Practice

IRS Enforcement: The Pendulum has Swung Too Far

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It has been less than ten years since the enactment of the IRS Restructuring and Reform Act of 1998.[1] As tax practitioners will recall, this legislation followed widely publicized Congressional hearings into alleged abusive conduct by the IRS. Fairly or not, the public image of the IRS was at a low ebb. The perception, by Congress and the media, was that the IRS had lost track of its mission to serve the citizenry.

The result was a reorganization of the IRS into four divisions intended to reflect broad groups of taxpayers with common interests, the now familiar Large & Mid-Size Business (LMSB), Small Business/Self-Employed (SB/SE), Wage and Investment (W&I) and Tax Exempt & Government Entities (TE/GE) divisions. The Criminal Invstigation Division was separately the focus of an independent commission headed by former FBI and CIA director William H. Webster.[2] The Commission's conclusions, commonly called the Webster Report, resulted in a revamping of the IRS Criminal Investigation Division in mid-2000.[3]

The IRS Has Moved From Service Back To Enforcement

Two core principles were thought to have emerged from the intense scrutiny and subsequent restructuring of the IRS during this period. First, when dealing with taxpayers generally, the IRS was to become more aware of its service mission. Second, when allocating resources to criminal investigations, IRS CID was to focus on its core mission of enforcing "the criminal statutes relative to tax administration and related financial crimes in order to encourage and achieve, directly or indirectly, voluntary compliance with the internal revenue laws."[4]

For a period of time following the Congressional hearings, the IRS gave attention to its service mission.

While it may have gone too far in referring to taxpayers as "customers," genuine efforts to improve communication, for example through such simple initiatives as more clearly drafted and more consistent taxpayer notification of IRS actions, were surely a welcome change. And most certainly, the creation of the Taxpayer Advocate Service has been one of the most meaningful changes to emerge from the period of reform. From assisting individual taxpayers to resolve the complications that result from IRS bureaucracy, to serving as a watch dog for the citizenry at large, the Taxpayer Advocate has become an invaluable and indispensable part of the effort of the IRS to meet its mission.

> In contrast to demonstrating qualification for the deduction, documenting compliance with the computational rules of the Code Sec. 199 deduction may involve computations and methodologies across all taxpayers, without regard to industry.

It was not long after the IRS reform efforts, however, that the IRS found itself confronted with the proliferation of structured tax transactions marketed nationwide to large numbers of taxpayers. The memory of Congressional hearings into abusive IRS enforcement activity were overtaken by Senate hearings into the activities of national accounting and law firms in developing these tax strategies.[5]

Practitioners who have represented taxpayers in connection with the IRS's conduct in response to so-called abusive tax shelters know too well that the IRS has moved far from any mindset of service, and is now well into an era of increased enforcement. Of concern, however, is that, in so doing, the IRS is increasingly acting with diminished regard to procedural safeguards and fundamental fairness for individual taxpayers. Of perhaps greater concern, this new mindset of enforcement has extended beyond the so-called war on tax shelters to become an institutionalized way of doing business by the IRS.

The Risk That the War On Tax Shelters Will Give Rise to an Entrenched Enforcement Mindset

On March 9, 2007, LMSB announced that it was "implementing an Industry Issue Focus (IIF) approach to compliance."[6] In effect, LMSB set up a three-tiered system for tax enforcement. In the Fact Sheet accompanying the announcement of this new program, LMSB described a "new Industry Issue Focus Strategy to concentrate on high risk tax issues." Explaining this "new strategy," LMSB stated that "[o]nce identified, issues are prioritized or tiered based on how prevalent they are across industry lines and the level of compliance risk they present."[7]

LMSB has already identified lists of Tier I and Tier II issues. Tier I issues are described by LMSB as "of high strategic importance to LMSB and have significant impact on one or more industries."[8] Tier II issues are described as reflecting "areas of potential high noncompliance or significant compliance risk to LMSB or an industry."[9]

It should come as no surprise that LMSB has placed all listed transactions on its Tier I list. Some consideration should be given, however, to the listed transaction regime, and the impact that this approach has had on transforming tax administration into tax enforcement in the trenches.

