Practice

By Charles P. Rettig

Responsible Tax Enforcement and the Uncertainties of Litigation

Practitioners roundly support the IRS efforts with respect to responsible enforcement and efficient tax administration. For years, the IRS has been attempting to "do more with less" while Congress has historically kept it somewhat confused and underfunded. From 1997 to 1998, Senator Bill Roth and the Senate Finance Committee held hearings on perceived abuses by IRS employees (subsequently discredited by a GAO Report) that led to the IRS Restructuring and Reform Act of 1998 (RRA '98).[1] RRA '98 substantially shut down ongoing tax enforcement efforts by, in part, threatening career IRS employees with termination if they committed any of the "10 deadly sins"—by simply attempting to assess and collect what they believed to be the proper amount of tax. Further, RRA '98 changed the mission of the IRS on the theory that a better-educated taxpayer would somehow become more compliant. Some have suggested that these enforcement lapses merely increased the ability of a better-educated taxpaying public to become noncompliant. The continued refusal of Congress to appropriately fund the IRS and its enforcement efforts only serves to exacerbate an extremely sensitive situation. Appropriately funding the IRS is a sound investment that Congress should not ignore.

IRS Commissioner Mark Everson has been working to "change the calculus" of shelter participation by requiring 100 percent of claimed losses or deductions plus penalties as part of settlement agreements.[2] The IRS has had an almost unfettered ability to choreograph a strong anti-tax shelter environment. On August 27, 2004, in *Long-Term Capital Holdings (LTCH),*[3] the U.S. District Court for the District of Connecticut helped this environment by upholding the government's denial of a prestigious hedge fund's $106 million claim of capital losses determining that it lacked economic substance and seriously questioning the reasonableness of any reliance on "assumed facts" legal opinions received by sophisticated taxpayers. The court concluded that the transaction had no business purpose other than tax avoidance and possessed no economic substance beyond the creation of tax benefits.

The *LTCH* District Court imposed the 40-percent gross valuation overstatement penalty and, in the alternative, the 20-percent substantial understatement penalty. The substantial underpayment penalty followed the economic substance holding and the gross valuation overstatement penalty followed the court's step-transaction holding. The gross valuation overstatement penalty could not apply to the economic substance holding due to the zero basis remedy. LTCH received "should" level opinions from separate law firms with prestigious national reputations supporting the basis of the underlying shares and the partners' claimed losses utilizing the transferred basis. However, the transferred basis opinion was not reduced to writing until approximately nine months after the filing of the LTCH return reporting the stock sale. The court questioned the credibility of counsel for LTCH testifying as a witness relating to the underlying business purpose on the basis that such counsel had represented LTCH on audit and in settlement negotiations and assisted in the litigation.

The *LTCH* court felt the opinions "assumed" a business purpose and "assumed" a reasonable expectation of a material pre-tax profit apparently based on the representations of LTCH. The court seemed significantly influenced by a perception that LTCH attempted to conceal the claimed loss on its tax return by netting it against unrealized investment gains for a net number on its corporate general partners' Schedule M-1 (presumably attempting to reduce audit exposure for the $106 million of claimed tax losses). Following the *LTCH* opinion, the IRS Appeals Office quickly (1) "reassessed and tightened" its settlement guidelines under which it would accept offers to settle cases with taxpayers that participated in certain abu-

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sive transactions, and (2) made certain previously offered settlement terms less favorable to taxpayers reporting losses and deductions from transactions similar to those involved in *LTCH*.

Last year, the IRS announced that it "will not accept reliance on an opinion from a non-independent tax advisor as proof of reasonable cause and good faith" even though the taxpayer would not likely have a reason to know of any potential lack of such independence.[4] Historically, the IRS Appeals Office provided an opportunity for the objective, reasonable consideration of a taxpayer's reliance on his professional advisors. However, a new Appeals policy concerning the settlement of penalty issues provides that Appeals "will no longer trade penalty issues. … Penalties can and should still be settled, but the settlement should be based on the merits and the hazards surrounding each penalty issue standing alone."[5] Hopefully, individual Appeals Officers won't read the new policy as a dictate that penalties are now to be decided in the courtroom. Shortly thereafter, the Office of IRS Chief Counsel weighed in by stating:

> When properly developed and applied, penalties assist the Service in promoting sound tax administration by increasing the economic costs of non-compliance. ... Although Service policy specifically provides that penalties are not a 'bargaining point', taxpayers and their representatives frequently offer to agree to all, or a larger portion, of a deficiency in exchange for a government concession of the penalties. When the Service develops and imposes penalties properly, a concession of the penalties does not reflect the hazards of litigation, even if the net dollar settlement for a larger deficiency would produce the same revenue as a settlement for a portion of the deficiency and a portion of the penalty. Conceding penalties in such cases also risks undercutting efficient tax administration by reducing the deterrent effect of penalties.

