The Settlement Initiative for Investors in a Variety of Bond and Option Sales Strategies Was Successful and Surfaced Possible Next Steps for Curtailing Abusive Tax Shelters

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FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

March 31, 2006

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION
COMMISSIONER, LARGE AND MID-SIZE BUSINESS DIVISION

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Settlement Initiative for Investors in a Variety of Bond and Option Sales Strategies Was Successful and Surfaced Possible Next Steps for Curtailing Abusive Tax Shelters (Audit # 200530002)

This report presents the results of our review of the Internal Revenue Service's (IRS) Bond and Option Sales Strategies. The overall objectives of this review were to determine the success of implementing the settlement initiative for participants in a variety of Bond and Option Sales Strategies, commonly referred to as the "Son of Boss" tax shelter, and the actions taken against those that declined or were ineligible to participate in the initiative.

The taxpaying public has long sought ways to minimize tax liabilities by sheltering income and gains from taxes through investments and other financial-related transactions. Some tax shelters, however, have received widespread publicity because they purportedly abuse the tax law, represent a significant loss of tax revenue, and undermine the public's confidence in the tax system. The Son of Boss is one such abusive tax shelter. For this abusive tax shelter, the IRS estimated understated tax liabilities in excess of $6 billion.

Synopsis

The IRS considers identifying and combating abusive tax shelters extremely important, and this priority was reflected in the emphasis given to resolving the Son of Boss abusive tax shelter and ensuring a successful settlement initiative. The IRS publicly announced the settlement initiative in May 2004, and IRS management at all levels closely coordinated the initiative's implementation to ensure its success. A centralized office was established to receive investor application packages, where they were screened for suitability and forwarded to Examination

function groups located in offices throughout the country. Once the packages were received in the groups, examiners were assigned to validate the accuracy of the information on an investor application, determine the amount of out-of-pocket expenses[1] to allow, compute the amount of additional taxes owed, execute a closing agreement, and make arrangements with the investor to receive payment for the taxes owed. Throughout the initiative, interim reports were prepared as a control mechanism to monitor progress and track the cases for both investors participating in the settlement and nonparticipating investors. As of March 16, 2005, interim reports showed 1,039 participating investors had settled their cases by paying or agreeing to pay over $2.7 billion in taxes, interest, and penalties.

Based on our work, we have two observations the IRS may find useful in its efforts to curtail abusive tax shelters. First, experience demonstrated that the general 3-year statutory assessment period was insufficient for tax administrators to examine and assess all identified participants in the Son of Boss abusive tax shelter. Although it is difficult to precisely estimate the fiscal impact of abusive tax shelters, State officials in California estimated losing between $2.4 billion and $4 billion over 4 years to various abusive tax shelters. They changed State income tax laws to give California State tax administrators up to 8 years to assess additional taxes related to abusive tax shelters. Steps were also taken in New York and Illinois to double statutory assessment periods from 3 years to 6 years.

At the Federal Government level, where the loss from abusive tax shelters has been estimated at $85 billion,[2] a provision in the American Jobs Creation Act of 2004 (AJCA)[3] provided the IRS with up to 1 additional year to assess taxes related to a “listed” transaction[4] if it is not properly disclosed on the return. Despite the positive, open-ended feature in the AJCA provision, our analysis of 1,958 income tax return examinations of investors in the Son of Boss abusive tax shelter found the 1-year limitation does not accurately reflect the time needed to complete the examination and assessment process involved in resolving complex, technical abusive tax shelters. As a result, the 1-year limitation in the AJCA could prove overly restrictive to realizing intended benefits from the extended assessment period.

Another possible next step the IRS could take is to plan for and conduct an assessment that captures the overall successes achieved and lessons learned in resolving the Son of Boss abusive tax shelter. Such an assessment could provide an important tool for managers to use if they are faced with a challenge of this magnitude in the future and would be in line with both the

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[1] Out-of-pocket expenses are transaction fees that were typically paid by investors to promoters.
[2] *Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters* (GAO-04-104T, dated October 2003).
[3] Pub. L. No. 108-357, 118 Stat. 1418 (2004).
[4] A listed transaction is the same as or substantially similar to one of the types of transactions the IRS determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance.

Government Performance and Results Act of 1993[5] and IRS guidance for analyzing performance and identifying improvement options.