The Internal Revenue Code defines a "listed transaction" as "a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction of Section 6011."[10] A "reportable transaction" is in turn defined as "any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion."[11]

The IRS decision to denote activity as a listed transaction merely reflects the IRS's position concerning the merits of the tax treatment of the transaction, and is not a judicial determination or even necessarily a final determination by the IRS. As the IRS itself has noted on its website, the definition of specific listed transactions have been subject to later clarification and transactions have been de-listed.[12] In most instances, the transaction is listed years after taxpayers have concluded the transaction and taken positions on filed returns concerning its tax treatment. In a fair analysis,

the IRS act of listing a transaction should be seen as nothing more than the IRS's assertion of a position that it plans to take in any subsequent examination or litigation with taxpayers, which may change on subsequent review by the IRS, or may not ultimately prevail in court.

Taxpayers and practitioners who find themselves involved in activities that become listed transactions encounter an altered enforcement regime from the IRS. These taxpayers and practitioners are confronted with special rules concerning disclosure, registration and information maintenance.[13] Added burdens are imposed on practitioners concerning written opinions.[14] Interest on tax liabilities are subject to different rules.[15] Heightened standards exist for any potential mitigation of accuracy-related penalties.[16] Notably, the very definitions of reportable and listed transactions are contained in the penalty provisions of the Code.[17] There is an implicit presumption that listed transactions and reportable transactions will result in some imposition of a penalty.

Taxpayers subject to IRS enforcement activity in connection with listed transactions have commonly been met with coordinated IRS efforts. In ways large and small, taxpayers have seen their interests in having the specific merits of their matters give way to unyielding cookie-cutter enforcement by the IRS. Through various settlement initiatives, the role of the IRS Appeals Office as an independent reviewer has been put into question, undermined or in some notable instances wholly vitiated. In many instances, the IRS has brought formidable coordinated resources against individual taxpayers, who may neither have sufficient amounts at stake nor possess the financial wherewithal to sustain the IRS's enforcement efforts. While IRS officials have trumpeted the success of collecting tax liabilities and penalties in connection with so-called abusive tax shelters, the touted victories have come at a high price to tax administration. There is a disheartening coarseness to the IRS's bullying approach that has spread far beyond enforcement in connection with listed transactions.

The risk now is that the IRS, through initiatives such as LMSB's Industry Issue Focus initiative, will take its hard-line approach against so-called abusive tax shelters and make it an institutionalized way of doing business. Practitioners are already incorporating the concept of "Tier I" issues into the nomenclature as readily as "listed transactions."

Without question, tax enforcement is vital to the nation. Without question, Congress should be heard by the IRS when legislators raise concerns about the tax gap, and the IRS should be heard by Congress when seeking more resources to address the tax gap. In that mix, however, the rights and interests of taxpayers should never be overlooked. The IRS should not move from its enforcement against the tax shelter industry to a state of permanent war with taxpayers and practitioners. It is also vital to tax enforcement that the issues of each taxpayer be given individual consideration, and the rights of each taxpayer be forever safeguarded. The mere act by the IRS of putting a transaction on a list has become too facile an excuse to overlook these concerns. The new tiered-prioritization of the Issue Industry Focus initiative should not be allowed to have the same impact.

Criminal Enforcement Has Moved Far From Traditional Safeguards

As we discussed in a previous column, the IRS Criminal Investigation Division has moved far down the road of parallel criminal and civil enforcement. Revenue Agents are being encouraged to look for indicia of fraud, and to move cases more quickly toward criminal enforcement.[18] Again, the long-standing safeguards afforded taxpayers in a more deliberative system risk falling by the wayside.

