

THE SON OF BOSS TAX SHELTER

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Forward:

This website uses the infamous son of Boss tax shelter¹ as a tool to explain how our income tax code² is manipulated by some of the sharpest and most devious minds in the country. At its core, the son of Boss tax shelter involves the same concept employed by other tax shelters to reduce or eliminate capital gains: the creation of an artificial tax loss to offset a taxable gain. What sets the son of Boss tax shelter apart is the magnitude of tax dollars lost to the U.S. Treasury, as well as the tortured logic of its creators. Understanding how the son of Boss transaction distorts economic reality offers an insight into how tax shelters work, as well as how the dysfunctional nature of our current tax code provides the opportunity to attain such illogical results.

Why Bother Reading This?

Good question. The short answer: The tax code directly impacts your life and the lives of everyone you know. The tax code embodies the most complicated set of rules concocted by any society. It controls the taxation of trillions of dollars a year and affects the financial decisions made by multi-billion-dollar international conglomerates, as well as individuals of modest means, for there is just one tax code for all U.S. taxpayers³. Almost every political fight between rich and poor, old wealth and new wealth⁴, is laid bare in the tax code.

¹ First there was a BOSS (Bond Options Sales Strategy) tax shelter, which was struck down by IRS. Clever promoters then changed the original shelter slightly and the son of Boss tax shelter was born.

² The “tax code” is shorthand for the U.S. Internal Revenue Code of 1986 as amended. The tax law is comprised of the tax code and regulations, as well as judicial case law. IRS rulings, procedures and notices are not, strictly speaking, part of the tax law. They represent the IRS’s position on tax issues and are binding on IRS, but not courts.

³ Of course, there are different tax rates and provisions for corporations, partnerships, trusts and individuals, but all are contained in one tax code.

⁴ When one understands the tax code, it becomes apparent that the conflicts are not between liberals and conservatives, but rather the battle is between old wealth (both liberal and conservative) and new wealth – those living on investments verses those earning an income. Thus, the estate tax, capital gains, and tax-free bonds

Much of the tax code chronicles a never-ending battle between the cops (the government) and robbers (clever taxpayers intent on exploiting loopholes).⁵ Each time the cops change the law to catch the robbers, the robbers change tactics. Much of the tax code's heft (over thousands of pages) is attributable to Congressional efforts to close loopholes exploited by past robbers.

For instance, the tax code provisions regarding foreign trusts and foreign corporations were a direct result of entertainers forming foreign corporations to stash their earnings to avoid taxes. The rules regarding related party transactions (involving parents, spouses, children, siblings) were devised to thwart efforts to obtain a favorable tax result, usually a loss or reduction of tax rates by splitting income among the family, without actually relinquishing control of the asset or income.

Decoding the tax code is reminiscent of the popular computer game, *Myst* (first released in 1993), an overly-complex mystery puzzle that millions of computer wizards attempted to solve. And to date, the most audacious assault on tax code by the robbers has to be the son of Boss transaction, a text-based version of the game, *Myst*.

Tax Shelters in a Nutshell

Here is the basic pattern [\(see the diagram\)](#) contained in the son of Boss “inflated basis” types of tax shelters. These transactions reduce or eliminate capital gains⁶ by creating artificial capital losses. Although the pattern is simple, it is obfuscated with mounds of

laws favor old wealth, while those earning large incomes (professionals, business owners, entertainers and athletes) pay the highest rates on their compensation income, as well as employment taxes.

⁵ Keep in mind that taxpayers have the right to minimize their taxes through proper tax planning. What is at issue is artificial transactions structured solely for tax purposes, without regard to any underlying economic substance.

⁶ Capital gains occur from the sale of an asset for profit. The son of Boss tax shelters targeted those who sold stock for large gains. In addition, the sale of real estate or other investment assets for large gains would be the logical target for a son of Boss tax shelter promoter. Generally, the son of Boss tax shelter would not eliminate large amounts of ordinary income, usually income from compensation (salaries bonuses, commissions), although there were efforts to modify the basic son of Boss transaction to reduce or eliminate ordinary income transactions through the use of foreign currency options (IRC Sec. 988).

paperwork, intricate financial instruments and virtually incomprehensible tax code provisions.