Recommendations

We recommended the Commissioner, Small Business/Self-Employed Division, in conjunction with the IRS Office of Chief Counsel and the Office of Tax Policy in the Department of the Treasury, determine whether the AJCA provision extending the statutory assessment period is adequate to protect tax revenues and deter participation in abusive tax shelters. If the determination shows the AJCA provision is likely to be ineffective, a proposal should be prepared for Congress to increase the 1-year limitation under the AJCA provision. We also recommended the Commissioner, Small Business/Self-Employed Division, designate an IRS study group to evaluate and document the IRS' overall performance in resolving the Son of Boss abusive tax shelter.

Response

IRS management agreed with one of our two recommendations and has convened a study group to evaluate the overall performance in resolving the Son of Boss abusive tax shelter. The study group's report is expected by June 30, 2006. The IRS did not agree to take action and determine whether the AJCA provision extending the statutory assessment period is adequate for protecting tax revenues and deterring participation in abusive tax shelters. IRS management indicated in their response that more experience is needed before they can determine whether the 1-year provision provided by the AJCA is adequate and made technical comments to further highlight their position for not taking action on the recommendation. Additionally, IRS management had comments to clarify specific sections of the draft report, and we made these changes where appropriate. Management's complete response to the draft report is included as Appendix IV.

Office of Audit Comment

We believe the IRS may be missing an opportunity to further strengthen its ability to combat abusive tax shelters by not taking action on the recommendation. With regard to three of the IRS' technical comments highlighting their position for not taking action on one of our recommendations, we believe some clarification is needed. First, the IRS stated that, due to complexities and other issues, Son of Boss abusive tax shelter cases were deliberately delayed to ensure appropriate issue development and are not representative of the population of other tax shelter returns. We view the sheer number of investors as significant and recognized in the

[5] Pub. L. No. 103-62, 107 Stat. 285 (codified as amended in scattered sections of 5 U.S.C., 31 U.S.C., and 39 U.S.C.).

report that issue development involving complex transactions, such as those found in Son of Boss abusive tax shelter cases, can involve a significant amount of time to make a correct tax determination. Consequently, we made a recommendation to determine if the 1-year AJCA provision extending the statute for assessment is adequate.

Second, the IRS suggested that we further clarify the impact of the extended assessment period under the AJCA throughout the audit report. We disagree with the IRS on this point and believe the analysis presented in the report shows that the AJCA could prove overly restrictive to fully realizing intended benefits.

Third, the IRS indicated that examiners may request consent from the taxpayer to extend the statute. Taxpayers, however, are not always willing to, nor are they required to, extend the statute of limitations for the assessment of taxes. Thus, we do not believe relying on the willingness of taxpayers, particularly those that may be involved in an abusive tax shelter, is a sufficient mechanism for protecting tax revenues and deterring participation in abusive tax shelters.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Curtis Hagan, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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Background

The taxpaying public has long sought ways to minimize tax liabilities by sheltering income and gains from taxes through investments and other financial-related transactions. Some tax shelters, however, have received widespread publicity because they purportedly abuse the tax law, represent a significant loss of tax revenue, and undermine the public's confidence in the tax system. The Son of Boss (Bond and Option Sales Strategies[1]) is one such abusive tax shelter. The Internal Revenue Service (IRS) determined that, other than generating tax benefits, the Son of Boss abusive tax shelter lacked a business purpose and it had understated tax liabilities in excess of $6 billion.

The IRS describes the Son of Boss abusive tax shelter as a highly sophisticated, technically complex, no-risk scheme designed to generate tax losses without corresponding economic risks that was promoted by some prominent firms in the financial services industry to investors seeking to shelter large gains from the sale of a business or capital asset. The scheme used flowthrough entities, such as partnerships, and various financial products[2] to add steps and complexity to transactions that had little or no relationship to the investor's business or the asset sale creating the sheltered gain. Additionally, the losses generated from the transactions were often reported among other "legitimate" items in several parts of the income tax return. Some losses from the Son of Boss abusive tax shelter, for example, were reported as a reduction to gross sales, cost of goods sold, or capital gains. Taken together, these characteristics, especially the use of flowthrough entities, made it very difficult for the IRS to detect the Son of Boss abusive tax shelter through its traditional process of screening returns individually for questionable items.

According to IRS officials, the Son of Boss abusive tax shelter surfaced as a way for promoters to circumvent the provisions of IRS Notice 99-59, issued in December 1999 to curtail the Boss tax shelter. The Son of Boss abusive tax shelter was initially identified from irregularities found in examinations and from information developed through a confidential informant. As more details emerged about the Son of Boss abusive tax shelter, the IRS initiated investigations of promoters to obtain lists of investors that purchased the transactions from the promoters and developed a strategy for resolving the investors' income tax returns.