Taxpayers and tax practitioners will have less incentive to voluntarily comply if they believe that they can routinely bargain away penalties. In the context of tax shelters (especially listed transactions and potentially abusive transactions), the proper imposition and sustention of penalties in Appeals and in litigation can serve as an effective tool to combat the proliferation of abusive tax shelters.

As a compliance tool, it is important that all Service functions coordinate the application of penalties so that: (1) examination employees consider, develop, and impose penalties where appropriate, with heightened scrutiny given to cases involving a listed transaction or a transaction that the Service has otherwise as potentially abusive; (2) Appeals and Counsel resolve penalties based on their merits, including a hazards assessment; and, finally, (3) Counsel defends the penalty determination in litigation based on an analysis of the hazards litigation for the penalty independent of the hazards of litigation for the underlying tax adjustments.

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Chief Counsel attorneys should consider the proper application and development of penalties when advising Service employees during examinations and in Appeals, and in the attorney's conduct of litigation. In deciding whether to settle docketed cases, Chief Counsel attorneys must consider the hazards of litigation with respect to the penalties independent of the hazards of litigation with respect to the underlying tax adjustments. The Counsel Settlement Memorandum should include an analysis of the hazards of litigation as to the penalties.

Just when the government thought it was safe to go outside, its penalty agenda suffered stunning setbacks inside three separate federal courtrooms: (1) the District Court for the District of Maryland determined that Black & Decker[6] properly used $560 million in losses generated in a contingent liability structured transaction to offset its capital gains resulting in a $57 million refund—and abated penalties (interestingly, Black & Decker specifically conceded that "tax avoidance" was its sole motivation for the transaction)[7]; (2) the Court of Federal Claims ordered

the IRS to refund more than $82 million to Coltec Industries, Inc.[8]—and abated penalties—after overturning an assessment stemming from the company's transfer of contingent liabilities in a corporate reorganization (the Court of Federal Claims determined that the Coltec contingent liability transaction was structured to satisfy all of the requirements of existing law and noted that Congress has repeatedly debated and declined opportunities to codify the economic substance doctrine. "Under our time-tested system of separation of powers, it is Congress, not the Court, that should determine how the federal tax laws should be used to promote economic welfare.")[9]; (3) the District Court in Connecticut ordered a $62 million refund to TIFD III-E, Inc., a subsidiary of GE Capital Corporation (Castle Harbour-I, LLP)[10]—and abated penalties—in yet another contingent liability structured transaction ("In short, the transaction, though it sheltered a great deal of income from taxes, was legally permissible. ... Under such circumstances, the IRS should address its concerns to those who write the tax laws.").[11]

Examinations of sophisticated transactions involving technical tax planning strategies require experienced, more specialized examiners and the institutionalization of well-designed audit plans and initiatives. The IRS must carefully analyze each transaction and must not rush to judgment on any particular transaction. Limited government resources must be allocated to maximize their potential impact on present as well as future compliance. Inappropriate allocations might have an impact on a known compliance issue while creating opportunities elsewhere. Providing prompt, reasonable settlement opportunities for extremely technical, complex resource-intensive transactions should be a priority for the government, taxpayers and their representatives.

There are literally thousands of transactions under examination by the federal and state tax authorities. Taxpayers should not proceed to costly litigation without a thorough analysis of the various risks inherent in such litigation. Efficient tax administration dictates some methodology to resolve the clear majority of these matters without unnecessary litigation. The IRS has suggested various Fast Track Appeals considerations as a method of potentially resolving listed transactions. Practitioners have expressed various concerns about using the Fast Track process for these transactions ranging from (1) the ability and desire of IRS Exam Teams to actually exercise their discretion to settle the transaction in the current environment even though they may have such authority (it might not be a career enhancement opportunity to make a significant concession in a transaction Congress and senior IRS representatives have publicly labeled as abusive), (2) a clearly identified purpose as resolving an individual case or setting guidelines for the resolution for a range of cases, (3) the potential for the taxpayer participating in Fast Track to be designated for litigation since their case will have been fully developed in the process, (4) the actual exchange of positions on legal theories and information (some have theorized that the government may be using the Fast Track process as a discovery vehicle), (5) assuring that the actual decision makers attend the Fast Track meetings, (6) fair and reasonable consideration of penalties in the context of the applicable rules as in existence when the transaction was consummated and reported on the return, (7) limits on *ex parte* communications, (8) the involvement of the Appeals Officer assigned to draft Appeals Settlement Guidelines (who, in many situations, has been working with the IRS Exam Team for many months before attempting to discuss the transaction with taxpayer representatives), and, possibly, (9) issues regarding potential referrals of those involved in the creation of transactions to the recently expanded IRS Office of Professional Responsibility (potentially "chilling" their desire to provide assistance) which has been reaching out to other divisions within the IRS for referrals concerning practitioner misconduct.