1. Tax shelter promoter sets up two companies, Company A and Company B and funds each company with \$50. Company A buys a briefcase for the \$50.

2. Client comes to promoter and says, "I have a \$1.0 million capital gain." Promoter says, "No problem, I can eliminate that gain for you by generating a \$1.0 million loss to offset your gain."

3. Promoter devises the following plan:

a. Client purchases the \$50 briefcase from Company A by paying Company A \$1,000,050!

b. Client pays \$50 in cash. In addition (here's the tax shelter part), Client "pays" another \$1.0 million by signing a promissory note (a promise to pay) payable to Company A for \$1.0 million in 30 years⁷. For tax purposes, Client purchased the briefcase for the cash payment and the promissory note, so the tax cost for Client's briefcase is \$1,000,050.

c. Client then sells the briefcase to Company B for \$50. Thus, economically, Client is made whole; Client paid \$50 for the briefcase and sold the briefcase for \$50. However, Client's tax basis in the briefcase was \$1,000,050 and by selling the briefcase for \$50, Client incurred a \$1.0 million loss! That loss will then be used to offset Client's \$1.0 million capital gain, effectively zeroing out his tax liability.

d. Assume that Company B then sold the briefcase back to Company A for \$50. Promoter is ready for his next client now that Company A has the briefcase and Company B has \$50, and the pattern can be repeated.

The foregoing example illustrates the core principles of how tax shelters work. The transaction is legal and fits within the literal rules of the tax code. Millions of taxpayers offset capital gains with capital losses. But does the transaction work? Of course, the answer is clearly no; otherwise, no one would ever pay a dime in capital gains taxes. This is an example of an "artificial basis step-up transaction," the cornerstone of many tax shelter schemes. The promoter, through an sham transaction designed solely for the purpose of manipulating the tax

⁷ Under the tax law, debt is considered part of the consideration paid to acquire an asset. Thus, the cost of a home is the down of the down payment and the amount borrowed.

code, creates a purported tax loss where there was no corresponding economic loss.

Tax Code Manipulations

IRS, courts and Congress are not stupid. The tax code collects trillions of dollars a year. If a simple, synthetic transaction that falls literally within the tax code provisions were allowed to stand, no one would ever pay any taxes. Although the doctrines devised to analyze these manipulations have evolved over many years, in a nutshell they all say the same thing: The tax code taxes real economic transactions, transactions of substance, not fake transactions that apart from gaining a tax advantage, have no economic significance.⁸

Over the years, the courts have uniformly struck down transactions with no economic consequences. This general concept, called the “economic substance doctrine⁹,” has withstood challenges for 70 years. Indeed, tax shelter programs and the legal opinions drafted to support them are based on literal technical compliance with the tax code. Invariably, these opinions do not discuss the actual merits of the transactions or how the judicial economic substance doctrines would nullify the particular tax shelter.

Of course, selling a tax shelter as simple as the one described above would be bad business on two accounts, First, the tax shelter promoter would earn little money if all that was involved was the purchase and sale of a \$50 briefcase. In order to generate big bucks from the shelter (after all, the client is supposed to save taxes on \$1.0 million dollars), the transaction needs to be secret and virtually impossible for the taxpayer to comprehend.

Second, the transaction needs to be hidden from IRS, because, in the end, the promoter knows that if IRS finds the transaction and flags it, the deduction will be disallowed and penalties will be imposed. A legal fight over the transaction will be costly with little, if any, real chance of prevailing in court. Thus, while the tax shelter transaction is structured to fit literally within the tax code and there is usually a legal opinion expressing that the transaction

⁸ Various doctrines used to analyze the economic substance of a transaction include the sham transaction doctrine, the step transaction doctrine, various anti-abuse provisions contained in the tax code (see: my article on [Judicial Tax Doctrines](#)).

