by-case basis.

In 1982, Congress enacted provisions enabling the Service to attack abusive and illegal tax shelters at the promoter level by seeking injunctive relief and penalties against the promoter (Code Sections 7408 and 6700), and by imposing substantial penalties on investors who invest in abusive shelters (Code Sections 6659 and 6661).

In November, 1983, the Tax Division of the Department of Justice formed the Office of Special Litigation, consisting of 21 attorneys, to handle the growing number of injunction and penalty actions arising out of the Service's utilization of the Sections 7408 and 6700 relief provisions. As of January 30, 1986, the Service has referred 167 cases to the Office of Special Litigation, involving 82,000 investors and \$9 billion of potential lost revenues. Of those 167 cases, 32 cases were closed following return to the Service. The Tax Division filed 98 suits and obtained 71 injunctions against promoters. As of March, 1986, the Office of Special Litigation was defending 25 cases involving approximately \$40 million in Section 6700 penalties.<sup>17</sup>

Since 1984, the Service's enforcement activities have increased with the implementation of measures aimed at identifying abusive shelters for examination and curbing abusive shelter activity at the promoter level. In the nine months after Congress enacted the tax shelter registration program<sup>18</sup> for tax shelters offered after September 1, 1984, more than 14,000 applications for registration were received and more than 13,000 numbers issued. New statutes require promoters to maintain investor lists which must be provided to the Service upon request.<sup>19</sup> Moreover, shelter investors now must file investor information forms with their tax returns, further enabling the Service examiners to flush out abusive shelters.

The combination of penalty statutes and the Service's enforcement programs has already achieved its goal. The enactment of the Tax Reform Act of 1986 should further reduce or eliminate tax shelter investments, due to the

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<sup>17</sup>Remarks of Roger M. Olsen, Acting Assistant Attorney General, Tax Division, Department of Justice, Tax Shelters 1986 Style: The Role of the U.S. Department of Justice, FIFTH ANN. INST., LEGAL TIMES, LAW & BUSINESS, INC. (Fordham University School of Law, New York, March 21, 1986).

<sup>18</sup>Tax Reform Act of 1984, § 141 and Code §§ 6111 and 6707.

<sup>19</sup>Tax Reform Act of 1984, § 142 and Code §§ 6112 and 6708.

passive loss limitation, repeal of the investment tax credit, lengthening of depreciation schedules, lowering of tax rates, placing limitations on deductible interest, and extending the "at risk" rules to real estate. There has been a shift within the investment community away from tax shelters to the promotion of economic deals. Nevertheless, over 400,000 cases remain under examination, presumably most of which are partnerships with many partners representing millions of taxpayers and virtually tens of billions of dollars in potential tax revenue. These statistics do not even reflect 1983-1985 tax years since audits for those years have not yet been completed. However, most cases remain unsettled principally due to the Service's refusal to offer equitable settlements and taxpayer awareness that it may take years before a case reaches the Tax Court docket.

### III. THE GREAT TAX SETTLEMENT

The Great Tax Settlement would raise billions of dollars for the federal coffer. Prior Service settlement policies have not effectively managed the explosion of problems associated with tax shelter investments. In many cases, taxpayers would rather face the risks of litigation than settle, particularly when the time it takes for a case to be fully audited, prepared for suit, prosecuted by the government, and to be collected on is about 10 to 15 years. For post-1981 years, the Service's extraction of penalties as part of the settlement will cause more taxpayers to litigate these cases. Taxpayers who otherwise have or will reject the Service's settlement offers will be induced to settle their tax deficiency bills now under The Great Tax Settlement.

The solution is to have Congress legislate and the Service adopt, on a national basis, a new settlement policy, whereby all tax shelter cases could be settled for one-half of the tax bill imposed as a result of a tax shelter examination. This settlement offer would be a greater inducement to the taxpayer to settle his case, due to the decreased taxes which would ultimately be paid by the investor. Settlement of tax shelter cases on a wide scale would serve to accelerate the influx of revenue to the federal treasury, thereby reducing the budget deficit by tens of billions of dollars in a relatively short time. The Government would be saved the administrative expense and burden of handling millions of tax shelter cases. Additionally, the Government's always present risks of litigation would be eliminated as to those cases which are settled.

This proposed 50% settlement would require no complicated calculation. Agents in the field could offer the settlement by simply cutting a proposed deficiency tax bill in half and presenting it to the taxpayer. Moreover, the unmanageable inventory of tax shelter examinations would be greatly reduced, thereby enabling the Service to re-focus its audit efforts to other abusive areas and once again achieve a level of examinations in the 2-3% range. The Tax Court docket would be simultaneously reduced, allowing the court to hear cases in-



volving issues that have been ignored due to the tax shelter case inventory.<sup>20</sup>

### CONCLUSION

It is clear that the Service's overall audit program has suffered tremendously as a direct result of the bulging inventory of over 400,000 tax shelter cases. Several years will pass before that inventory will be meaningfully reduced under current policy. The Tax Court docket has become utterly unmanageable for the same reason. Voluntary taxpayer compliance has also dropped significantly. However, tax shelter abuses have finally been curtailed through appropriate legislation. Now is the time to dig out from beneath the mountain of problems left by the tax shelter avalanche.

Billions of tax dollars and millions of taxpayers are involved in tax shelter litigation. Without doubt, the total amount of tax revenues at stake is staggering. The United States needs a meaningful reduction of its budget deficit today. The Great Tax Settlement would work to recover potentially lost tax revenues *now*, not 10 to 15 years from now, thereby substantially aiding in the deficit reduction effort. At the same time, as more and more tax shelter cases are settled, the other administrative and judicial problems associated with abusive tax shelters would be eliminated, allowing the system to regain fairness and efficiency.

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<sup>20</sup>There may be concern that this proposal is too generous for very high multiple write-off tax shelters, in which case the settlement offer could have a cut-off point, *e.g.*, it will not be available to tax shelters with more than 6-1 write-offs.