IRS Attacks the Dirty Dozen in 2022: Lessons from Extreme Enforcement

by

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ABOUT THE SPEAKER

Hale E. Sheppard is a shareholder in the Tax Controversy Section and Chair of the International Tax Section of Chamberlain Hrdlicka in Atlanta. Hale defends individuals and businesses during tax audits, tax appeals, and Tax Court litigation.

Recent Cases. Hale has participated in over 150 cases with the Tax Court. His reported cases include *Landow v. Commissioner*, T.C. Memo 2011-177, *Virginia Historic Tax Credit Fund v. Commissioner*, T.C. Memo 2009-295, *rev'd* 639 F.3d 129 (4th Cir. 2011), *Heartland Automotive Enterprises, Inc. v. United States*, 10 AFTR 2d 2009-2406 (M.D. Ga 2009), *Topping v. Commissioner*, T.C. Memo 2007-92, and *Vines v. Commissioner*, 126 T.C. 279.

Recent Rulings. In addition to resolving issues through Tax Court litigation, Hale has obtained dozens of favorable determinations from the IRS National Office on procedural, tax, and international issues. These include Private Letter Rulings 129360-19, 119920-19, 101685-19, 107887-17, 107272-17, 107273-17, 101616-17, 137767-16, 131079-14, 201408003, 201338014, 201309001, 201308003, 201242004, 201210009, 201131017, 201002030 and 200751012.

Education. Hale holds five college degrees. At the University of Kansas, he earned a B.S., with distinction, M.A., with honors, and J.D. He later received an LL.M. degree in international law, with highest distinction, from the Universidad de Chile. Finally, he obtained an LL.M. degree in tax from the University of Florida, where he was a graduate tax scholar.

Awards and Recognitions. During his studies, Hale received several awards for academic excellence, including the prestigious Harry S. Truman Foundation Scholarship, Janice Dawson Quinn Tax Scholarship, Tinker Foundation Scholarship, and Senator James B. Pearson International Fellowship. Hale also served as a graduate editor of the Florida Tax Review and member of the Kansas Journal of Law & Public Policy. Hale has been recognized as a leader in tax litigation for many years by Chambers USA and other respected organizations. He has also been inducted into the American College of Tax Counsel.

Publications. Hale ranks among the most active tax writers in the country. He has published over 200 articles in some of the nation's top tax journals, including Journal of Taxation, International Tax Journal, The Tax Adviser, Journal of International Taxation, Journal of Tax Practice and Procedure, Taxes Magazine, Practical Tax Lawyer, Journal of Passthrough Entities, Tax Management International Journal, Journal of Multi-State Tax & Incentives, Tax Notes International, Taxation of Exempts, Practical Tax Strategies, Corporate Business Taxation, and Journal of Real Estate Taxation. He has also published major articles in more than 20 university law reviews, both in the United States and Latin America.

Activities and Affiliations. Hale has held leadership positions in many professional and civic organizations, including: (i) Journal of Taxation, former Editorial Board Member and tax columnist, (ii) IRS-Practitioner Liaison Committee, state bar representative, (iii) Journal of Tax Practice & Procedure, Editorial Board Member, (iv) Georgia Bar Tax Section, former President, (v) Georgia Bar Journal, former Editorial Board Member, (vi) GSU Low-Income Taxpayer Clinic, Advisory Committee Member, and (vii) Atlanta Bar Tax Section Board Member.

TABLE OF CONTENTS

I. **INTRODUCTION** ... 6

A. Mounting and Diverse Enforcement Actions ... 6

II. **OVERVIEW OF EASEMENT DONATIONS** ... 6

A. Initial Observations ... 6
B. Common Options for Undeveloped Land ... 6
C. Conservation Purposes ... 7
D. Reserved Rights ... 7
E. Baseline Report ... 8
F. Value of Easement Donations ... 8
G. Documenting the Donation ... 9

III. **LEGISLATIVE ACTIONS** ... 10

A. Congressional Support for over 50 Years ... 10
B. Recurrent Warnings by the IRS ... 10
C. Bipartisan Support Recognized ... 11

IV. **SPECIALIZED ENFORCEMENT ACTIONS** ... 11

A. Introduction ... 11
B. Labeling Donations “Listed Transactions” ... 12
C. Implementing a Compliance Campaign ... 12
D. Attacking “Technical” Flaws, Not Valuation ... 12
E. Predetermined and Vague Conclusions ... 13
F. Attempts to Enjoin Activities ... 14
G. Name Calling ... 14
H. Congressional Inquiry ... 14
I. Pursuing Supposed “Promoters” ... 14
J. Searching for Fraud ... 15
K. Swifter Summonses ... 15
L. Neglecting the Facts ... 16
M. Revoking Procedural Protections for Appraisers ... 16
N. Challenging Qualified Offers ... 17
O. Attacking “Substantially Similar” Transactions ... 18
P. Lack of Sample Deed Language ... 19
Q. Criminal Penalties for Ignoring Summonses ... 20
R. Inappropriate Third Party Contacts ... 20

S. Further Revoking Procedural Protections for Appraisers ... 22

V. INTERNATIONAL PENALTY STACKING ... 22

A. Background ... 22
B. First Stacking Case – One Individual Plays Two Roles ... 23
C. Second Stacking Case – Multiple Penalties Linked to Same Event ... 24

VI. THREE CASES, THREE PROCEEDINGS, THREE LIABILITIES ... 26

A. Introduction ... 26
B. Key Facts ... 27
C. First Fight - Form 5471 Penalty Litigation in Tax Court ... 28
D. Second Fight – FBAR Penalty Litigation in District Court ... 28
E. Third Fight – Federal Income Tax Litigation in Tax Court ... 29

VII. ONGOING INTERNATIONAL DISCLOSURE PROGRAMS ... 29

A. Why Are Taxpayers Still Approaching the IRS? ... 29
B. Voluntary Disclosure Programs over the Years ... 30
C. Challenges of Participating Now ... 30

VIII. FIGHTS OVER SECA TAXES AND PASS-THROUGH ENTITIES ... 32

A. SECA – Components and Magnitude ... 32
B. Exclusion for Limited Partners ... 32

IX. THE LONG ROAD TO CHAOS ... 32

A. SECA Taxes Start in 1950 ... 33
B. Limited Partner Exception Appears in 1977 ... 33
C. First Proposed Regulations in 1994 ... 35
D. Second Proposed Regulations in 1997 ... 36
E. Congress Imposes a Moratorium in 1997 ... 38
F. Various Groups Offer Proposals from 1998 to 2005 ... 38
G. IRS Gives Taxpayers Hope in 2003 ... 39
H. IRS Rulings and Courts Cases ... 39
I. IRS Gives Taxpayers More Hope in 2011 ... 44
J. Compliance Campaign in 2018 ... 44
K. Concept Unit in 2019 ... 44
L. Removal from List of Priorities in 2019 ... 45
M. Administration Urges Congressional Action in 2021 ... 46
N. IRS Threatens More Litigation in 2021 ... 46