⁹ *Gregory v Helvering*, 293 U.S. 465 (1935) was the first case to uphold the economic substance doctrine and the courts have applied the doctrine consistently thereafter.

should work, the tax shelter promoters are hoping that IRS will not find the transaction in the first place.

The legal opinion is called “penalty” insurance. The assumption is if the opinion states the transaction works and the client relies on the opinion, the client should not be responsible for any penalties associated with the disallowed tax deduction.¹⁰ At worst, the client will have to pay the taxes he or she owed in the first place, plus interest. That’s not a bad risk, especially if the odds of being audited are about 1 in 100 and if the transaction is sufficiently “buried” in the tax return, the odds are even greater that IRS will never discover it.

So in the end, rather than having any real legal merit or possibility that the transaction might be upheld by a court, the promoter is employing a “needle-in-a-haystack” approach: bet on IRS never finding the transaction in the first place, but if it does, eliminate the risk of penalties through a legal opinion that says, based on a literal reading of the tax code, the transaction might work.

Son of Boss

With this background, let’s look at the son of Boss tax shelter specifically. As noted before, the son of Boss transaction is an artificial basis transaction: an asset’s basis is increased substantially to cause a tax loss on sale, without suffering a corresponding economic loss. The shelter uses offsetting stock options or currency options, and the artificial basis step-up mechanism involves the exploitation of a quirk in the partnership tax rules. Specifically, the tax shelter is built around the “contingent liability” rules regarding liabilities assumed by a partnership¹¹. Although the son of Boss transaction has several variations, the following example uses stock options ([see the diagram](#)).

¹⁰ The ability to rely on a legal opinion to avoid penalties has been greatly reduced in recent years. Thus, the penalty insurance aspect of the tax shelter has all but disappeared. At a minimum, the taxpayer must receive a legal opinion from an independent attorney, based on the real facts and law pertaining to the transaction and all assumptions and conclusions must be reasonable. The opinion must conclude that the taxpayer has a better than even chance of prevailing in court if the transaction is contested by IRS.

¹¹ In September, 2000, IRS reversed its position on contingent liabilities and issued Notice 2000-44 and in 2003, it issued a retroactive regulation, IRC Reg. 1-752-6, consistent with its reversal of position. Thus, the son of Boss offsetting-option transaction has been eliminated through changes in the tax regulations.

1. Taxpayer (“T”) purchases and sells a call option on stock that expires in 10 days. What this means is that T agrees to sell 1,000 shares of X stock at a price of \$150 per share (selling a call option). A buyer will have to pay T a premium for the right to buy X stock at \$150 a share. Let’s say the premium is \$20 a share. T makes a profit \$20,000 on the transaction. Let’s call this a “short position”, meaning that T makes money if the stock price declines.¹² The short position is a liability to T because he has an obligation to sell 1,000 shares of X stock at \$150 a share.

2. However, T does not own any X stock, so he purchases a call option to buy 1,000 shares of X stock at \$150 a share, which expires in 9 days (purchasing a call option). Let’s say the cost to taxpayer is \$21.00 a share. Let’s call this a “long position,” meaning that the taxpayer makes money if the stock price increases.¹³ The long position is an asset for T since he has the right to purchase 1,000 shares of X stock at \$150 a share and he can sell that right in the marketplace. After selling the short position and purchasing the long position, T’s net economic loss is \$1,000 (T made \$20,000 on the short position, but then turned around and purchased the long position for \$21,000).

3. T contacts his friend (“F”) and together they form a partnership, P. T contributes the purchase and call option for a 99% interest in P and F contributes \$10 for a 1% interest.

