How to Learn to Stop Worrying And Love Tax Practice

By Lee A. Sheppard

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I tell law students that they will not get rich planning tax shelters. I tell them that they will have one house instead of two, three cars instead of seven, and one wife instead of two. I tell them that if they want to get rich quick they should not be in any business that bills by the hour, but that they should become investment bankers instead.

One student responded, “But Goldman Sachs doesn’t take just anyone.”

So now I tell that story, and I never fail to get baleful looks from students and howls of laughter from their teachers.

The truth is that investment bankers think you’re schmucks. And they’re never gonna stop thinking that. When this talk was being planned, there was a big kerfuffle among local practitioners about a prominent lawyer who left a white-shoe law firm to go to a bank.

So what? Either way, you’re working for bankers, directly or indirectly. And the irony of the way things work these days is you might have more power to say no to crazy ideas inside a bank than outside it. The ostensibly independent outside lawyers are dependent on the banks as clients, while the bank’s internal lawyers can stop horrible things from seeing the light of day.

No matter where you are, you’re stuck with working for bankers, because the whole economy has been financialized.

You work for people who bemoaned the discontinuance of the long bond because they wouldn’t have them to play games with any more. Most of your clients are going to be banks of one sort or another, whether regulated as such or not.

Every large enterprise is a quasi-bank now. General Motors and Ford make cars as collateral for loans. They make no profit on the cars, and on the good days when they make money, the profit comes from lending. General Electric is a conglomerate that is mostly a bank. The lending operations and huge portfolios that many large corporations mean that they are morphing into banks or investment companies. Meanwhile, since no one makes anything in America anymore, the role of financial intermediaries in the economy has become larger.

How does this affect tax practice? The tax law has never figured out how to tax financial intermediaries — insurance companies were even allowed to write their own tax rules — but it didn’t matter when they were not the biggest part of the economy. What differentiates financial intermediation from other activities is the nearly complete control the participants have over the source, timing, character, and amount of their income.

When it comes to financial types of income, everything we thought we knew about character and tax ownership and source and timing is wrong. That is why the designers of subpart F wisely declared this slippery stuff passive per se rather than wrestle with it. Couple that with fairly sloppy auditing of banks on the part of the IRS, and it is a wonder that any financial intermediary pays any tax at all.

On top of that, there are derivatives. By separating economics from legal ownership, derivatives are turning the income tax on its head. Formal labels don’t matter at all, yet the tax administration is still being run by guys who grew up on nonsensical corporate formalities. The feline PRIDES ruling is not just an isolated instance of stupidity, but prima facie evidence that these guys just don’t get it. (Rev. Rul. 2003-97, 2003-34 IRB 380.) This lack of understanding is horrible for the system, but it is an absolute playground for practitioners who understand derivatives.

This is powerful stuff. The attacks on the income tax mounted by right-wing kooks are nothing compared to what financial intermediation is doing to destroy it. Washington is mostly clueless on the degree to which financialization and derivatives are undermining the income tax.

What should the systemic response be? First, end the piecemeal response to this or that security or financial contract. This is only making the problem worse.

Do bankers and issuers have the right to expect the tax law to accommodate everything they want to sell? Nope, not unless we raise the fee for a letter ruling to $20 million. Policymakers need to step back and decide how to treat derivatives before granting any more piecemeal favors.

By separating economics from legal ownership, derivatives are turning the income tax on its head.

Second, forget legal ownership. The law should say that whoever has the economics pays the tax, and we don’t care who the titleholder is.

Third, eliminate the realization requirement. Mark everything to market that can be priced. Timing is everything, and taxpayers should not be allowed to time the recognition of their income.

What about liquidity? Anyone big enough to hold investments outside of a tax-free pension account is liquid enough to pay tax. What about price? Wall Street prices everything every day. There is a price that is good enough for government work.

Fourth, move toward source taxation in international relations. This, of course, is completely opposite the current preference for residence-based taxation, in which source countries give up tax jurisdiction in treaties.

Residence-based taxation is obsolete. Put it this way: What are hedge funds but domestic investors that masquerade as foreign? Oh, but they’re partnerships, and
their domestic investors pay tax. Not necessarily. Only those investors who acknowledge their domestic status pay tax.

Yes, source is slippery for financial income, but residence for financial intermediaries is even more artificial. Europe is in an upheaval now because companies have learned to abuse the treaties, especially nonresident status. Countries can’t afford to give preferential treatment to investors as nonresidents anymore, not now that every investor can qualify as such. The countries that insist on not bargaining away their withholding taxes in treaty negotiations have a better understanding of this question than Americans do. (Then again, America needs to be really, really nice to foreign investors to be allowed to continue to consume their savings.)

Do not regard the government as the enemy.