O. Summary of Steps in the Journey to Chaos 46

X. PENDING TAX COURT CASE 48

A. Initial Remarks 48
B. Just the Facts, Ma'am 49
C. Summary Judgment Motion and Opposition 49
D. Arguments by the IRS 50
E. Conclusion 51

I. Introduction

A. Mounting and Diverse Enforcement Actions

1. Listed Transaction Notices
2. Transaction-of-Interest Notices
3. Annual "Dirty Dozen" list
4. Compliance Campaigns
5. Practice Units
6. Creation of Fraud Enforcement Office
7. Appointment of Promoter Investigations Coordinator
8. Formation of Joint Strategic Emerging Issues Team
9. Multi-billion dollar funding by Congress

II. Overview of Easement Donations

A. Initial Observations

1. There is so much hyperbole, distortion, chest-thumping and other "noise" surrounding conservation easement disputes it is difficult to get to the truth.
2. Most people agree on at least a few things, though.
    a. Congress has expressly incentivized donations of real property interests to charity for over 50 years,
    b. Increasing numbers of taxpayers have pooled their interests to utilize this tax benefit,
    c. The IRS believes that some taxpayers are exploiting the system, and
    d. The IRS has implemented a long list of tactics to challenge what it calls syndicated conservation easement transactions ("SCETs").
3. There is considerable disagreement about whether the IRS's actions have gone too far, undermining congressional intent and public confidence.

B. Common Options for Undeveloped Land

1. Taxpayers with undeveloped real property have several choices, including:

a. holding the property for investment, selling it when it appreciates,

b. determining how to maximize profitability from the property and do that, regardless of negative effects on the local environment, community, or economy, or

c. voluntarily restricting certain future uses of the property, such that it is protected forever for the benefit of society. This option, known as donating a "conservation easement," not only achieves the goal of environmental protection, but might also trigger another benefit, tax deductions for donors.[1]

C. Conservation Purposes

1. Taxpayers cannot donate an easement on any old property and claim a tax deduction; they must demonstrate that the property is worth protecting.

2. A donation has an acceptable "conservation purpose" if it meets at least one of the following requirements:

a. It preserves land for outdoor recreation by, or the education of, the general public;

b. It preserves a relatively natural habitat of fish, wildlife, or plants, or a similar ecosystem;

c. It preserves open space (including farmland and forest land) for the scenic enjoyment of the general public and will yield a significant public benefit;

d. It preserves open space (including farmland and forest land) pursuant to a federal, state, or local governmental conservation policy and will yield a significant public benefit; or

e. It preserves historically important land area or a certified structure.[2]

D. Reserved Rights

1. Taxpayers memorialize the donation to charity by filing a Deed of Conservation Easement ("Deed") or similar document.

2. In preparing the Deed, taxpayers often coordinate with the land trust to identify limited activities that can continue on the property *after* the

[1] Section 170(f)(3)(B)(iii); Treas. Reg. § 1.170A-7(a)(5); Section 170(h)(1); Section 170(h)(2); Treas. Reg. § 1.170A–14(a); Treas. Reg. § 1.170A–14(b)(2).
[2] Section 170(h)(4)(A); Treas. Reg. § 170A–14(d)(1); S. Rept. 96–1007, at 10 (1980).

donation, without interfering with the Deed, prejudicing conservation purposes, or jeopardizing tax deductions.[3] These are "Reserved Rights."

E. Baseline Report

1. The IRS will not allow the tax deduction stemming from a conservation easement, unless the taxpayer obtains, before making the donation, "documentation sufficient to establish the condition of the property at the time of the gift."[4] This is called the "Baseline Report."

F. Value of Easement Donations

1. The value of the conservation easement is the fair market value ("FMV") of the property at the time of the donation.[5]

2. FMV ordinarily means the price on which a willing buyer and willing seller would agree, if neither party were obligated to participate in the transaction, and if both parties had reasonable knowledge of the relevant facts.[6]

3. The best evidence of the FMV of an easement would be the sale price of other easements that are comparable in size, location, etc. The IRS recognizes, though, that it is difficult, if not impossible, to find comparable sales of properties encumbered by easements.[7]

4. Consequently, appraisers often must use the before-and-after method instead. This means that an appraiser must determine the highest and best use ("HBU") of the property *and* the corresponding FMV twice.

   a. First, the appraiser calculates the FMV as if the property were put to its HBU, which generates the "before" value.

   b. Second, the appraiser identifies the FMV, taking into account the restrictions on the property imposed by the conservation easement, which creates the "after" value.[8]

   c. The difference between the "before" value and "after" value of the property, with certain adjustments, produces the donation's value.

5. A property's HBU is the most profitable use for which it is adaptable and needed in the reasonably near future.[9]

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[3] Treas. Reg. § 1.170A-14(b)(2).
[4] Treas. Reg. § 1.170A-14(g)(5)(i).
[5] Section 170(a)(1); Treas. Reg. § 1.170A-1(c)(1).
[6] Treas. Reg. § 1.170A-1(c)(2).
[7] Internal Revenue Service. Conservation Easement Audit Techniques Guide (11/4/2016), pg. 41.
[8] Internal Revenue Service. Conservation Easement Audit Techniques Guide (11/4/2016), pg. 41.
[9] *Olson v. United States*, 292 U.S. 246, 255 (1934).

a. HBU also means the use of property that is physically possible, legally permissible, and financially feasible.[10]

b. Valuation in the easement context does *not* depend on whether the owner has actually put the property to its HBU in the past.[11]

c. The HBU can be *any* realistic potential use of the property.[12]

d. Common HBUs are construction of a residential neighborhood, active retirement community, or mixed-use development, mineral mining, or solar energy farming.

