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Practice

By Charles P. Rettig

Crossing the Rubicon– A Lesson in Accountability

Government and private tax practitioners are each accountable to the system of tax administration and to our profession—lessons not to be forgotten by any of us in these most-difficult times. This issue of the JOURNAL OF TAX PRACTICE AND PROCEDURE includes a compilation of presentations at the UCLA Extension 2005 Annual Tax Controversy Institute. For more than 20 years, this has been the preeminent conference in the United States solely dedicated to tax controversy and tax litigation. The Institute's continued success is structured around extremely high-quality, practical presentations by sophisticated government and private tax practitioners who enjoy an open forum discussion of sensitive practice issues.

The 2005 Annual Tax Controversy Institute included presentations by the Honorable Stephen J. Swift, Judge, United States Tax Court, Washington, D.C.; John C. Klotsche, Senior Advisor to IRS Commissioner Mark W. Everson, Washington, D.C.; Kevin M. Brown, Commissioner, IRS, Small Business/Self-Employed Division, Washington, D.C.; David Robison, Chief, IRS National Director of Appeals, Washington, D.C.; Kurt Kawafuchi, Director, Department of Taxation, State of Hawaii; Peter LaBelle, Division Counsel, Large and Mid-Size Business Division, Washington, D.C.; Sandra Brown, Chief, Tax Division, United States Attorney's Office (C.D. Cal.); Michael Kochmanski, Special Agent in Charge, IRS Criminal Investigations, Los Angeles; Luis A. Tejeda, Supervisor, IRS Fraud Technical Advisor, Los Angeles, and others.

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Crossing the Rubicon

During the Keynote Luncheon presentation, Mr. Klotsche commented upon the current enforcement environment with citations to the recent Indictment and Superseding Indictment emanating from the Southern District of New York,[1] and the broad-based Settlement Initiative described in IRS Announcement 2005-80.[2] Mr. Klotsche stressed that these Indictments did not relate to an evaluation of the merits of any particular transaction. Instead, Mr. Klotsche indicated that a review of the public documents filed with the District Court in New York reveals that the government's case relates to "core criminally fraudulent activities" in four specific contexts—asserting that various individuals conspired to do some or all of: (1) preparing false and fraudulent tax returns; (2) preparing false and fraudulent factual representations as part of the underlying documentation and issuing tax opinions based on those false representations; (3) actively concealing listed transactions from the IRS by failing to register them; and/or (4) impeding IRS examinations by knowingly failing to produce summonsed documents. Further, it was pointed out that neither the Deferred Prosecution Agreement between KPMG and the U.S. Department of Justice, nor the firm's admissions conclude that the underlying tax strategies (identified as the BLIPS, SOS, and FLIP/OPIS strategies) are criminally fraudulent tax shelters *per se*, nor do the admissions conclude that the firm was being penalized for its aggressive promotional activities of the listed transactions. KPMG, which is apparently cooperating with the federal prosecutors, avoided criminal prosecution by agreeing to payments totaling $456 million to the government and admitting wrongdoing associated with the foregoing transactions.

The Indictments do not mention other tax strategies (involving KPMG or otherwise). At present, no Court has ruled that the underlying tax strategies failed to comply with the terms and provisions of the Internal Revenue Code. There have been no direct assertions that the basic structures of the underlying listed transactions warrant a criminal sanction

Rather, some have emphasized that the Indictments, and other publicly available documents, identify KPMG as having "crossed the Rubicon" from the civil to the criminal arena.

The Rubicon River was a small stream in Northern Italy. As the Governor of Gaul, Julius Caesar's popularity with the people soared following his display of outstanding military skill in subduing the native Celtic and Germanic tribes presenting a threat to the power of the Senate and to Pompey, who held power in Rome. Accordingly, the Senate called upon Caesar to resign his command and disband his army, or risk being declared an "enemy of the state". Pompey was entrusted with enforcing this edict—creating the foundation for civil war. While staying in the Northern Italian city of Ravenna, Caesar had to decide whether to acquiesce to the Senate's command, or to move southward to confront Pompey and plunge the Roman Republic into a bloody civil war. An ancient Roman law forbade any General from crossing the Rubicon and entering Italy proper with a standing army. Crossing the stream would mark the point of no return . . . to do so was treason.