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[1] Internal Revenue Service Notice 99-59, *Tax Avoidance Using Distributions of Encumbered Property*, 1999-2 C.B. 761; 1999-52 I.R.B. 761. Notice 99-59, dated December 27, 1999, described "Boss" transactions as certain losses involving partnerships and foreign corporations that would not be allowed for tax purposes.

[2] The IRS defines financial products as instruments used in the global marketplace; they include, among others, stocks, bonds, foreign currencies, mortgages, commodities, and derivatives.

Although the IRS does not know the total number of participants in the Son of Boss abusive tax shelter, promoter investigations combined with other efforts, such as cross-checking information reported under disclosure statements, identified thousands of potential investors in Son of Boss transactions. Absent the Son of Boss settlement initiative, the sheer number of potential investors identified could have posed significant resource challenges for the IRS with a potential backlog of cases that needed to be examined and possibly litigated.

Announced publicly on May 5, 2004, the goal of the settlement initiative was to provide an opportunity for the IRS and investors to quickly resolve disputes over the Son of Boss abusive tax shelter. As such, the initiative provided benefits for both parties. For the IRS, the initiative (1) saved time and resources by streamlining the resolution process; (2) promoted voluntary compliance by having investors disclose their participation, if any, in other listed transactions; and (3) accelerated tax collections by requiring investors to immediately pay or make arrangements to pay any additional taxes, interest, and penalties owed. For the investors participating in the settlement initiative, it similarly saved time and money they may have spent in a protracted dispute with the IRS. It also allowed investors to avoid the imposition of penalties under certain circumstances and to offset disallowed losses attributable to the Son of Boss abusive tax shelter by the amount of out-of pocket transaction fees they had paid to promoters.

This review was performed in the IRS Large and Mid-Size Business (LMSB) and Small Business/Self-Employed (SB/SE) Divisions, which are respectively headquartered in Washington, D.C., and New Carrollton, Maryland, during the period October 2004 through August 2005. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Results of Review

The Son of Boss Abusive Tax Shelter Received Top Priority to Ensure a Successful Settlement Initiative

The IRS considers identifying and combating abusive tax shelters extremely important, and the SB/SE and LMSB Divisions reflected this priority in the emphasis given to resolving the Son of Boss abusive tax shelter and ensuring a successful settlement initiative. Prior to offering the Son of Boss settlement initiative publicly, the IRS was already actively pursuing promoters of the Son of Boss tax shelter and had initiated investigations of 36 promoters to gain access to the lists of investors who bought Son of Boss transactions. The investigations resulted in, among other things, identifying thousands of investors in the Son of Boss abusive tax shelter and other potentially abusive transactions.

In its efforts to enhance techniques for identifying and dealing with participants in the Son of Boss abusive tax shelter, the IRS worked with State and city tax officials through information-sharing agreements. The agreements, according to the IRS Commissioner, enabled tax administrators at the Federal Government and local levels to support each others' efforts and avoid duplication of work. Although we did not systematically measure the results from the information-sharing agreements, we did interview tax officials from three States and compared the investors in the Son of Boss abusive tax shelter the States had identified to those detected by the IRS. In doing so, we saw evidence of strategies, procedures, and lists containing participants in the Son of Boss abusive tax shelter being exchanged and evaluated. We did not find any instances in which the States were pursuing enforcement action against a participant in the Son of Boss abusive tax shelter that had not been detected by and/or shared with the IRS.

The IRS publicly announced the settlement initiative in May 2004, and management at all levels closely coordinated the initiative's implementation to ensure its success. A centralized office was established to receive investor application packages, where they were screened for suitability and forwarded to Examination function groups located in offices throughout the country. Once the packages were received in the groups, examiners were assigned to validate the accuracy of the information on the investor application, determine the amount of out-of-pocket expenses to allow, compute the amount of additional taxes owed, execute a closing agreement, and make arrangements with the investor to receive payment for amounts owed. Throughout the initiative, interim reports were prepared as a control mechanism to monitor progress and track the cases for both investors participating in the settlement and nonparticipating investors.

