

Tax Collectors at Work

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A century ago, Congress decided it would be a good idea to amend the Constitution so the federal government could impose a small tax on high incomes. We know how that turned out. Over the years, the income tax and the federal government grew and grew. Many substantial earners now send a third of their net income to Washington. With help from that river of revenue and massive borrowing beyond it, the federal government has assumed a dominant role in – and sometimes taken over entirely – areas as diverse as agriculture, banking, education, health care, housing, scientific research, student loans, transportation, welfare, and, until just recently, transgender bathrooms.

As a result of the growth in federal taxing and spending, federal income tax planning drives many business decisions and the structure of many business transactions. State and local governments, as well as many nonprofits of all types, focus much of their fiscal effort on getting as much money from the federal government as possible.

Maybe this is good. Maybe it's bad. But the massive federal tax collection effort has also had a more mundane effect on legal documents and how we do business every day. In each case, the IRS identified some threat to tax collection. That concern led to some new nuisance or new requirement that became part of the backdrop and culture of the business world.

At one point the IRS focused on tax shelter schemes and noticed that a lot of promoters wanted their clients/victims to maintain confidentiality. So the IRS issued a rule that attached potentially bad consequences to any confidentiality agreement that related to tax structures. And, voila, every confidentiality agreement in the United States needed a new paragraph saying the restrictions didn't apply to anything about tax structures. Perhaps the IRS achieved its goal, at the expense of adding a little extra complexity to routine documents from coast to coast. Eventually the IRS changed its mind and the tax language went away.

Something similar happened when the IRS got tired of hearing about taxpayers who broke the rules but claimed they had relied on professional advice. So the IRS required a new warning: taxpayers couldn't rely on tax advice to avoid penalties unless it met certain standards. That warning, written with the elegance, brevity, and grace of any federal regulation, found its way into the standard text of email messages from most law firms. As email messages triggered replies and further discussion, the warnings multiplied like bamboo. Taxpayers were more than adequately warned. Then one day the IRS decided the warnings were no longer necessary. They have now mostly joined confidentiality disclaimers in the graveyard of outdated tax-driven verbiage.

Tracking of interest income became a concern at one point. So the IRS got Congress to require borrowers or lenders to maintain a registry for some loans, to track who owns them. The rules were probably supposed to apply to loans that could be readily sold or hidden from the IRS. But the scope of "registration-required" loans was and is defined in a murky way. So conservative tax lawyers sometimes say ordinary commercial mortgage loans require a registry.

Most commercial mortgage loan documents contain no such requirement, hence creating a problem. And when that problem gets solved by adding new registry language, it becomes another example of purely tax-driven language that has no practical purpose except perhaps to achieve technical compliance with some IRS requirement.

Tax reporting requirements have become an important step in many of the most trivial business transactions. No one can open a bank account without filling out a W-9 form. That sounds trivial and routine until somehow one screws it up and it becomes a huge emergency. Part of each New Year's ritual includes sending notices to certain business counterparties and the tax collectors to report millions or maybe even billions of transactions of as low as a few hundred dollars. The ritual has added a new verb to the language: "1099," which is what you do to someone when you send one of these notices.

Until just a couple of years ago, if a single individual owned a limited liability company, any 1099 reports sent to that company would identify it by its employer identification number. But then the great minds at the IRS decided instead to require use of the individual owner's social security number – perhaps slightly simplifying tax collection but at the cost of requiring broad disclosure of sensitive identifying information.

Through these and other measures, enforcement of federal income tax requirements has at times become a substantial part of all business activity and everyday life. It's quite an achievement for what was supposed to be a very low tax that applied only to the highest earners.

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