4. Now here’s the tricky part: T maintains that his investment in the partnership is \$21,000, the value of the purchased option. This is called his “outside” basis (the basis in his 99% partnership interest in P). Generally, the outside basis in a partnership interest is reduced by the liabilities transferred by the partner to the partnership. If this were the case, in T’s situation his outside basis would be \$1,000 since the value of the long position, an asset, would be offset by the short position, a liability.

However, T asserts that the short position liability of \$20,000 is a contingent liability, which means it may never be paid. Under partnership tax law -- and for reasons unrelated to offsetting long and short stock positions -- historically a contingent liability did not reduce T’s outside basis. Thus, the tax shelter promoter has created the “perfect storm,” a mismatch between economic reality and tax accounting.

¹² The taxpayer is betting the stock declines and the call option will never be exercised. In stock market lingo, this is called a “short” position. That way, the taxpayer keeps the \$20 per share premium. For example, if the call option expires and the stock is worth \$145, the purchaser will not exercise his right to acquire the stock at \$150, so T keeps the stock and \$20 per share premium.

¹³ Here, if the stock increases to \$200 per share, the taxpayer has the right to buy the stock at \$150 per share, so he is betting the stock will increase. Of course, since the taxpayer has offsetting positions, if the stock increased to \$200 per share, the person holding the short position would exercise his right to buy the stock at \$150 a share, so there really is no way for taxpayer to make money in the transaction.

5. P sells both the short and long position and, let's assume there is a net gain of 400 on the sales. P then terminates and distributes to T \$390 and \$10 to F. T's economic loss is \$610 (the \$1,000 loss on the initial purchase and sale of the call options, less the \$390 received). But T asserts his outside basis in his partnership interest was \$21,000, so his loss for tax purposes is \$20,610. T is using the contingent liability rules to create a mismatch between the economic loss and the tax loss in order to claim a tax loss that is more than 32 times larger than the actual economic loss! Does this actually work? Of course not.

IRS Response

In September, 2000, IRS issued [Notice 2000-44](#) which described this variation of the son of Boss tax shelter transactions and stated the transaction was bogus on a variety of fronts. The transaction lacked economic substance, was an abuse of the partnership laws, was an abuse of the contingent liability rules and the loss was not deductible by the taxpayer in any event because only legitimate economic losses can be deducted on a tax return. In Notice 2000-44, the IRS made it clear that it was changing its position regarding contingent liabilities and that a contingent liability would reduce a partner's outside basis. Thus, in the example above, taxpayers' outside basis would be \$1,000, not \$21,000 and the tax loss would be \$610, not \$20,610.

IRS went further and warned taxpayers that the transaction must be red flagged on their tax returns as a "listed transaction" and that taxpayers could be liable for penalties, in addition to the taxes owed. Because the transaction described above involved a major valuation overstatement (the loss claimed was 32x the size of the actual economic loss) the negligence penalty is doubled from 20% to 40%. Further, IRS warned that if promoters or taxpayers attempted to hide the transaction by netting out the capital gains and losses on a tax return filed by an entity, rather than the taxpayer, there could be criminal penalties. This is a not-so-subtle warning that efforts to deceive IRS about the transaction could result in prison.

IRS Settlement Initiative

On May 1, 2004, IRS launched a [settlement initiative](#) regarding the son of Boss tax shelter. Generally, those who came forward and paid the taxes and interest would be liable for

only ½ the negligence penalty or 10%. The settlement initiative ranked in approximately \$3.5 billion in tax revenues. Approximately 1,200 taxpayers participated and the typical payment was \$1.0 million, although one taxpayer paid more than \$100 million. But what about those who chose to fight the IRS rather than settle?

The Courts Weigh In

Not surprisingly, the courts have been hostile to taxpayer arguments that the son of Boss transaction worked. The courts used the economic substance doctrine to rule in favor of IRS, noting that transactions with little if any economic loss cannot generate huge tax losses – it just cannot happen under the tax law.

