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TAX LITIGATION ISSUES

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IRS Offers Taxpayers a "Break" in Its Battle Against Tax Shelters

For more than two years, the Internal Revenue Service (IRS) has been on a campaign to increase enforcement and deter abusive tax shelter deals.

A quick look at the service's Web site reveals dozens of press releases regarding the IRS' intensified civil and criminal promoter investigations, targeted summons enforcement actions and litigation and a more robust oversight program of tax professionals.

The latest action by the IRS in this regard was announced on Oct. 27, in a press release entitled "IRS Launches Abusive Transaction Settlement Initiative."

This initiative allows taxpayers who engaged in certain identified transactions until Jan. 23, 2006 to file settlement forms with the service to resolve certain civil tax disputes with the service. Commissioner of the IRS, Mark Everson, stated that "[t]he IRS has acted to shut down [abusive tax shelters], as has Congress, in passing stiffer disclosure requirements and promoter penalties last fall. We're offering taxpayers a quick, quiet and cost-effective way to put these deals behind them."¹ According to the IRS, to date, the service has identified more than 4,000 taxpayers involved in such transactions, including wealthy individuals, large corporations and small business taxpayers.² The settlement initiative is available to taxpayers both known and unknown to the IRS, however.

Covered Transactions

The IRS' announcement identifies 21 transactions eligible for the settlement program. The service, in conjunction with the Office



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of Chief Counsel and the Treasury Department, regularly updates and issues formal guidance on certain tax avoidance or "abusive" transactions referred to as "listed transactions." Sixteen of the 31 listed transactions are set forth in the recent settlement initiative; five are other "potentially abusive" transactions.³ These transactions include a wide-range of tax "schemes" including funds used for employee benefits, charitable remainder trusts, offsetting foreign currency option contracts, debt straddles, lease strips and certain abusive conservation easements.

The 21 transactions are sub-divided into three groups. Groups 1 and 2 contain the 16 listed transactions, while Group 3 contains the five transactions that have not formally been listed, but which concern the IRS. The distinction between each group for purposes of the Settlement Initiative is the penalty to be imposed for engaging in each transaction.

Who Is Eligible?

The easiest way to assess who is eligible to participate in the settlement proposal is to set forth who is not eligible. Ineligible persons include: 1) promoters; 2) persons related to promoters (such as a person in partnership with a promoter or more than five percent shareholder in a promoter organization); 3) persons who engaged in an indicated transaction, but have been informed by the IRS that the transaction has been designated for

litigation; 4) persons currently in litigation with the IRS concerning the transaction; 5) persons against whom the IRS has imposed a fraud penalty or have been informed that the IRS is considering the imposition of such a penalty; and 6) persons under criminal investigation.⁴

If not identified by these categories as an ineligible person, any person that claimed a federal tax benefit from a described transaction may participate in the settlement initiative. In addition, certain individuals defined as ineligible under the first three categories, may file an "election" that identifies each reason the person is an ineligible person and requests that the IRS permit settlement nonetheless.⁵

Terms of the Settlement Initiative

The IRS will settle with taxpayers by disallowing the allegedly improperly claimed tax benefits in "a manner consistent with relevant published guidance providing the service's view of the transactions...and the facts and circumstances surrounding the specific transaction."⁶ This means that either the transaction will be treated as not having occurred for tax purposes or that the transaction is recharacterized. In the former instance, the taxpayer must concede all claimed tax benefits of the transaction; in the latter, the taxpayer must concede tax benefits that differ from any benefits allowed under the recharacterized transaction.

Thus, settling taxpayers will be required to pay 100 percent of the taxes owed, interest and, depending on the transaction, a percentage of the penalty the IRS would otherwise seek. A taxpayer settling under the initiative will pay a percentage of the maximum applicable penalty, depending upon which group the transaction falls under. Transactions under Group 1 will pay half of the maximum applicable penalty, while transactions in Groups 2 and 3 will pay a quarter of the maximum penalty amount.⁷

Finally, the settlement terms identify two

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circumstances under which a settling taxpayer will owe no penalty. First, no penalty is due if the taxpayer made a voluntary disclosure to the IRS under the program described in Announcement 2002-2. That announcement proclaimed an IRS disclosure initiative to encourage taxpayers to disclose their tax treatment of tax shelters and other items for which the IRS might find it necessary to impose an accuracy-related penalty. The 2002 initiative gave taxpayers until April 23, 2002 to disclose this information to the IRS to receive a waiver of any accuracy-related penalty for any underpayment of tax attributable to the disclosed transaction.⁸ Thus, where a taxpayer previously had disclosed a transaction to the service under Announcement 2002-2, and that same transaction is covered under the terms of the settlement initiative, the service will impose no penalty for taxpayer's involvement in the so-called abusive transaction.

Second, no penalty is due if the taxpayer obtained a written tax opinion before filing the tax return that: (i) was not part of the package sold by the promoter, but was given by a tax adviser, and (ii) was a "more likely than not" opinion, described by the IRS as an opinion that "concluded at a confidence level greater than 50 percent that the significant tax issues would be resolved in the taxpayer's favor." The waiver of a penalty under these circumstances is consistent with the service's recent position on opinion letters.