In January of 49 B.C., Julius Caesar led his army across the Rubicon, plunging the Roman Republic into civil war. Caesar's rival, Pompey, fled to Greece, and then Egypt. Within months, Caesar defeated the legions loyal to Pompey—receiving Pompey's severed head in the process. Although outnumbered, Caesar crushed his enemy's forces before returning to Rome, having firmly established control of the entire Italian peninsula. Continuing to consolidate his power, Caesar declared himself Dictator for Life in February 44 B.C. This act, along with his efforts to continually adorn himself with the trappings of power, turned many in the Senate against him—leading to his eventual assassination on the Senate floor—where he fell at the foot of the statue of Pompey.

There have recently been two commentaries in the WALL STREET JOURNAL[3] discussing the Indictments—asserting that the government may ultimately have a somewhat difficult task in the criminal arena—depending on the information uncovered during its investigation. Obviously, those of us outside the government do not know what information they have uncovered, and may continue to uncover, beyond that stated in the Indictments. Traditional administrative review processes often require a few years to effectively move either a civil tax dispute or a criminal investigation into the courtroom. However, the ongoing Congressional spotlight on listed transactions identified by the IRS may have dictated a quick, harsh punitive action by the IRS and the Department of Justice. Often, the government feels the need to move quickly, where a failure to do so would allow some questionable behavior to persist. With respect to listed transactions, the government has been extremely effective in publicizing their position that the strategies aren't within the

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government's interpretation of the intended framework of the Internal Revenue Code and relevant case authorities. The listing process—often referred to as "death by publication"—has effectively terminated what the government would assert is overly aggressive tax planning by even mainstream tax practitioners. The complexity found within the Internal Revenue Code will long continue to be a significant problem for effective tax administration *and* even for tax practitioners exercising their best efforts to try to do the right thing.

Most of us won't be overly concerned for the well-being of a practitioner who actually crossed the tax-Rubicon. In the criminal context, the issue will be to determine who built the boats, who was merely walking around with wet feet and who was unknowingly pulled into the river. Obviously, time, and a lot of government and private resources, will ultimately make this determination in the Southern District of New York and possibly elsewhere. Some have indicated that it is highly unlikely that the government may actually be able to prove that each of the indicted professionals (which may well exceed 19 by the time the dust has had a chance to begin to settle) conspired together and determined that it was in their collective best interests to commit tax evasion (whether or not their clients would have had any idea of such actions). However, again, it must be remembered that those of us outside the government do not know what information and evidence the government may have uncovered in its lengthy investigation. Ultimately, the judicial system will set the mark for what is and is not proper in this arena . . . from both a civil and from a criminal perspective.

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Announcement 2005-80

It is too early to get a reading on the potential success of the new Settlement Initiative set forth in Announcement 2005-80[4] (identifying 21 eligible listed and nonlisted transactions that the IRS believes were participated in by as many as 4,000 taxpayers) providing for a 100-percent taxpayer concession of the merits, deductions for transaction costs and payment of a percentage of applicable penalties. Undoubtedly, for various reasons, some taxpayers will have an interest in resolving their tax matters and moving on. Others not apprehensive about litigation with the government, may not settle. Those without penalty exposure may not be much at risk if they choose not to settle—their risk is essentially limited to the possible retroactive loss of interest suspension as a result of the Katrina legislation and the deduction for the transaction costs and expenses associated with the litigation (which are often not material when compared with the potential tax exposure). It is imperative that each taxpayer have their advisors calculate the economics of settling versus not settling and then factor in the relative hazards and costs of any potential litigation associated with a decision not to settle. With 21 different transactions and some 4,000 taxpayers having been identified, it should be clear that every transaction is not as good or as poor as another. Transactions, like taxpayers' attitudes toward settlement initiatives, *are* different.

The government resource allocation to effectively contest and possibly litigate the residual of thousands of potential cases is enormous. The IRS and the Department of Justice won't likely be successful in litigating all of the remaining cases . . . and neither will the taxpayers. So far, Congress has not appropriately funded these ongoing enforcement efforts, which dictates some methodology—like this global Settlement Initiative—to attempt to effectively deal with such a large number of potential open cases.