Interim reports on March 16, 2005, showed 1,039 participating investors had settled their cases by paying or agreeing to pay over $2.7 billion in taxes, interest, and penalties. Our review of closed case files supporting 41 of the participating investor settlements determined that taxes, interest, and penalty amounts were accurately incorporated into and reflected on the March 16, 2005, interim report and that all 41 investors were eligible for the settlement. As summarized in Figure 1, examiners validated and documented evidence to support allowing investors to deduct their out-of-pocket transaction costs of $17.2 million, which were typically paid to promoters, in exchange for agreeing to tax, interest, and penalty assessments totaling $95.9 million. Examiners discussed the terms of the settlement with investors and accurately prepared the closing agreements that were signed by the examiner and the investor or his or her designee.

Figure 1: Selected Characteristics From 41 Son of Boss Investor Settlement Packages

Dollars in Millions

Selected Characteristics	*Average*	*Range*	*Total*
Gross Income Reported on Investors' Tax Returns	**$4.4**	**$0 – 63.7**	**$180.9**
Taxable Income Reported on Investors' Tax Returns	**$3.8**	**$0 – 56.2**	**$155.7**
Son of Boss Adjustments to Reported Taxable Incomes	**$7.9**	**$0 – 51.3**	**$323.0**
Out-of-Pocket Expenses Allowed As Deductions	**$0.4**	**$0 - 3.2**	**$17.2**
Additional Taxes Assessed	**$2.0**	**$0 – 16.1**	**$80.7**
Penalties Assessed	**$0.1**	**$0 – 0.6**	**$4.1**
Interest Assessed	**$.3**	**$0 – 2.6**	**$11.1**
Taxes, Penalties, and Interest Assessed	**$2.3**	**$0 - 18.7**	**$95.9 (〃)**

(〃) Due to rounding, numbers may not add or subtract precisely.
Source: Complied by the Treasury Inspector General for Tax Administration (TIGTA) from IRS Investor Settlement Packages.

Despite the successes achieved by the IRS in the settlement initiative, much work remains to resolve the tax accounts of the investors that declined or were ineligible to participate in the settlement initiative. For example, as of March 16, 2005, IRS officials had identified 670 of these nonparticipating investors and had their income tax returns under or selected for examination. As recently as July 2005, IRS officials reported that they were continuing to work on nonparticipating investor cases by ensuring all related flowthrough entities were included in examinations, so all tax benefits from the Son of Boss abusive tax shelter could be disallowed.

Issues That Surfaced During the Settlement Initiative Suggest Possible Next Steps for Curtailing Abusive Tax Shelters

Based on our work, we have two observations the IRS may find useful in its efforts to curtail abusive tax shelters. First, the length of time allowed for Federal Government and State tax administrators to thoroughly examine and assess additional taxes against all identified participants in the Son of Boss abusive tax shelter was insufficient. Although extending the assessment period would require a legislative change, an extension could be a powerful tool for curtailing participation in abusive tax shelters and protecting the Federal Government's revenue by recovering taxes that might otherwise be lost. Second, the IRS could benefit by evaluating and documenting its overall performance in resolving the Son of Boss abusive tax shelter should it face a similar challenge of this magnitude in the future.

Extension of the statutory assessment period could provide a powerful tool for curtailing participation in abusive tax shelters

Under the Internal Revenue Code, the IRS has generally[3] a 3-year period to examine a tax return and assess any additional income tax that may be due. This statutory period for assessment is usually the same at the State level since most State income tax laws mirror those of the Federal Government. However, experience demonstrated that 3 years was insufficient for tax administrators to examine and assess all identified participants in the Son of Boss abusive tax shelter. As of July 2005, the IRS estimated that $21.9 million of taxes related to 71 income tax returns of Son of Boss investors could not be assessed because of expired statutes. The actual loss to the Department of the Treasury is likely much higher because the estimate does not include interest and penalties.

Legislators at both the State and Federal Government levels recognized the benefits that could be realized by extending the statutory assessment periods for participants in abusive tax shelters and enacted legislation. Specifically, the extended periods are intended to better protect tax revenues because they afford tax administrators more time to identify, thoroughly examine, and assess additional taxes against those involved in abusive tax shelters. In short, the longer the statute remains open, the greater the risk participants have in being detected by tax administrators, which can have a positive effect on deterring participation in abusive tax shelters.

Although it is difficult to precisely estimate the fiscal impact of abusive tax shelters, State officials in California estimated losing between $2.4 billion and $4 billion over 4 years to various

[3] The Internal Revenue Code also provides for various automatic extensions of the assessment period. For example, when the IRS issues a statutory notice of tax deficiency, the assessment statute of limitations is extended 90 days to give the taxpayer the opportunity to petition the Tax Court. Taxpayers and the IRS can also mutually agree to extend the statute of limitations indefinitely or for a specified period of time. This agreement usually occurs when the IRS determines it needs additional time to complete an examination and related administrative processing actions.

abusive tax shelters. They changed State income tax laws to give California State tax administrators up to 8 years to assess additional taxes related to abusive tax shelters. Steps were also taken in New York and Illinois to double statutory assessment periods from 3 years to 6 years.