G. Documenting the Donation

1. Properly claiming the tax deduction from an easement donation is surprisingly complicated.

2. Among other things, taxpayers/donors must:

a. obtain a "qualified appraisal,"

b. from a "qualified appraiser,"

c. demonstrate that the land trust is a "qualified organization,"

d. obtain a Baseline Report describing the condition of the property at the time of the donation and why it is worthy of protection,

e. complete a Form 8283 (Noncash Charitable Contributions) and have it executed by all relevant parties,

f. assuming that the taxpayer is a partnership, file a timely Form 1065 (U.S. Return of Partnership Income), enclosing Form 8283 and the qualified appraisal,

g. complete a Form 8886 (Reportable Transaction Disclosure Statement), enclose it with Form 1065, and send a copy to the Office of Tax Shelter Analysis,

h. complete a Form 8918 (Material Advisor Disclosure Statement) and timely send it to the Office of Tax Shelter Analysis, and

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[10] *Esgar Corp. v. Commissioner*, 744 F.3d 648, 659 n.10 (10th Cir. 2014).
[11] *Esgar Corp. v. Commissioner*, 744 F.3d 648, 657 (10th Cir. 2014).
[12] *Symington v. Commissioner*, 87 T.C. 892, 896 (1986).

i. receive from the land trust a "contemporaneous written acknowledgement," for the easement and for any stewardship amount donated to finance perpetual protection of the property.[13]

III. Legislative Actions

A. Congressional Support for over 50 Years

1. Congress has generally recognized the deductibility of a partial interest in real property since 1969.[14]

2. In 1980, Congress enacted Section 170(h), thereby allowing landowners to claim a tax deduction for the donation of conservation easements.[15]

    a. Section 170(h) has been modified and enhanced several. For instance, in 2006, Congress made the deduction even more appealing by allowing taxpayers to deduct up to 50 percent of their adjusted gross incomes (instead of 30 percent) and to carry forward unused deductions for up to 15 years (instead of five years).[16]

    b. Congress later extended these enhanced benefits several times, from 2008 through 2014.[17] It made them permanent in 2015.[18]

B. Recurrent Warnings by the IRS

1. The IRS has cautioned Congress every step of the way about potential abuses in the conservation easement context.

2. For instance, the Treasury Department urged Congress not to be hasty in enacting Section 170(h) in 1980, urging it to postpone approval of

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[13] *See* Internal Revenue Service. Conservation Easement Audit Techniques Guide (11/4/2016), pgs. 24-30; IRS Publication 1771, Charitable Contributions – Substantiation and Disclosure Requirements; IRS Publication 526, Charitable Contributions; Section 170(f)(8); Section 170(f)(11); Treas. Reg. § 1.170A-13; Notice 2006-96; TD 9836.

[14] Tax Reform Act of 1969, Public Law No. 91-17, Section 201 (1969); U. S. House of Representatives, Tax Reform Act of 1969, 91st Congress, 1st Session, Report No. 91-782 (Dec. 21, 1969); *See also* Tax Reform Act of 1976, Public Law No. 94-455, Section 2124(e) (1976); *See also* Tax Reduction and Simplification Act of 1977, Public Law No. 95-30, Section 309 (1977).

[15] Tax Treatment Extension Act, Public Law No. 96-541, Section 6(a) (1980); U.S. Senate, Tax Treatment Extension Action of 1980, 96th Congress, 2d Session, Report No. 96-1007 (Sept. 30, 1980).

[16] Pension Protection Act, Public Law No. 109-280, Sections 1206 and 1219.

[17] Food, Conservation, and Energy Act, Public Law No. 110-246, Section 15302 (2008); Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act, Public Law No. 111-312, Section 723 (2010); American Taxpayer Relief Act, Public Law No. 112-240, Section 206 (2013); Tax Increase Prevention Act, Public Law No. 113-295, Section 106 (2014).

[18] Protecting Americans from Tax Hikes Acts, Public Law No. 114-113, Section 111 (2015).

conservation easement donation deductions to allow for more analysis. Congress rejected that notion on the following grounds:

a. "Although we appreciate the Treasury's position, and its wish for more time, *we wish to note that conservation easements have been in existence for over fifteen years, and apparently no major abuses have come to light during that interval which would be sufficient to suggest that the Congress should abandon the use of the federal income tax laws to encourage donations of partial interests in real property for conservation and preservation purposes*."[19]

3. Similarly, shortly before the enhancement of Section 170(h) in 2006, a high-ranking IRS official stated the following at a Senate hearing:

a. "Conservation easements are becoming a matter of greater concern and attention at the [IRS]. From a practical point of view, we are primarily concerned about two aspects: first, whether the easements are being created exclusively for conservation purposes; second, whether the appraisals that determine the value of the deduction are reasonable as opposed to fanciful and inflated."[20]

C. Bipartisan Support Recognized

1. Congress has steadily championed conservation easements and the corresponding tax benefits, despite its full awareness of potential valuation and other challenges.

2. Indeed, even a recent report by the Senate Finance Committee, which was critical of SCETs, acknowledged that "the conservation-easement tax incentive . . . has enjoyed broad bipartisan support."[21]

IV. Specialized Enforcement Actions

A. Introduction

1. Notwithstanding the backing by Congress described above, the IRS and Department of Justice ("DOJ") have attacked partnerships involved in SCETs or substantially similar transactions ("SSTs") the past several years.

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[19] U.S. House of Representatives, Committee on Ways and Means, Subcommittee on Select Revenue Measures, Hearing, 96th Congress, 1st Session, Report Serial No. 96-55 (Nov. 9, 1979), pg. 83.
[20] U.S. Senate, Committee on Finance, "The Tax Code and Land Conservation: Report on Investigations and Proposals for Reform," June 8, 2005, Tax Notes Doc. 2005-13563 (statement by Steven T. Miller).
[21] U.S. Senate, Committee on Finance. Syndicated Conservation Easement Transactions, 116th Cong., 2nd Session, Senate Report 116-44 (August 2020), pg. 1; *See also* Conservation Easement Incentive Act of 2015, Senate 330, 114th Cong,; Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 2015, JCS-1-16 (March 2016).

B. Labeling Donations "Listed Transactions"

1. The IRS issued Notice 2017-10 in December 2016, labeling SCETs and SSTs as "listed transactions."[22]

2. This triggered the need for various parties to file Forms 8886 and Forms 8918, providing the IRS details it could utilize in its enforcement activities.

3. This also created possible penalties and methods of keeping the assessment-period open.

C. Implementing a Compliance Campaign

1. The IRS launched a "compliance campaign" centered on SCETs and SSTs, devoting dozens of specialized IRS personnel to the cause.

D. Attacking "Technical" Flaws, Not Valuation

1. The IRS has consistently stated that the main problem with SCETs and SSTs is inflated valuations.

2. However, the IRS's primary focus in tax disputes thus far has been on "technical" flaws; that is, supposed problems with the Deed, Baseline Report, Qualified Appraisal, Form 8283, or other documents affiliated with conservation easement donations.