Many tax plans result from tax legislation designed and created by Congress with something else in mind. If that process generates unintended tax attributes, the result is not necessarily "abusive" (see, for example, *Black & Decker*, *Coltec*, and *GE Capital*)[5] *nor* criminal. In the recent *BDO* opinion[6] regarding claims of privilege, Judge Holderman (Chicago Federal District Court) determined that the IRS failed to present a *prima facie* case stating, "The court is not prepared to accept the far-reaching and blanket assertions by the IRS at this time." Further, "The government has based its arguments . . . on what to this point is speculation and innuendo." Finally, "The fact that the IRS characterizes a business or individual's transactions as abusive and unlawful cookie-cutter tax shelters does not mean that this characterization is a proper conclusion as a matter of law."

The government has frequently stated that listed transactions generate claimed tax benefits that are "too good to be true" . . . but some might respond that a Code Sec. 1031 exchange ("I used to own that building and now I own this building, but there is no tax on the transfer . . . Why?"), the non-tax status of an S corporation ("I have a C corporation that is subject to tax at the corporate level; I file an S corporation election by simply sending in a Form 2553 *(Election by a Small Business Corporation*) to the IRS and fully eliminate the federal corporate-level tax . . . Why?"), gift and estate

valuation discounts for interests in an LLC or a family limited partnership ("If I buy a building for $10 million and put it in an FLP/LLC with my kids, it is now valued at $6-$8 million for transfer tax purposes—where the transfer taxes based on the valuation . . . What happened to the other $2-$4 million of valuation?"), and more, could similarly be deemed "too good to be true." Few, if any, of the individual taxpayers under examination regarding listed transactions have any degree of tax sophistication. Many have participated in a Code Sec. 1031 exchange, an FLP/LLC or have an S corporation. All were surrounded by perceived sophisticated professionals where it was thought reasonable to follow the clearly rendered advice. It *is* still reasonable and proper for taxpayers to rely upon and follow the advice of their professional tax advisors:

> When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion" or to try to monitor counsel on the provision of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place."[Citations omitted.] "Ordinary business care and prudence"' do not demand such actions.[7]

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An "opinion," in the official context *is* an opinion; it is not a conclusion to a legal certainty. Opinions are rendered by different individuals with different firms having differing degrees of tax sophistication. Lawyers, accountants, the government and others frequently disagree about the possible tax results flowing from a transaction . . . which is why they build federal courtrooms and why our judicial system is comprised of independent federal judges with lifetime appointments.

IRS leadership has stressed the importance of enforcement in their tax administration policies and there has been considerable focus on listed transactions within these policies. There has been an ongoing government effort to terminate the creation and promotion of transactions emphasizing tax considerations, rather than non-tax considerations. However, listed transactions were not created in complete ignorance of the Internal Revenue Code. They are typically founded within the complexities of the Internal Revenue Code and its distinctions favoring certain types of transactions by practitioners having a great degree of knowledge about the Code and relevant case authorities.

We should carefully recall the perspective of the late 1990s and early 2000s and the fact that Americans are trained to rely upon branding. At the time, large professional services firms were raiding national law firms seeking the "best and the brightest" passthrough tax practitioners. It is logical to rely upon the clearly rendered advice of a large professional services firm and you often pay a huge premium for the pleasure. Otherwise, taxpayers looking to stay behind the curtain would likely seek out a practitioner they thought they might be able to control to some extent. Individual taxpayers simply can't control the opinions rendered by professional services firms with their many internal review processes and numerous offices around the country. Often, the positions set forth within opinions rendered by large firms then found their way into the opinions of other tax advisors, who received and concurred in the initial opinions. Along the way, the branding of the originator was not forgotten.

Overall, settlement initiatives represent an extremely intelligent process for the government and for those taxpayers interested in resolving their ongoing disputes with the government. Announcement 2005-80 indicates that the government has identified 4,000 taxpayers involved in these 21 transactions. This initiative is similar to the IRS template created around the global Settlement Initiative for the "Son of BOSS" transactions—often stated by the IRS to include the most abusive transactions they have encountered. Given the large number of taxpayers who did not accept the Son of BOSS Initiative (said to exceed 680 from a taxpayer pool approximating 1,800), a transaction the IRS deemed to be the "most abusive"—why peg this initiative at that same level? Sound tax administration requires a resolution process providing sufficient incentives to administratively resolve large numbers of open cases. Time will tell whether the terms of this initiative actually hit the mark for any significant portion of the affected taxpayers.