At the Federal Government level, where the loss from abusive tax shelters has been estimated at $85 billion,[4] Congress similarly provided the IRS with additional time to identify, examine, and assess additional taxes related to abusive tax shelters. A provision in the American Jobs Creation Act of 2004 (AJCA),[5] enacted on October 22, 2004, allows the IRS up to 1 additional year on the normal 3-year statutory assessment period to assess taxes related to a "listed" transaction[6] if it is not properly disclosed on the tax return. Notably, the additional year does not begin until an unreported listed transaction is disclosed to the IRS by either the investor or material advisor.[7] Consequently, the statutory assessment period could remain open indefinitely, so long as the IRS is not properly furnished the required information.

Despite the positive, open-ended feature in the AJCA provision, its 1-year limitation could prove overly restrictive to fully realizing intended benefits from the extended assessment period. As summarized in Figure 2, we analyzed 1,958 income tax return examinations of investors in the Son of Boss abusive tax shelter and found that, after the investors were identified, over 2 years elapsed (on average) before the examinations were completed and assessments made.

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[4] *Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters* (GAO-04-104T, dated October 2003).

[5] Pub. L. No. 108-357, 118 Stat. 1418 (2004).

[6] A listed transaction is the same as or substantially similar to one of the types of transactions the IRS determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance.

[7] A person is a material advisor if the person is required to register the transaction under the Internal Revenue Code, or the person receives or expects to receive at least a minimum fee with respect to the transaction, and the person makes a tax statement to or for the benefit of a taxpayer required to disclose the transaction.

Figure 2: Time Periods for Examining Son of Boss Investor Returns and Assessing Additional Taxes Owed

Milestones for Participants and Nonparticipants in the Son of Boss Settlement Initiative	*Average Days*	*Median Days*
Participating Investors		
Identification Date to Examination Start Date	**495**	**545**
Examination Start Date to the Earlier of the Assessment Date or September 30, 2005	**384**	**288**
Overall Time Period for 1,380 Income Tax Returns Analyzed in This Category	**869**	**966**
Nonparticipating Investors		
Identification Date to Examination Start Date	**470**	**508**
Examination Start Date to the Earlier of the Assessment Date or September 30, 2005 (✓)	**453**	**399**
Overall Time Period for 578 Tax Returns Analyzed in This Category	**894**	**1,006**
Overall Time Periods for 1,958 Tax Returns Analyzed in Both Categories	**877**	**972**

(✓) We used September 30, 2005, as a cutoff date for 369 examinations that were ongoing as of this date.
Source: Compiled by the TIGTA from the Examination Records Control System and the Office of Tax Shelter Analysis databases.[8] *For the taxpayer data used in the compilation, a promoter was contacted by the IRS for an audit of promoter activities.*

At least two factors can affect the amount of time it takes to complete the examination and assessment process after participants in an abusive tax shelter are identified. First, resource constraints can affect the time it takes to start examinations. With recent statistics showing the IRS is significantly increasing the number of individual and corporate examinations it conducts, examiners are likely involved in ongoing examinations and may not always be in position to immediately start new examinations. As a result, a tax return scheduled for examination may be held for a period of time in the unassigned inventory of examiners. Second, examination of abusive tax shelters can take a significant amount of time even for the most experienced examiners. Abusive tax shelters often involve complex, technical transactions that take on different variations and require examining multiple flowthrough entities to make a proper tax

[8] The Examination Returns Control System automates tax return inventory control and time-reporting processes. The Office of Tax Shelter Analysis database is intended to be used by all of the IRS as a source of reference and as a research tool for revenue agents across division lines. It is also used for management reporting to Congress, the Department of the Treasury, IRS executives, and the Government Accountability Office.

determination. We did not find that either factor was considered in the legislative process that established the 1-year limitation.