3. Below is a partial list of the technical challenges pursued by the IRS:[23]

   a. The donation of the easement lacked charitable intent, because there was some form of *quid pro quo* between the partnership and the charitable organization;

   b. The donation of the easement was conditioned on receipt by the partnership of the full tax deduction claimed on its Form 1065;

   c. The land trust failed to issue a "contemporaneous written acknowledgement" letter;

   d. The appraisal was not attached to the Form 1065;

   e. The appraisal was not prepared in accordance with the Uniform Standards of Professional Appraisal Practice;

   f. The appraisal fee was based on a percentage of the easement value;

[22] IRS Notice 2017-10, 2017-4 Internal Revenue Bulletin 544 (Dec. 23, 2016).
[23] Internal Revenue Service. Conservation Easement Audit Techniques Guide. (Rev. 11/4/2016).

g. The appraisal was not timely because it was not sufficiently proximate to making the donation or filing the Form 1065;

h. The appraisal was not a "qualified appraisal;"

i. The appraiser was not a "qualified appraiser;"

j. The Form 8283 was missing, incomplete, or inaccurate;

k. Not all appraisers who participated signed Form 8283;

l. The "basis" calculation on Form 8283 was inaccurate;

m. The Baseline Report insufficiently described the property;

n. The conservation easement was not "granted" in perpetuity;

o. The conservation easement was not "protected" in perpetuity;

p. Any mortgages or other encumbrances on the property were not satisfied or subordinated to the easement before the donation;

q. The Deed contains an improper clause regarding how the proceeds from a forced sale of the property upon extinguishment of the easement would be allocated;

r. The Deed contains an amendment clause, which, in theory, might allow the parties to modify the donation, after taking the tax deduction, in such a way as to undermine the conservation purposes;

s. The Deed was not timely filed with the proper court;

t. The land trust was not a "qualified organization;" and

u. The property lacks acceptable "conservation purposes."

E. Predetermined and Vague Conclusions

1. The IRS has implemented a practice of issuing audit reports and final notices claiming that essentially *all* partnerships that engaged in an SCET or SST should get a charitable deduction of $0 and should be severely penalized, *period*.

2. In issuing FPAAs triggering many years of litigation, the IRS does not specify the factual, legal, or tax reasons for its attacks.

3. In addition to fully disallowing the easement-related deduction based on a combination of alleged technical and valuation issues, the IRS ordinarily proposes several alternative penalties, ranging in severity.

a. These include negligence, substantial understatement of income tax, substantial valuation misstatement, gross valuation misstatement, reportable transaction understatement penalty, or civil fraud.

b. Importantly, there is no "reasonable cause" defense to gross valuation misstatement penalties; they are mathematical in nature.

F. Attempts to Enjoin Activities

1. The DOJ filed a Complaint in District Court seeking a permanent injunction against alleged organizers and appraisers, along with disgorgement of the proceeds that they obtained from their dealings with SCETs or SSTs.[24]

G. Name Calling

1. The IRS featured SCETs and SSTs on its "dirty dozen" list for years.[25]

H. Congressional Inquiry

1. The Senate Finance Committee conducted an inquiry and issued a report in 2020, suggesting that the SCETs and SSTs that it reviewed constituted "abusive tax shelters," understood as such by both organizers and partners.[26]

2. However, the report did not offer any specific recommendations about how to address perceived problems, and it underscored that the Section 170(h) deduction should remain. In this regard, the report explained that the Senate Finance Committee believes that Congress, the IRS, and Treasury Department "should take further action to preserve the integrity of the conservation-easement tax deduction."

I. Pursuing Supposed "Promoters"

1. The IRS appointed a new "Promoter Investigations Coordinator," who is in charge of coordinating with the Civil Division, Criminal Investigation Division, Chief Counsel, and the Office of Professional Responsibility ("OPR") to develop promoter enforcement.[27]

2. The IRS can assert severe "promoter penalties" against people falling into various categories, namely, any person who:

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[24] *United States v. Nancy Zak, Claud Clark, EcoVest Capital Inc., Alan N. Solon, Robert M. McCullough, and Ralph R. Teal*, Case No. 1:18-cv-05774, D.C. N.D. Ga, Compliant filed Dec. 18, 2018.
[25] *See, e.g.,* IR-2019-47 (March 19, 2019).
[26] U.S. Senate, Committee on Finance. Syndicated Conservation Easement Transactions, 116th Cong., 2nd Session, Senate Report 116-44 (August 2020), pg. 105.
[27] Kristen A. Parillo. "IRS Assigns Point Person on Promoter Investigations," Federal Tax Notes Today Doc. 2020-6890 (Feb. 25, 2020).

a. organizes, or assists in organizing, a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement,

b. participates directly or indirectly in the sale of ownership interests in any such entity, plan, or arrangement,

c. makes or furnishes, or causes another to make or furnish, a statement regarding the allowability of any deduction or credit, the excludability of any income, or the attainment of any other tax benefit by a taxpayer, *and* actually knows, or has reason to know, that such statement is materially false or fraudulent, or

d. makes or furnishes, or causes another to make or furnish, a "gross valuation overstatement."[28]

3. The IRS has recently initiated various "promoter investigations" of persons who organized partnerships that engaged in SCETs or SSTs.

J. Searching for Fraud

1. In March 2020, the IRS formed the new "Fraud Enforcement Office," whose leader will work with the new "Promoter Investigations Coordinator" described in the preceding segment.[29]

2. The DOJ has made allegations of fraudulent activity in its Complaint, mentioned above, seeking a permanent injunction of certain easement-related activities.[30] The IRS attorneys have made similar allegations in several Tax Court cases recently.

K. Swifter Summonses

1. The IRS issued a memo in 2020 containing important changes to the audit process involving "listed transactions," such as SCETs and SSTs.[31]

2. The normal Information Document Request ("IDR") enforcement process features "three graduated steps." Revenue Agents:

a. first issue a Delinquency Notice,

b. followed by a Pre-Summons Letter, and

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[28] Section 6700.
[29] IRS News Release IR-2020-49 (March 5, 2020).
[30] *United States v. Nancy Zak, Claud Clark, EcoVest Capital Inc., Alan N. Solon, Robert M. McCullough, and Ralph R. Teal*, Case No. 1:18-cv-05774, D.C. N.D. Ga, Compliant filed Dec. 18, 2018.
[31] Tax Notes Doc. 2020-7524 (Feb. 25, 2020), consisting of LB&I-04-0220-004.

c. ultimately, a Summons.[32]

3. The multi-layer process was "mandatory and has no exceptions."[33]

4. The IRS streamlined matters in the context of SCETs and SSTs by eliminating the three-step process. Thanks to the recent IRS legal memo, the previous "mandatory" process is no longer required; Revenue Agents will now adhere to swifter Summons procedures.[34]

5. Doubling down on this mindset, the IRS issued another legal memo in 2020, with guidance about the use of Summonses in the context of SCETs.[35] It instructs audit personnel to "use all available administrative tools," promptly issue Summonses, and if full compliance does not ensue, initiate Summons enforcement in the courts.