Circular 230

Our professional life has become consumed by concerns about complying with Circular 230. Most practitioners have (hopefully) included automatic disclaimers on their e-mail traffic and correspondence. Schoolchildren of various practitioners have even become apprehensive about turning in their homework without an appropri-

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ate Circular 230 disclaimer! Boilerplate disclaimers have become substantially similar to warnings on the back of Major League Baseball tickets . . . you know it's there, but still attend the game. Does any practitioner knowingly give the wrong advice? What will a court ultimately do regarding penalties when presented with clearly written tax advice that includes a disclaimer *solely* because the practitioner is concerned about Circular 230 (the disclaimer certainly does not even imply that the advice is somehow flawed in any manner). The advice is the same—it's only the practitioners' relationship with the IRS that may have changed. Judges know the current version of Circular 230 emanates from the proliferation of listed transactions. Will judges ignore the clearly rendered (but disclaimed) advice when facing an almost-accurate Code Sec. 1031 exchange involving Mom & Pop? Will the IRS ignore the advice and assert penalties? As to both, hopefully not . . .

We live in a country founded by discarded smugglers and those resisting the exercise of government power in England. Our government encounters many situations that require a strong response. Mainstream practitioners don't see what the government sees . . . the government needs the ability to effectively reprimand inappropriate conduct—by practitioners as well as by those within the government. If practitioners overreach, they deserve an appropriate response. If the government provides an inappropriate response to a particular situation under the guise of Circular 230, practitioners should be expected to appropriately respond. Strong regulations applied with appropriate discretion will serve us all quite well. Abuse of power and discretion may lead to tea being dumped into the harbor in Boston . . .

Practitioners should operate under their own personal "best practices" code and should be proud of their daily accomplishments! We should be equally proud to be professionals with high standards not afraid to comment upon any potential government overreaching into our professionalism. From a tax administration standpoint, the IRS would obviously prefer to have all practitioners adopt standards exceeding the requirements of Circular 230 or the Internal Revenue Code, even though not required to do so. Our actions should first be judged by the profession—the folks who live in the tax trenches of private practice. If the profession fails to make an appropriate response, we should anticipate strong government intervention. However, this intervention should likely acknowledge the realities of life in the trenches—quick decisions are often required based on limited available information.

The vast majority of tax practitioners are professionals who take great pride in their services with a very high degree of personal integrity and credibility! Mainstream tax practitioners have been somewhat blemished by the investigations and various public comments from high-ranking government officials. Was Senator Joseph McCarthy always right? Was he always wrong? Was Lenny Bruce fairly tested in the waters surrounding the First Amendment? Where would we be today if Edward R. Murrow was afraid to put on his boots and sit high in the saddle? Our history will be what we make of it . . . or not.

Reputations are earned (and lost) everyday . . . . Learn to respect those who can do nothing for you or to you and help those who are less fortunate and unable to help themselves . . . .

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Endnotes

1 *U.S. v. Stein*, Case No. S1 05 Cr. 0888 (LAK).
2 Ann. 2005-80, IRB 2005-46, October 27, 2005.
3 October 12, 2005 and October 6, 2005.
4 Ann. 2005-80, IRB 2005-46, October 27, 2005.
5 *Black & Decker Corp.*, DC Md., 2004-2 USTC ¶50,390; *Coltec Industries, Inc.*, FedCl, 2004-2 USTC ¶50,402; *TFID III-E, Inc.*, DC Conn., 2004-2 USTC ¶50,401. TFID III-E is a subsidiary of GE Capital Corporation (Castle Harbour-I, LLP).
6 *BDO Seidman, LLP*, DC Ill., 2005-1 USTC ¶50,264.
7 *U.S. v. Boyle*, 85-1 USTC ¶13,602, 469 US 241, 105 SCt 687..

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