In [Klamath Strategic Investments Fund, LLC v. U.S.](#), (Dist. Court, Eastern Texas) 1/31/07, No. 5:04-cv-00278, the U.S. district court found that a son-of-Boss tax shelter transaction was a sham, lacking economic substance. The court, however, refused to impose penalties on the taxpayers, holding that the retroactive treasury regulations under IRC Sec. 1.752-6 regarding contingent liabilities could not serve as a basis for negligence, since those regulations were not in force at the time of the transaction.

In [Jade Trading, LLC v U.S.](#) (Ct. Claims) 12/21/07, a lengthy, well-reasoned opinion that thoroughly discussed the son of Boss tax shelter, the U.S. Court of Claims found the shelter lacked economic substance and sustained a 40% overvaluation statement penalty, holding that the economic substance doctrine prevailed over the taxpayer's reliance on the *Helmer*¹⁴ line of contingent liability cases. The court held that [Coltec Industries v. U. S.](#) 454 F.3d 1340 (Fed. Cir. 2006) firmly established that the economic substance doctrine applied to the analysis of tax shelter cases.

In [Cemco Investors, LLC v U.S.](#), (7th Circuit) 2/8/08, No. 07-2220, Judge Easterbrook's opinion mocked the attorney who created the son-of-Boss tax shelter involved¹⁵ and stated

¹⁴ *Helmer v CM*, 34 TCM 727 (1975) and several other cases held that a contingent liability does not reduce a partner's outside basis. None of these cases involved offsetting financial positions or tax shelters.

¹⁵ Evidently, the attorney was attempting to shelter his profits from promoting the son of Boss shelter by using his own creation – a bold show of faith.

that the Helmer line of contingent liability cases do not control the outcome of the case. Once again, Judge Easterbrook reaffirmed the economic substance doctrine as the proper approach to analyze a tax shelter transaction. The court held that the retroactive regulation, IRC Reg. 1.752-6 were valid and effective retroactively, and that taxpayers had sufficient notice of the change, since [Notice 2000-44](#) was issued a few months before the transaction occurred. The court criticized the [Klamath Strategic Partners](#) case in this regard. The court also upheld the 40% valuation overstatement penalty.

In [Kornman & Assoc., Inc. v. United States](#), No. 06-11422 (5th Cir. 5/12/08), a variant of the son-of-Boss tax shelter, the Fifth Circuit held that the obligation to close a short sale was a “liability” under the partnership tax rules (IRC Sec. 752) and disallowed the tax loss claimed by the taxpayers. The court found that an attempt to generate a \$100,000,000 tax loss by engaging in a series of transactions costing only \$200,000 was devoid of any economic substance. The court remarked that the tax shelter’s promised results was akin to alchemy:

Before we begin our excursion into Subchapter K, we would be remiss if we did not comment on the elephant in the room. The Trust acknowledges that it only suffered a \$200,000 economic loss in connection with these transactions, yet it claimed a \$102.6 million tax loss on its return. The Trust used this fake loss in 1999 to offset over \$2 Million in legitimate income and capital gains in 2000 and 2001. The Appellants' premeditated attempt to transform this wash transaction (for economic purposes) into a windfall (for tax purposes) is reminiscent of an alchemist's attempt to transmute lead into gold.

NOTE: In [Carlos E. Sala et ux. v. United States](#), No. 05-cv-00636-LTB (D. Colo. Apr. 22, 2008), the U.S. District Court of Colorado upheld the plaintiff's tax loss generated by a classic son of Boss scheme involving a foreign currency options investment transaction. In a rare and stunning loss for the government, the court found the taxpayer had an independent business purpose for entering into the transactions, even those the investment was characterized by the government as an abusive tax shelter transaction.

Conclusion

While son of Boss has been vanquished, the basic artificial basis step-up transaction will undoubtedly resurface in a different disguise. So the never-ending chase between the cops and robbers continues. This time, the cops found a solution to shutting down the son of Boss tax shelter, but expect the robbers to keep at it. Who knows, the next round of tax shelters are probably on the market and escaping detection. Stay tuned.