L. Neglecting the Facts

1. Revenue Agents have traditionally issued taxpayers an acknowledgement-of-facts IDR at the end of the audit process.

2. The purpose was to ensure that both the taxpayers and the IRS agreed on the key facts, such that the dispute, when elevated to the Appeals Office and/or Tax Court, could focus largely or solely on legal/tax issues.[36]

3. The IRS has underscored the benefits of the acknowledgement-of-facts IDR for years, suggesting that it facilitates resolution of issues during the audit phase, saves resources on both sides, avoids Appeals Officers referring cases back to Revenue Agents for further development, and allows the IRS to prepare the most comprehensive audit reports and FPAAs possible.[37]

4. The IRS changed its tune in 2020, when it issued a legal memo dictating that Revenue Agents who audit "listed transactions," like SCETs and SSTs, are not required to send taxpayers acknowledgement-of-facts IDRs.[38]

M. Revoking Procedural Protections for Appraisers

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[32] IRM § 4.46.4.6.3 (12-13-2018) and IRM Exhibit 4.46.4-2.
[33] IRM Exhibit 4.46.4-2.
[34] Tax Notes Doc. 2020-7524 (Feb. 25, 2020), consisting of LB&I-04-0220-004.
[35] Frederic Lee, "IRS Emphasizes Summons Power in Conservation Easement Cases," 2020 Tax Notes Today Federal 222-3 (Nov. 17, 2020).
[36] IRM § 4.46.4.2 (12-13-2018) and IRM § 4.46.4.10 (12-13-2018).
[37] IRM § 4.46.4.10 (12-13-2018); IRS Publication 5125 (Large Business & International Examination Process) (2-2016).
[38] Tax Notes Doc. 2020-7524 (Feb. 25, 2020), consisting of LB&I-04-0220-004.

1. The Internal Revenue Manual ("IRM") has historically contained a multi-level review process designed to ensure that an appraiser engaged in serious wrongdoing before assessing penalties, making referrals to OPR, etc.[39]

2. The prior procedures required analysis by at least five experienced IRS employees (*i.e.*, the Revenue Agent, Examining Appraiser, Primary Review Appraiser, Secondary Review Appraiser, and Review Manager) before Section 6695A penalties could be assessed.[40]

3. However, the IRS issued a memo in 2020 called "Interim Guidance on IRC 6695A Penalty Case Reviews" ("Interim Guidance") whose purpose was remarkably clear: "Eliminating the multi-tiered review process for IRC 6695A appraiser penalty cases."[41]

4. Under the Interim Guidance, if an Examining Appraiser determines a gross valuation misstatement while, say, auditing an SCET, he simply needs to obtain written approval from his immediate supervisor and then notify the Revenue Agent that the Section 6695A penalty might apply.

5. In summary, the prior procedures required input by at least five experienced IRS employees before seeking Section 6695A penalties, whereas the Interim Guidance contemplates that a Revenue Agent, who likely has no training or education whatsoever in the field of valuation, make this decision alone, or with input from just one Examining Appraiser.

N. Challenging Qualified Offers

1. Section 7430 generally provides that the "prevailing party" in any administrative proceeding or litigation with the IRS in connection with the determination, collection, or refund of any tax, penalty, or interest may be awarded reasonable administrative and/or litigation costs.

2. There is a lesser known way for taxpayers to obligate the government to pay: making a "qualified offer."

3. If the IRS ignores or rejects a qualified offer, the case goes to trial, and the court rules that the taxpayer's liability is equal to or less than the amount in the earlier qualified offer, then the IRS must reimburse the taxpayer's reasonable administrative and/or litigation costs.[42]

[39] IRM § 20.1.12.7 (12-18-2017).
[40] IRM § 20.1.12.7.4 (12-18-2017).
[41] Tax Notes Doc. 2020-3440 (Jan. 22, 2020), consisting of LB&I-20-0120-001.
[42] Section 7430(c)(4)(E)(i); Treas. Reg. § 301.7430-7(a); Treas. Reg. § 301.7430-7(b)(1).

4. Only two cases have addressed whether partnerships subject to the TEFRA proceedings are able to make qualified offers.[43] Just one of these cases yielded a decision with precedential value, and it explained that TEFRA partnerships *are entitled* to file qualified offers.[44]

5. Nevertheless, the IRS seems entrenched in its traditional position, arguing that TEFRA partnerships are ineligible to file qualified offers, period.[45]

O. Attacking "Substantially Similar" Transactions

1. The issuance of Notice 2017-10 identifying SCETs as "listed transactions" triggered the need for participants in SCETs to file Forms 8886 and for materials advisors to file Forms 8918.

2. These duties apply to SCETs *and* SSTs.

3. Some taxpayers are seeking ways to arrange matters to accomplish their goals, while not being considered "substantially similar" to an SCET. The IRS is countering by broadly construing this concept.

4. Concept of SSTs

a. The term SST broadly encompasses any transaction that is expected to obtain the same or similar types of tax consequences, and that is either factually similar or based on a similar tax strategy.[46]

b. The regulations state the following:

i. The term "substantially similar" must be broadly construed in favor of making disclosures to the IRS;

ii. Receipt of a tax/legal opinion regarding the tax consequences of a transaction is not relevant to the issue of whether such transaction is the same as or substantially similar to another transaction; and

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[43] *BASR Partnership v. United States*, 130 Fed. Cl. 286 (2017), 119 AFTR 2d 2017-614; *BASR Partnership v. United States*, 915 F.3d 771 (Fed. Cir. 2019); *Hurford Investments No. 2, Ltd. v. Commissioner*, Docket No. 23017-11, Tax Court Order, 12/21/18; *Hurford Investments No. 2. Ltd. v. Commissioner*, Tax Court Docket No. 23017-11, Order dated September 11, 2019.

[44] *See* Hale E. Sheppard, "Partnerships, Qualified Offers, and Conservation Easement Disputes: Analyzing Problems with the IRS's Positions, Now and Later," 22(4) *JOURNAL OF TAX PRACTICE & PROCEDURE* 33 (2020).

[45] *Little Horse Creek Property, LLC v. Commissioner*, Tax Court Docket No. 7421-19.