It is also apparent from recent events that the current IRS view of criminal enforcement has little regard for innocent bystanders caught in its wake. As a telling example, on March 29, 2007, the IRS announced that it had reached a resolution with the law firm of Jenkens & Gilchrist, resolving criminal and civil enforcement in connection with alleged tax shelter promotion activities. By letter dated March 26, 2007, the U.S. Attorney's Office for the Southern District of New York agreed not to bring criminal charges against the Jenkens firm, which in turn agreed to pay a $76 million promoter penalty to the IRS. In its March 26, 2007 letter, the U.S. Attorney's Office recited that its decision to forbear criminally was based in part on representations by the Jenkens firm that its "offices have already been or will soon be closed" and that the firm will remain in operation solely to wind down its business.

The IRS Commissioner stated, in the press release that announced the resolution of the Jenkens matter: "While it is unfortunate that the 56-year-old national firm of Jenkens & Gilchrist is terminating its legal practice, this should be a lesson to all tax professionals that they must not aid or abet tax evasion by clients or promote potentially abusive or illegal tax shelters, or ignore their responsibilities to register or disclose tax shelters," and added: "Pursuing abusive tax shelters is a top priority for the IRS."

Lawyers whose practices in no way touched on structured tax transactions, along with secretaries, paralegals, and other support staff, found the business from which they drew their livelihood destroyed. This is more than unfortunate. It is a lesson offered at too high a price, not only to the individuals involved, but to the tax system. We support a system that appropriately punishes those who cross the line. However, historically this same system has not punished those who happen simply to live in the same neighborhood. A civilized, ordered society should retain a preference for a strategic strike rather than the annihilation of the entire village.

ENDNOTES

[1] IRS Restructuring and Reform Act of 1998 (P.L. 105-206).

[2] IRS Publication 3388, *Review of the Internal Revenue Service's Criminal Investigation Division* (April 22, 1999).

[3] One of the odder outcomes of the Webster Report was that, for a period of time, the Criminal Investigation Division dropped the "Division" from its name. It has since gone back to the long-familiar acronym "CID," and we will do so here as well.

[4] IRM 9.1.4.2.

[5] *See, e.g.,* "The Role of Professional Firms in the U.S. Tax Shelter Industry," Report prepared by the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, U.S. Senate, February 8, 2005.

[6] Information on LMSB's new focus can be found on the IRS website at *www.irs.gov/businesses/article/0,,id=167377,00.html.*

[7] LMSB's Industry Issue Focus (IIF) Fact Sheet can be found on the IRS website at *www.irs.gov/businesses/article/0,,id=168490,00.html.*

[8] *See* www.irs.gov/businesses/article/0,,id=167377,00.html. Tier I issues can be found on the IRS website at www.irs.gov/businesses/article/0,,id=167379,00.html. Tier II issues can be found on the IRS website at *www.irs.gov/businesses/article/0,,id=167381,00.html.*

[9] *Id.*

[10] Code Sec. 6707A(c)(2); *See* Code Sec. 6011.

[11] Code Sec. 6707A(c)(1); *See* Code Sec. 6011.

[12] Indeed, the IRS's website recognizes the provisional nature of a listing when it describes a listed transaction as one where the "Service has officially notified taxpayers by notice, regulation or other form of published guidance as *potentially* abusive and therefore subject to the disclosure requirements of the regulations under I.R.C. § 6011." (emphasis added); *see* www.irs.gov/businesses/corporations/article/O,,id=120633,00.html.

[13] *See, e.g.,* Code Secs. 6011, 6111, 6112, and regulations thereunder.

[14] *See* Circular 230, Title 31, CFR, Subtitle A, Part 10, §10.35.

[15] *See* Code Sec. 6404(g)(2)(E).

[16] *See* Code Secs. 6662, 6664 and regulations thereunder.

[17] Code Sec. 6707A(c)(1) and (2); *see* Code Sec. 6011.

[18] *See* Charles P. Rettig and Kathryn Keneally, Practice, *Expedited Fraud Examinations: A Call for the Return to the Rack and Screw?* J. TAX PRAC. & PROC., March–April 2007.