Opinion Letter Requirements

At the end of 2003, the service issued amendments to the regulations governing practice before the IRS. One of the effects of these amendments was to heighten the standards for the use of opinion letters as a defense against IRS penalties.⁹ Attorneys preparing "more likely than not" opinion letters now are required to: (1) identify and consider all relevant facts and not rely on any unreasonable factual or legal assumptions or representations; (2) relate the applicable law to the relevant facts; (3) consider and reach a conclusion as to all "material federal tax issues;" and (4) provide an "overall conclusion" as to the federal tax treatment of the tax shelter item.¹⁰ Furthermore, taxpayers are not able to argue that they relied in good faith on these opinion letters if they fail to disclose their participation in abusive transactions. Finally, Commissioner Everson has stressed that under no circumstances may a taxpayer rely on the advice of practitioners who they know to have financial arrangements or referral agreements with shelter promoters.¹¹

The waiver of penalties under the new settlement initiative is in line with these rules, requiring full disclosure of the "abusive transaction" before allowing good-faith reliance on opinion letters to serve as a defense to tax penalties. The service's increased enforcement efforts with respect to tax shelters has weakened the significance of opinion letters and placed increasing responsibility on tax attorneys who prepare such letters to ensure their accuracy or face disciplinary consequences. The government's recent indictment of KPMG executives, for the sale of fraudulent tax shelters, and of Raymond Ruble, who prepared opinion letters for use by KPMG clients, is an example of the government's declining view of the protection afforded taxpayers by such opinion letters.

The settlement terms also provide that settling taxpayers will be permitted to treat as an ordinary

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loss those transaction costs, including promoter fees and fees paid for accounting, appraisal and legal services, actually paid by the taxpayer. To accept these terms and settle with the IRS, taxpayers must file an Election Form with the IRS indicating an intent to participate. Once the papers have been reviewed by an examining agent or appeals officer where the taxpayer is under audit or at appeals, the parties will enter into an acceptable payment plan and execute a closing agreement.

Son of Boss Transactions

This settlement initiative is similar to prior initiatives offered by the IRS with respect to schemes involving transfers by executives of stock options to family controlled entities and Son of Boss transactions.¹² According to the government, these settlement initiatives were hugely successful. The IRS reported that the response to the Executive Stock Option Initiative was "robust," resulting in responses from 105 of the 124 executives and 41 of the 46 corporations identified to have engaged in such transactions. In addition, the settlement initiative revealed four new

companies and seven executives not previously known to the IRS.¹³

Further, the IRS reported more than 1,200 taxpayers elected to participate in the Son of Boss Settlement Initiative, resulting in the collection of almost \$4 billion in taxes, interest and penalties by the government.¹⁴ According to news reports, about 400 people decided not to settle with the IRS under the Son of Boss Settlement. Commissioner Everson noted in response that those who challenge the IRS in court will be publicly named, while people who settle with the agency will stay anonymous.¹⁵

If the response to prior transaction-specific settlement initiatives is any indication, taxpayer participation in the most recent settlement initiative may be tremendous, especially given the wide range of transactions covered. Furthermore, the IRS clearly touts these settlement initiatives as an opportunity to "quietly" settle outstanding claims, which no doubt is appealing to many taxpayers. Continued success with these programs will further bolster the IRS in its efforts to "aggressively counter abusive tax avoidance transactions."

1. Press Release, Internal Revenue Service, IRS launches Abusive Transaction Settlement Initiative (Oct. 27, 2005) (available at <http://www.irs.gov/newsroom/article/0,,id=150072,00.html>).

2. *Id.*

3. Internal Revenue Service Fact Sheet 2005-17, October 2005 (available at <http://www.irs.gov/irs/article/0,,id=150073,00.html>). The remaining 15 listed transactions are excluded from the settlement initiative for a variety of reasons, including that they have been the subject of previous settlement initiatives or the listed transaction is dormant. *Id.*

4. Internal Revenue Service Announcement 2005-80 (available at <http://www.irs.gov/pub/irs-drop/a-05-80.pdf>).

5. *Id.*

6. Internal Revenue Service Announcement 2005-80.

7. See *id.*; Internal Revenue Service Fact Sheet 2005-17, October 2005.

8. See Internal Revenue Service Bulletin 2002-2, Jan. 14, 2002 (containing Announcement 2002-2) (available at www.irs.gov/pub/irs-irbs/irb02-02.pdf).

9. See Tigue, John J. and Temkin, Jeremy H., "Tax Shelter Enforcement Efforts," NYLJ, March 18, 2004.

10. 31 CFR §10.35.

11. See "Treasury and IRS Issue Tough New Tax Shelter Rules," Standard Fed. Tax. Rep., Vol. 91, Issue 3, 2004 WLNR 11209996.

12. Son of Boss is a spinoff of an earlier shelter known as Boss, for bond and option sales strategy. Under Son of Boss, buyers used financial products such as currency options to create allegedly bogus losses that offset their gains from selling stock options or business assets. See Iwata, Edward, "IRS Gets \$3.2B in Crackdown on 'Abusive' Tax Shelter," USA Today, March 24, 2005.

13. Press Release, Internal Revenue Service, Robust Response for Executive Stock Option Initiative; Son of Boss Settlement Heading for \$4 Billion (July 11, 2005) (available at <http://www.irs.gov/newsroom/article/0,,id=141014,00.html>).

14. *Id.*

15. See Iwata, Edward, "IRS Gets \$3.2B in Crackdown on 'Abusive' Tax Shelter," USA Today, March 24, 2005.

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