[46] Treas. Reg. § 301.6011-4(c)(4).

iii. A transaction may be substantially similar to a listed transaction, even though it involves different entities and/or applies different provisions of the tax code.[47]

c. The regulations contain the examples demonstrating how liberally the IRS will interpret the notion of substantially similar:

i. "Notice 2000-44 . . . sets forth a listed transaction involving offsetting options transferred to a partnership where the taxpayer claims basis in the partnership for the cost of the purchased options but does not adjust basis under Section 752 as a result of the partnership's assumption of the taxpayer's obligation with respect to the options. *Transactions using short sales, futures, derivatives or any other type of offsetting obligations to inflate basis in a partnership interest would be the same as or substantially similar to the transaction described in Notice 2000-44. Moreover, use of the inflated basis in the partnership interest to diminish gain that would otherwise be recognized on the transfer of a partnership asset would also be the same as or substantially similar to the transaction described in Notice 2000-44*."[48]

P. <u>Lack of Sample Deed Language</u>

1. Various parties have asked the IRS to issue "model language" to utilize in their Deeds to avoid triggering unintentional "technical" flaws, unrelated to conservation purposes, and unrelated to the value of the donation.[49]

2. One such party is the National Taxpayer Advocate. It made the following recommendation: "Develop and publish guidance to provide safe harbors and/or sample easement provisions to provide taxpayers with examples of how they may construct a conservation easement deed that satisfies the statutory requirements and prevent unnecessary litigation."[50]

3. The official response by the IRS was that it shares the goal of preventing unnecessary litigation by making it easier for taxpayers to prepare Deeds that comply with applicable law and regulations, the IRS is in the process of drafting sample clauses, but the IRS has not yet published any guidance because of "other workload priorities."[51]

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[47] Treas. Reg. § 301.6011-4(c)(4).
[48] Treas. Reg. § 301.6011-4(c)(4) Example 1.
[49] Kristen A. Parillo. "Yellen and Rettig Asked to Clarify Easement Rules," 2021 Tax Notes Today Federal 15-7 (Jan. 25, 2021).
[50] National Taxpayer Advocate. Annual Report to Congress (2019), pg. 203.
[51] National Taxpayer Advocate. Annual Report to Congress (2019), Appendix 1, pgs. 194-195.

Q. Criminal Penalties for Ignoring Summonses

1. The most common tool used by the IRS to gather data is the IDR. The IRS has other avenues, too, including Summonses.

2. If the recipient of a Summons fails to respond adequately, the IRS has several options, including asking the court to enforce the Summons.[52]

3. In the context of SCETs, though, the IRS has taken an extreme position. It has threatened to *criminally* charge those whose fail to obey a Summons.

4. An obscure tax provision states that any person to whom the IRS issues a Summons and who fails to appear to testify and/or provide the requested materials can be convicted of a crime, fined as much as $1,000, and imprisoned for up to one year.[53]

5. A DOJ attorney stated that this instrument is "underused," often "stacked" with other penalties, does not require "willful" actions or inactions by the person charged, and should be "taken to heart" by the public.[54]

6. These type of admonitions are noteworthy because they directly contradict IRS guidance to its own personnel. For instance, the IRS acknowledges that potential criminal prosecution is a "powerful tool" to compel compliance, but cautions that using it often backfires.[55]

    a. According to the IRM, a criminal action "does *not* accomplish the primary purpose of the Summons, namely, obtaining the needed information, because any proceedings to enforce the Summons would be held in abeyance pending the outcome of the criminal proceedings."[56]

R. Inappropriate Third Party Contacts

1. Getting audited is bad enough, but having the IRS tell friends, colleagues, employers, clients and others about it might be far worse. The mere fact that the IRS is auditing someone can cause serious reputational, business, and financial damage to the person under scrutiny.

2. The IRS enjoys broad powers in doing its job. For instance, the IRS can examine any books, records or other data that might be relevant or material.

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[52] Section 7604.
[53] Section 7210.
[54] Nathan J. Richman. "Prosecutor is Looking for More Tax Summons Criminal Charges," 2021 Tax Notes Today Federal 18-4 (Jan. 28, 2021).
[55] IRM § 5.17.6.21 (12-11-2007).
[56] IRM § 5.17.6.21 (12-11-2007) (emphasis added).

It can also issue Summonses to taxpayers, persons in possession, custody or control of data, and "any other person that the [IRS] may deem proper."[57]

a. The IRS often seeks information from persons *other than* the taxpayer; this is called making third party contacts ("TPCs").

3. Broad powers often result in abuse. This is what came to light in the late 1990's, which led Congress to enact the IRS Restructuring and Reform Act. That law introduced limitations on TPCs. The legislative history contained the following rationale for imposing new restrictions:

a. "[T]he [Senate Finance] Committee believes that *taxpayers should have the opportunity to resolve issues and volunteer information before the IRS contacts third parties*."[58]

4. Consistent with the legislative history, the IRM emphasizes that Revenue Agents should not utilize TPCs as a primary auditing tool, but rather they should first grant the taxpayer a chance to supply the relevant data. The IRM makes this clear in several places:

a. "[Revenue Agents are directed] to give notice to taxpayers, allowing them an opportunity to provide the information, *before* disclosing to a third party that the taxpayer is the subject of an [IRS] action."[59]

b. "The intent behind this statute is to provide the taxpayer, in most cases, with the opportunity to produce the information and documents requested *before* the IRS must obtain the information from third parties."[60]

5. Certain Revenue Agents auditing SCETs ignore the guidance about TPCs from Congress, IRS publications, and the courts. Specifically, in response to written requests for data about TPCs, some Revenue Agents have:

a. refused to respond on grounds that taxpayers supposedly can only make requests every 90 days,

b. suggested that a request is void if it asks for any information beyond just the names of those receiving TPCs,

c. indicated that the IRS does not need to first seek data from the partnership before making TPCs, and/or

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[57] Section 7602(a); Treas. Reg. § 301.7602-1(a).
[58] U.S Senate, Committee on Finance. Internal Revenue Service Restructuring and Reform Act of 1998. 105th Congress, 2nd Session, Report 105-174 (April 22, 1998), pg. 77.
[59] IRM § 4.11.57.1 (5-26-2017) (emphasis added).
[60] IRM § 4.11.57.2 (5-26-2017) (emphasis added).

d. threatened to refer representatives of the partnerships to the OPR for doing nothing more than seeking data about TPCs.

S. Further Revoking Procedural Protections for Appraisers

1. As explained above, the IRS first revoked procedural protections of appraisers when it issued the Interim Guidance Memo in 2020. This triggered complaints, comments and concerns.