The government certainly didn't anticipate the quick succession of federal court opinions supporting structured transactions it long asserted to be abusive in *Black & Decker*, *Coltec*, and *GE Capital*. These courts followed a literal reading of the applicable statutory provisions and declined to render interpretations beyond the clear meaning of the statute. LTCH has filed a Notice of Appeal. It is a virtual certainty that the government will appeal *Black & Decker*, *Coltec* and *GE Capital*, and we should not anticipate any significant changes in the government's positions as applied to other taxpayers at least until the opinions are issued by the respective Courts of Appeal.

Litigation outcomes are, at best, unpredictable and uncertain. Experienced trial lawyers exhaust all avenues at obtaining a meaningful settlement before stepping into the courtroom. For some, the decision to litigate may be easier than attempting to explain a basis for conceding any portion of a transaction that has been repeatedly labeled by members of Congress and senior government representatives as "abusive." However, it should not be anticipated that taxpayers will readily abandon the tax aspects of transactions

where prestigious national law and accounting firms have provided opinions confirming that the resulting tax benefits would "more likely than not" or "should" be sustained on the merits. With these opinions, the government should not anticipate taxpayers lining up to fully concede the tax aspects in every remaining listed transaction.

Courts should be expected to scrutinize each matter they are presented with and to not blindly accept the assertions of the government or the taxpayers. Hopefully, future settlement initiatives will more closely reflect the now more-visible potential hazards of litigation for transactions the government asserts to be abusive. The "Son of BOSS" initiative dictating a 100-percent taxpayer concession plus penalties should not be the template for the future. Federal courts will not allow the government to push too hard or too far (as when it attempted to invalidate the Announcement 2002-2 Disclosure by Black & Decker) but, instead, will follow the law. If there are taxpayer options within some statutory language in the Internal Revenue Code, we should expect that the judicial system will be guided by these express statutory provisions. It is not for the judicial system (or the IRS) to make new law or create language in the applicable statutes that simply doesn't exist.

LTCH created support for the government's penalty theories without regard to factual distinctions among taxpayers, almost ignoring factual variations in reliance on an opinion. Responsible enforcement dictates anything but a "one-size-fits-all" approach to the imposition of penalties. Taxpayers and the IRS will have to adjust to whatever transpires inside the courtrooms across the country. The survival of efficient tax administration dictates the responsible, prompt resolution of the thousands of listed transactions currently clogging the administrative pipelines.

The American Jobs Creation Act of 2004[12] signed by President Bush on October 22, 2004, includes substantial penalties for failing to disclose certain tax-motivated transactions, eliminates the benefits of interest suspension under Code Sec. 6404(g) for listed and reportable transactions, and indefinitely extends the statute of limitations for transactions that are not properly disclosed. However, Congress chose not to codify the "economic substance doctrine" (which would deny tax benefits arising from transactions that did not result in a meaningful change to the taxpayer's economic position other than a purported reduction in federal income tax), which many asserted would have jeopardized legitimate business transactions.

The current environment has brought a halt to all but the most aggressive taxpayers. Precious government audit resources (and many of its best and brightest examination teams) will continue to be deployed unless a meaningful resolution—short of years of litigation with uncertain and inconsistent results—can be promptly achieved. Caution and responsibility must be demonstrated by taxpayers and by the government.

ENDNOTES

1 IRS Restructuring and Reform Act of 1998 (P.L. 105-206).
2 Interview with Mark W. Everson, *Big-Money Tax Evaders in IRS Cross Hairs*, Rocky Mountain News, Aug. 5, 2004.
3 *Long-Term Capital Holdings*, DC Conn., 2004-2 USTC ¶50,351.
4 Mark W. Everson, IRS Commissioner, *Penalty Policy Statement*, Dec. 30, 2003.
5 Memorandum for all Appeals Employees by David B. Robison, Chief, Appeals, re *Interim Guidance on Appeals Policy Regarding Trading Penalties*, June 21, 2004. This Guidance will be incorporated into IRM 8.6.1.3 by March 2005.
6 *Black & Decker Corp.*, DC Md., 2004-2 USTC ¶50,390.
7 *Id.*
8 *Coltec Industries, Inc.*, FedCl, 2004-2 USTC ¶50,402.
9 *Id.*
10 *TFID III-E, Inc.*, DC Conn., 2004-2 USTC ¶50,401.
11 *Id.*
12 American Jobs Creation Act of 2004 (P.L. 108-357).