The IRS could benefit by analyzing and documenting its overall performance in resolving the Son of Boss abusive tax shelter

Another possible next step the IRS could take is to plan for and conduct an assessment that captures the overall successes achieved and lessons learned in resolving the Son of Boss abusive tax shelter cases. Such an assessment could provide an important tool for managers to use in the future if they are faced with a challenge of this magnitude and would be in line with both the Government Performance and Results Act of 1993[9] and IRS guidance for analyzing performance and identifying improvement options. Because of the analysis already performed by the IRS staff that was involved in planning and implementing the Son of Boss settlement initiative, we do not believe the assessment would involve a significant amount of time or resources. At the request of the Chairman and Ranking Member of the Senate Finance Committee, for example, IRS staff provided a detailed progress report as recently as July 2005 outlining the extensive amount of work that had been accomplished on the Son of Boss settlement initiative.

The report identified a number of lessons learned in the Son of Boss settlement initiative that should be useful in identifying any changes in procedures or processes that might be needed in future settlement initiatives. The report also noted that about $36 million was spent on the initiative, while approximately $54 million in resource expenditures were saved. However, cases involving hundreds of investors identified in the Son of Boss abusive tax shelter have yet to be resolved because investors were either ineligible or decided not to participate in the settlement initiative. There are likely opportunities to capture additional valuable lessons learned as these cases move through the tax system to final resolution.

Recommendations

As the executive manager over the Son of Boss settlement initiative, the Commissioner, SB/SE Division, should:

Recommendation 1: Work with the IRS Office of Chief Counsel and the Office of Tax Policy in the Department of the Treasury to determine whether the AJCA provision extending the statutory assessment period with respect to listed transactions that are not disclosed is adequate to protect tax revenues and deter participation in abusive tax shelters. That determination should consider the results of work done by us and the IRS, including the numerous Son of Boss investors the IRS has identified as avoiding additional assessments due to the statute of limitations. If the determination is made that the AJCA provision is likely to be

[9] Pub. L. No. 103-62, 107 Stat. 285 (codified as amended in scattered sections of 5 U.S.C., 31 U.S.C., and 39 U.S.C.)

ineffective, these Offices should prepare a proposal for Congress to increase the statutory assessment period under the AJCA, so it more accurately reflects the time needed to identify, examine, and assess participants in technically complex abusive tax shelters.

Management's Response: The IRS did not agree to take action and determine whether the AJCA provision extending the statutory assessment period is adequate for protecting tax revenues and deterring participation in abusive tax shelters. IRS management indicated in their response that more experience is needed before they can determine whether the 1-year provision provided by the AJCA is adequate and made technical comments to further highlight their position for not taking action on the recommendation. Additionally, IRS management had comments to clarify specific sections of the draft report, and we made these changes where appropriate.

Office of Audit Comments: We believe the IRS may be missing an opportunity to further strengthen its ability to combat abusive tax shelters by not taking action on the recommendation. With regard to three of the IRS' technical comments, we believe some clarification is needed.

First, the IRS stated that, due to complexities and other issues, Son of Boss abusive tax shelter cases were deliberately delayed to ensure appropriate issue development and are not representative of the population of other tax shelter returns. We did not intend, nor do we believe it is implied in the report, for our analysis to represent the population of tax shelter returns because this was outside the scope of the review. However, we view the sheer number of investors as significant and recognized in the report that issue development involving complex transactions, such as those found in Son of Boss abusive tax shelter cases, can involve a significant amount of time to make a correct tax determination. Consequently, we made a recommendation to determine if the 1-year AJCA provision extending the statute for assessment is adequate.

Second, the IRS suggested that we further clarify the impact of the extended assessment period under the AJCA throughout the audit report. We disagree with the IRS on this point and believe the analysis presented in the report on the 1,958 income tax return examinations from investors involved in the Son of Boss abusive tax shelter along with the accompanying narrative show that the AJCA could prove overly restrictive to fully realizing intended benefits.

Third, the IRS indicated that, when a taxpayer meets the 1-year period, the examiner may request consent from the taxpayer to extend the statute. Our report acknowledged that examiners and taxpayers can mutually agree in writing to extend the statute of limitations indefinitely or for a specified period of time. However, taxpayers are not always willing to, nor are they required to, extend the statute of limitations for the assessment of taxes. Thus, we do not believe relying on the willingness of taxpayers, particularly those that may be

involved in an abusive tax shelter, is a sufficient mechanism for protecting tax revenues and deterring participation in abusive tax shelters.

Recommendation 2: Designate a study group to evaluate the IRS' overall performance in resolving the Son of Boss abusive tax shelter. The evaluation should identify all challenges the IRS faced in dealing with the Son of Boss abusive tax shelter, including the successes and lessons learned in resolving tax accounts for investors that did not participate in the settlement initiative. Additionally, the evaluation should be well documented, to provide a roadmap for dealing with future abusive tax shelters of this magnitude.