You have a job because of the government. The tax law doesn’t really need lawyers to interpret it. If tax law were certain and simple and not complicated, accountants could do it all instead of just most of it.

You should especially not hate this administration. This administration is not enforcing the law. Given the intangibles expensing regulations and unjustified interest deductions for publicly traded hybrid securities and the utter failure to police cross-border arbitrage, it is surprising that any corporation pays any tax at all. We in journalism believe that some corporations would simply be embarrassed to put a goose egg on their returns, so that’s why they pay something.

The failure to enforce the law is not necessarily a Republican or Democratic thing. I vividly recall discussions about who should be IRS chief counsel after Clinton was elected, and the message was that business would not tolerate anyone who would do the job too well. That is why there has never been a woman chief counsel. The present chief counsel, a loyal Republican, makes a show of going after tax shelters while not enforcing the law in any other area.

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The corporate income tax is a white-collar jobs program. Don’t whinge about uncertainty. You get paid for uncertainty. Every time the tax administrator promulgates one of those nonsensical facts-and-circumstances tests, that’s more billable time for the lawyers. Of course the clients will go away less than happy. But they’re not particularly happy to have to hire you in the first place.

When planning, think like a litigator.

You have to poke holes in your own deals. If you don’t do it, I will. Or on a good day, the government will.

Poking holes in your own deals is easier said than done. In planning, people seem to hold hands and collectively wish problems away. The person who points out problems with the proposed deal is denounced as not being a team player and is advised to seek other employment. And that’s how tax planning gets into trouble.

Problems are ignored and waved away, only to rear their ugly heads again when the desired result is challenged.

If everyone else all over town is signing off on a transaction, do you have to sign off on it too? Is it your ethical obligation to go as far as possible to reduce your clients’ tax liabilities?

It was Max Weber who reasoned that capitalism depends on everyone thinking he doesn’t have enough. We all have enough.

I would say no, and that is the perspective of someone who spent time in Washington. You have a relationship with the government, whether you know it or not. Tax lawyers are part of the compliance system. Tax compliance takes place in practitioners’ offices. Tax practitioners are not advocates for clients’ return positions. A tax return is an attested disclosure document, not an opening offer. Every bit of advice you give ultimately ends up on a tax return, which also means that most of it is not privileged.

Moreover, your personal credibility with the government matters. You flip them off one day, you may have to be back before them the next day asking for a favor on behalf of another client. Having a rap as someone who signs off on bad transactions will not help you represent clients before the government. (Woffman, Holden, and Harris, Standards of Tax Practice, 6th ed. (Tax Analysts).)

Be grateful for what you have.

Tax lawyers are at the top end of the service-provider class, and janitors are at the bottom end. Tax lawyers are at the top, up there with the astrologers and interior decorators, because the rentier class values their services in keeping their money away from government. (Who’s left in the middle? The fortunate white-collar workers whose jobs are not being done in India and the fortunate blue-collar workers whose jobs are not being done in China.)

Yes, there are people that you are heavily exposed to — clients, investment bankers, hedge fund managers — who have vastly more money than you ever will. Do not think you have to compete with them. Do understand that the concentration of wealth will only get worse.

In the bullpens in the brokerage firms, trainee brokers are encouraged to put up a picture of the fancy car or house or boat or what have you that is the subject of their material desires. This is regarded as an incentive to make money. Likewise, employers like for their employees to be married and mortgaged, not merely because they are squares, but also because they know that those obligations keep the employees chained to the desks. It was Max Weber in The Protestant Ethic and the Spirit of Capitalism who reasoned that capitalism depends on everyone thinking he doesn’t have enough. We all have enough.

Don’t take life too seriously.

Everything you need to know about America and American values is encapsulated in the Coke machine scene from Stanley Kubrick’s masterpiece, Dr. Strangelove or: How I Learned to Stop Worrying and Love the Bomb.
In this scene, Peter Sellers (who also plays the title character) plays Group Captain Lionel Mandrake, a seconded British officer who is trying to use a pay phone at a military base to call the White House to give the president the secret code to call off imminent nuclear Armageddon. He finds he is short of change, so he tries to persuade an American colonel, played by Keenan Wynn, who has just arrested him, to shoot the locks off a nearby Coca-Cola vending machine to get at the coins within.

The colonel initially demurs, with the words “That's private property.”

That ought to be enough. That already is everything anyone needs to know about America — where the argument that a proposed solution might deleteriously affect moneymaking automatically stops the discussion — but Kubrick drives the point home. So when the colonel finally relents — concluding that saving the world might be worth a little property destruction — he sternly warns the Sellers character:

Okay, I’m gonna get your money, but if you don’t get the president of the United States, you know what’s gonna happen to you? You’re going to have to answer to the Coca-Cola Company.