2. IRS Doubles Down - CCA in July 2021

a. The question presented in CCA 202129909 was whether a Revenue Agent could assess a Section 6695A penalty against an appraiser, *without* sending a Letter 4477 notifying him that he was under examination, *without* submitting to the appraiser even one IDR, and *without* conducting an interview of the appraiser.

b. The language in the CCA strongly implies that the Revenue Agent consulted the relevant portions of the IRM, and was trying to gauge whether he must obey them.

c. Advice from IRS attorney

i. The CCA begins by telling the Revenue Agent that "the IRM is *not* legally binding on the IRS."

ii. The CCA continues by explaining that there is no case law or other guidance on point, but the IRS's position is that, while "it may be a good policy decision" to take the three actions before assessing the Section 6695A penalty, "the IRS is not legally required" to do so.

iii. The CCA also reasons that the more-likely-than-not exception to penalties, rooted in Section 6695A(c), is merely a defense that an appraiser can raise *after* being sanctioned, but it is "not a prerequisite to assessing it" in the first place.

iv. The CCA concludes that as long as the Revenue Agent can establish the evidence necessary to meet the criteria in Section 6695A, then he can assess the penalty, *without* warning or directly engaging with the appraiser.

d. The CCA seems to evoke a new motto for the IRS when it comes to appraisers: no notice, no examination, no problem.

V. International Penalty Stacking

A. Background

1. The IRS has been aggressively targeting international tax non-compliance in recent years. In punishing this conduct, the IRS has used "stacking" of penalties in two different ways.

B. First Stacking Case – One Individual Plays Two Roles

1. *Wilson v. United States* addresses penalty stacking in situations where one U.S. person plays two roles with respect to a foreign trust.[61]

2. Relevant Facts

a. The taxpayer, in anticipation of a divorce action, formed the Perfect Partner Trust ("PPT") in 2003. He was both the grantor and sole beneficiary, which is the key to this case. PPT held accounts in two foreign countries.

b. The divorce began in 2004 and concluded around 2007. With no further need for holding assets abroad, the taxpayer terminated PPT in 2007 and had all funds wire-transferred back to domestic accounts. The funds had grown to around $9.2 million by then.

c. The IRS began an audit and eventually assessed a penalty of approximately $3.2 million on the following building blocks.

i. The taxpayer was the "beneficiary" of PPT and he received a distribution in 2007 (*i.e.*, the wire-transfer when he terminated PPT). As a beneficiary, he had to file a timely, accurate, complete 2007 Form 3520. Because he failed to do so, the penalty was 35 percent of the total distribution.

ii. In situations where the taxpayer is both an owner *and* a beneficiary of a foreign trust, and the taxpayer fails to file Form 3520 *and* Form 3520-A, the IRS can assess one penalty for 35 percent of the gross reportable amount under Section 6048(c) *and/or* one for five percent under Section 6048(b). The IRS chose the higher penalty, logically.

d. The taxpayer disagreed with the penalty, but he paid it anyway. He then filed a timely Claim for Refund. The IRS ignored him, so he later filed a Suit for Refund with the District Court.

3. Analysis by the District Court – Taxpayer Victory

[61] *Wilson v. United States*, 124 AFTR 2d 2019-6693 (D.C. NY 2019).

a. "The IRS can therefore assess *only* the 5% penalty under [Section 6677] - *not both or either* the 5% and/or 35% penalty - for [the taxpayer's] untimely filing of his 2007 Form 3520."

b. The District Court added that the penalty, derived from the "gross reportable amount," is five percent of the value of "the trust's assets at the close of the year." Because the value of PPT was $0 at the end of 2007, the penalty would be $0.

4. Reversal by Court of Appeals – IRS Victory

a. The DOJ asked the Second Circuit Court of Appeals to review the earlier determination by the District Court.[62]

b. The Court of Appeals explained that Section 6048(c) demonstrates that when a "U.S. person" fails to report to the IRS a distribution from a foreign trust, he triggers a penalty equal to 35 percent of the "gross reportable amount" under Section 6677.

c. The Court of Appeals then noted that the term "U.S. person" generally includes "everyone [and] makes no exception for a beneficiary who is also the owner of a foreign trust." The taxpayer in *Wilson* was a U.S. person who did not file a Form 3520 to disclose the distribution of about $9.2 in 2007. Therefore, the IRS was correct in imposing the 35 percent penalty.

C. <u>Second Stacking Case – Multiple Penalties Linked to Same Event</u>

1. *United States v. Garrity*, is a variation on the "stacking" theme.[63] It focuses on the IRS's ability to impose multiple penalties in connection with the same foreign events.

2. Relevant Facts

a. The taxpayer ("Paul") established the Foreign Trust in 1989. Paul was the primary beneficiary from inception, and, during his lifetime, he retained the right to amend or revoke the governing documents. Moreover, Paul entered into an agreement with the foreign trustee, mandating that all members of the Board of Directors of the Foreign Trust act in accordance with his instructions.

[62] *Wilson v. United States*, 128 AFTR 2d 2021-XXXX (2nd Ct. 2021).

[63] *United States v. Garrity et al*, Case No. 3:15-cv-243 (D.C. Conn. 2018).

b. Paul also opened a foreign account in the name of the Foreign Trust ("LGT Account"), while the foreign trustee formed a company ("Foreign Corporation")

c. All documents were either signed or initialed by Paul.

d. Paul instructed the foreign trustee to arrange for "suitable documentation" between his domestic company and the Foreign Corporation, showing that the former was supposedly paying the latter for providing certain services.

e. The DOJ claims that the Foreign Corporation never performed any services, and the sole purpose of the arrangement was to disguise transfers of pre-tax funds from the domestic company, through the Foreign Corporation, to Paul and his LGT Account.

3. Three proceedings and three types of penalties

a. *Garrity* is fascinating for a number of reasons, one of which is that the fight took place on several fronts simultaneously.

b. Income Tax Case

i. The IRS issued a Notice of Deficiency for unpaid taxes and accuracy-related penalties related to the 2005 Form 1040. Representatives of Paul's estate filed a timely Petition, the case sat with the Tax Court while other battles raged on, and the parties ultimately settled matters, presumably on terms favorable to the IRS, after seven years.[64]

c. FBAR Penalty Case

i. Along with demanding taxes, the IRS assessed a willful FBAR penalty for 2005 related to the LGT Account. Its balance on the date of the FBAR violation was at least $1,873,382; therefore, the IRS asserted a penalty equal to 50 percent of that amount, or $936,691.

ii. Paul's estate objected to alleged penalty stacking.

iii. The District Court sided with the DOJ

(a) It said that, even assuming that the penalties at issue constitute "fines" for purposes of the Eighth Amendment, the FBAR violation is "legally and

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[64] *Estate of Paul G. Garrity et al v. Commissioner*, Tax Court Docket No. 006561-12. The Petition was filed in March 2012 and the Stipulated Decision was entered in June 2019.

factually distinct" from the Form 3520 and Form 3520-A violations.