Management's Response: IRS management agreed with this recommendation and stated they have convened a study group to evaluate the overall performance in resolving the Son of Boss abusive tax shelter. The study group's report is expected by June 30, 2006.

Appendix I

Detailed Objectives, Scope, and Methodology

The objectives of this review were to determine the success of implementing the settlement initiative for participants in a variety of Bond and Option Sales Strategies, commonly referred to as the "Son of Boss" tax shelter, and the actions taken against those that declined or were ineligible to participate in the initiative. During the review, we relied on databases provided to us by the Internal Revenue Service (IRS). Although we did not perform audit tests to determine the accuracy and reliability of the information in any of the databases, we checked the reasonableness of our results against source information in closed case files. Our tests are described below and did not identify any errors in the information used from the databases. Additionally, unless otherwise noted, we used judgmental sampling techniques to minimize time and travel costs. To accomplish the objective, we:

I. Reviewed source material to gain an understanding of the Son of Boss abusive tax shelter and the related settlement initiative. These sources included the Internal Revenue Code; Treasury Regulations; IRS notices, announcements, and revenue procedures; and the Internal Revenue Manual.

II. Reviewed prior Government Accountability Office and Treasury Inspector General for Tax Administration reports, discussion papers, and similar documents prepared by the IRS, State tax administrators, and other stakeholders to identify concerns and issues with abusive tax shelters.

III. Analyzed case files supporting a judgmental sample of 41 of 659 investors participating in the settlement initiative whose cases were closed to verify whether they met eligibility requirements; provided evidence to support the allowance of out-of-pocket expenditures;[1] had their liabilities for taxes, penalties, and interest accurately computed; paid or made arrangements to pay the taxes, interest, and penalty amounts computed as owed; signed closing agreements that were accurately prepared based on the amount of taxes, interest, and penalties owed; and had their accounts on the IRS Master File[2] updated to reflect the amounts reflected in the closing agreements.

IV. Analyzed the accounts of the investors the IRS had identified as of March 16, 2005, that were not participating in the settlement initiative to verify whether they were or had been under examination.

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[1] Out-of-pocket expenses are transaction fees that were typically paid by investors to promoters.

[2] The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and tax-exempt and government entity data.

V. Interviewed key IRS officials who were involved with or whose work was affected by the Son of Boss settlement initiative to obtain their opinions about how well the initiative was working and learn about problems encountered.

VI. Consulted with State tax administrators from California, Illinois, and New York to learn about their experiences with and efforts to combat the Son of Boss abusive tax shelter.

VII. Analyzed Son of Boss and Examination Records Control System[3] data to determine the length of time involved with discovering, examining, and assessing taxes owed from 1,958 examined tax returns in the Son of Boss abusive tax shelter. This represents the total number of returns under examination for which we identified a material advisor[4] under examination and the tax shelter participant return was opened for examination.

[3] The Examination Returns Control System automates tax return inventory control and time-reporting processes.
[4] A person is a material advisor if the person is required to register the transaction under the Internal Revenue Code, or the person receives or expects to receive at least a minimum fee with respect to the transaction, and the person makes a tax statement to or for the benefit of a taxpayer required to disclose the transaction.

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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Deputy Commissioner, Large and Mid-Size Business Division SE:LM
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Examination, Small Business/Self-Employed Division SE:S:E
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- Chief Counsel CC
- Commissioner, Large and Mid-Size Business Division SE:LM
- Commissioner, Small Business/Self-Employed Division SE:S

Appendix IV

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

RECEIVED
MAR 29 2006

March 27, 2006

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kevin M. Brown
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Settlement Initiative for Investors in a Variety of Bond and Option Sales Strategies (Boss) Was Successful and Surfaced Possible Next Steps for Curtailing Abusive Tax Shelters (Audit # 200530002)

We have reviewed your draft audit report on the Son of Boss Settlement Initiative. First, we appreciate your acknowledging our efforts to combat abusive tax shelters and the high priority we placed in ensuring a successful settlement initiative. As you know, the Son of Boss Initiative, Announcement 2004-46, was very successful and broke many barriers relating to the extensive resolution of complex issues with a large population of participants.

With respect to the audit recommendations, we agree with recommendation 2 and have already put together a study group to evaluate the overall performance in resolving the Son of Boss abusive tax shelter. However, we believe it is premature to make a determination with respect to the adequacy of the American Jobs Creation Act (AJCA) provision extending the statutory assessment period. Since the one-year extension period is effective for tax returns filed beginning in tax year 2005, we will not be able to thoroughly assess the impact of the provision as you have recommended until at least 2009.

