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Seeking Shelter In Tax Shelters?

You might think that a tax lawyer practicing full time for over 30 years could spot a tax shelter a mile away. Sometimes I can. Sometimes, though, even experienced tax professionals have difficulty. To be sure, there are a fair number of times when spotting them is no trouble at all.

Tax shelters are defined by the tax code to include any plan or arrangement having a significant purpose of avoiding or evading federal income tax. That sounds incredibly broad, for a huge number of transactions have tax ramifications as a significant purpose! The key is whether the tax ramifications are the ***reason*** the person is entering into the transaction.

Economics and business goals will usually be more important. The fact that the ***manner*** of accomplishing the business goal is tax efficient doesn't mean it is a shelter. Yet if the tax goals are paramount and the transaction is marketed specifically for tax benefits, it seems fair to call it a tax shelter. The challenge is that the literal statutory definition is broad enough to encompass many ordinary transactions. For more, see Know Tax Shelters When You See Them? and Tax Shelters Not Über Alles.

Definitions are important, since tax shelters are required to be registered with the IRS. The IRS discusses registration requirements here. But your return will not necessarily be audited even if you participate. Those surprising results were revealed by a report issued by the Treasury Inspector General for Tax Administration. See Internal Controls for Surveying Tax Returns With Abusive Tax Avoidance Transactions Need to be Strengthened.

We're not just talking about the IRS choosing not to audit some of the time. The report says the IRS declined to audit 97% of the returns with potential tax shelters. However, jumping to conclusions seems unwise, even though some headlines for this report may suggest it's great news for taxpayers who are tempted to get into bed with the tax shelter muse. (My advice: ***don't***.)

This report and its statistics are odd, so don't draw far-reaching conclusions. First, this study is based on a relatively small sampling. Plus, this report is mostly about internal IRS procedures, how, when and why returns are selected for audit, and what happens when they are.

IRS employees made decisions to survey tax returns showing activity from abusive tax avoidance transactions. That happened a majority of the time. But evidently IRS group managers did not follow internal IRS guidelines in the selection and processing of the returns and the way taxpayers were contacted. For ***those*** reasons (procedural irregularities that could have jeopardized IRS efforts to collect taxes and penalties) the look-see by the IRS was apparently stopped.

I would ***not*** read this report to suggest that tax shelter activity is likely to skate by the IRS. In fact, if anything this report is likely to increase scrutiny so the IRS does a better job with monitoring shelters and the returns that claim their putative benefits.

Want more practical advice how to spot a shelter? If a transaction promises multiple tax benefits for every dollar you invest, beware. Many shelters attacked by the IRS involve 5 for 1, 10 for 1 or greater tax write-offs. Watch for transactions that promise little economic gain other than tax benefits, that use unusual financing techniques, or that rely on strained interpretations of the tax laws.

For more about shelters, see:

Abusive Tax Shelters and Transactions

Abusive Tax Schemes – Criminal Investigation

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