Our comments on your recommendations follow:

RECOMMENDATION 1
Work with the IRS Office of Chief Counsel and Treasury's Office of Tax Policy to determine whether the AJCA provision extending the statutory assessment period with respect to listed transactions that are not disclosed is adequate to protect tax revenues and deter participation in abusive tax shelters. That determination should consider the results of work done by us and the IRS, including the numerous Son of Boss investors the IRS has identified as avoiding additional assessments due to the statute of limitations. If the determination is made that the AJCA provision is likely to be ineffective, then these Offices should prepare a proposal for Congress to increase the

statutory assessment period under the AJCA, so it more accurately reflects the time needed to identify, examine, and assess participants in technically complex abusive tax shelters.

CORRECTIVE ACTION

More experience is needed before we can determine if the additional one-year period provided by AJCA is adequate. Since this provision is effective for tax returns filed beginning in tax year 2005, we will not be able to thoroughly assess the impact of the provision until at least 2009. In addition, a legislative change proposal for congressional consideration is at the discretion of the Department of Treasury.

Furthermore, the sample of Son of Boss returns giving rise to this recommendation is not representative of the population of tax shelter returns. Due to complexities and other issues, the Son of Boss cases were delayed deliberately to ensure appropriate issue development.

Consideration should be given to further clarify the impact of the extended assessment period provided by section 6501(c) (10) throughout the audit report. The assessment period is not only extended by one additional year, but is open indefinitely unless the one-year period is triggered. In such cases, the time the IRS has to assess the tax related to the transaction will remain open until one year after the earlier of the date the taxpayer furnishes the IRS with the information required under section 6011 or the date that a material advisor meets the requirements of section 6112.

Even when the one-year period on the statute is triggered, it is still not a fixed date; the statutory period can be extended by mutual consent of the taxpayer and the IRS. When a tax return is discovered that meets the one-year period, the examiner may request a consent to extend the statute from the taxpayer.

IMPLEMENTATION DATE

Not applicable.

RESPONSIBLE OFFICIAL(S)

Not applicable

CORRECTIVE ACTION MONITORING PLAN

Not applicable

RECOMMENDATION 2

Designate a study group to evaluate the IRS' overall performance in resolving the Son of Boss abusive tax shelter. The evaluation should identify all challenges the IRS faced in dealing with the Son of Boss abusive tax shelters, including the successes and

lessons learned in resolving tax accounts for investors that did not participate in the settlement initiative. Additionally, the evaluation should be well documented, to provide a roadmap for dealing with future abusive tax shelters of this magnitude.

CORRECTIVE ACTION

Before the release of the audit report, we convened a study group to evaluate the overall performance in resolving the Son of Boss abusive tax shelter. A report from that team, covering the initiative and the resolution of participating cases, is expected by June 30, 2006. All pertinent documents regarding the Son of Boss initiative will be located in a centralized location for accessing when responding to Freedom of Information Act and discovery requests and for establishing historical records. Lessons learned will be documented in the final report.

Lessons learned from the Son of Boss Initiative have been shared with the team responsible for implementing the Executive Stock Options Settlement Initiative described in IRS Announcement 2005-19 as well as with the team responsible for implementation of Announcement 2005-80 on abusive tax avoidance transactions. The Large & Mid-Size Business (LMSB) Division will use lessons learned from the Son of Boss initiative and other settlement initiatives when they redesign the Issue Management Team process.

With regard to non-participants, we developed a litigation strategy. These taxpayers differ from non-participants in other settlement initiatives in that Son of Boss non-participants were not allowed to go to the Appeals Division; they could either litigate their cases or default, with a default resulting in a tax assessment. The litigation strategy includes working all investor cases with the key partnership entity, clustering cases by promoter, and putting certain clusters in suspense before issuance of Final Partnership Administrative Adjustments (FPAA) while other clusters are moved forward through FPAA and assessment.

IMPLEMENTATION DATE

November 15, 2006

RESPONSIBLE OFFICIAL(S)

Director, Abusive Transactions, Small Business/Self Employed Division

CORRECTIVE ACTION MONITORING PLAN

The Program Manager for the Lead Development Center will advise the Director, Abusive Transactions, of any corrective action delays concerning the recommendations and actions outlined in the final report.

If you have any questions, please call me at (202) 622-0600 or Steve Burgess, Director, Examination, Small Business/Self-Employed Division at (904) 665-0503.