(b) The District Court then explained that the FBAR case only involved 2005, whereas the Foreign Trust case encompassed all of 1996 through 2008.

(c) Finally, the District Court emphasized that the elements of each violation are different.

iv. The District Court upheld the FBAR penalty, plus a late-payment penalty of $338,000, plus interest of $56,000.[65]

d. Form 3520 and Form 3520-A Penalty Case

i. The IRS assessed penalties for unfiled Forms 3520 and unfiled Forms 3520-A for certain years.

ii. When Paul's estate refused to pay, the DOJ filed a collection lawsuit in District Court, seeking a total of $1,504,388.[66]

iii. The representatives cited the FBAR penalties of about $1.1 million (addressed in the District Court action), the accuracy-related penalties of about $13,000 (addressed in Tax Court), *and* the proposed Forms 3520 and Forms 3520-A penalties surpassing $1.5 million.

iv. The representatives argued that the U.S. government "unconstitutionally stacked" penalties against Paul in connection with the same activities, entities, and funds.

v. The representatives settled the Foreign Trust matters, without a trial, paying $850,000 to resolve all Form 3520 and Form 3520-A penalties.

VI. Three Cases, Three Proceedings, Three Liabilities

A. Introduction

1. What is remarkable about international non-compliance is that it often triggers three interrelated disputes, occurring in three different venues, and generating three potential liabilities

[65] *United States v. Garrity*, 123 AFTR 2d 2019-941 (DC Ct. 2019).
[66] *United States v. Garrity et al*, Case No. 2:18-cv-00111 (D.C. Conn.).

2. A recent trilogy of court decisions, broadly referred to in this outline as the *Flume* cases, provide a teachable moment, an opportunity to see, in real life, what a taxpayer with unreported foreign assets could face if caught.[67]

B. Key Facts

1. Husband and Wife are U.S. citizens who moved to Mexico in 1993. Before heading south, Husband worked as an urban planner and real estate developer in the United States. Husband was engaged in the same type of activities in Mexico, operating a real estate company that developed land, sold lots, and built high-end homes.

2. In 1995, Husband and another U.S. individual formed a corporation in Mexico called Franchise Food Service de Mexico S.A. de C.V. ("Franchise Food"). They started as equals, each owning 50%. Husband was also the president. Franchise Food was created in order to operate Mexican locations of Whataburger and Fanny Ice Cream.

3. In addition to Franchise Food, Husband and Wife formed at least two other foreign corporations, one of which was Wilshire Holdings, Inc. ("Wilshire"). This entity was originally formed in the Bahamas in 2000 and then reincorporated in Belize in 2001.

4. In 2005, Wilshire opened an account at UBS in Switzerland.

5. Husband and Wife filed timely Forms 1040 for 2001 through 2009, but they did ***not*** (i) report certain income generated by Franchise Food or Wilshire, (ii) report passive income generated by the UBS account, (iii) enclose Forms 5471, and (iv) separately file FBARs.

6. In the early 2000's, Husband hired return preparers with offices in the United States and Mexico to prepare annual Forms 1040 ("Mexican Accountants"). They prepared the Forms 1040 for the relevant years disclosing only the existence of Husband's account in Mexico, but not the larger account in Switzerland.

7. Husband did not file timely FBARs for 2007 or 2008. He filed them late, in June 2010, and even then he understated the value of the Swiss account by approximately $600,000 one year.

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[67] The *Flume* cases consist of the following: *Flume v. Commissioner*, T.C. Memo 2017-21 (Tax Court case focused on civil penalties for unfiled Forms 5471 to disclose ownership of foreign corporations); *United States v. Flume*, 122 AFTR 2d 2018-5641 (S.D. Texas 2018) (Order by District Court in response to Motion for Summary Judgment filed by the U.S. government regarding FBAR penalties) and *United States v. Flume*, 123 AFTR 2d 2019-2211 (S.D. Texas 2019) (Verdict by District Court regarding FBAR penalties); *Flume v. Commissioner*, T.C. Memo 2020-80 (Tax Court case focused on federal income taxes and tax-related penalties).

C. First Fight - Form 5471 Penalty Litigation in Tax Court

1. The first fight centered on non-disclosure of Husband's interest in the two foreign corporations, Franchise Foods and Wilshire.

2. IRS Audit and CDP Hearing

a. Husband did not pay the Form 5471 penalties, so the IRS sent him a pre-levy notice in December 2013.

b. Husband filed a timely request for a CDP hearing, claiming, among other things, that he was not required to file Forms 5471 for Wilshire for 2001 through 2009 because he had only a 9% interest, and thus was not a "U.S. shareholder" with a filing duty.

c. The Settlement Officer issued a Notice of Determination, concluding that the IRS was free to seize Husband's assets.

3. Tax Court Litigation Contesting Result of CDP Hearing

a. Husband filed a timely Petition with the Tax Court challenging the conclusions in the Notice of Determination.

b. The Tax Court reduced this case to its essence.

i. Regarding Franchise Food, the Tax Court concluded that Husband was obligated to file a Form 5471 each year.

ii. Regarding Wilshire, the Tax Court noted that Husband had a constant Form 5471 filing obligation, and Husband "merely provided self-serving testimony and a backdated document to support his claim that he maintained only a 9% ownership interest during the tax years in issue."

iii. Finally, the Tax Court rejected the notion that Husband should be relieved of penalties under a reasonable reliance theory because Husband was unable to demonstrate that the Mexican Accountants had sufficient qualifications, expertise, or access to the relevant data.

D. Second Fight – FBAR Penalty Litigation in District Court

1. While the IRS was seeking Form 5471 penalties in Tax Court, the DOJ was busy initiating a collection action in District Court to recoup "willful" FBAR penalties for 2007 and 2008.

2. Rulings by the District Court

a. The District Court found that Husband had willfully violated his FBAR duties and upheld large penalties for the following reasons.

b. First, the Husband's testimony was "not credible."

c. Second, the financial structure used by Husband as a "sophisticated tax evasion scheme." He operated businesses in Mexico for decades, he instructed UBS not to invest in U.S. securities, he transferred Wilshire from the Bahamas to Belize to avoid government oversight, and he did not file tax returns in Mexico.

d. Third, the Mexican Accountants sent Husband an annual reminder of his FBAR duties.

e. Fourth, the fact that Husband disclosed the existence of a Mexican account on Schedule B to his Forms 1040 shows that he was aware of the requirement and "made a conscious choice" not to similarly disclose the Swiss account.

f. Fifth, Husband learned of the IRS's investigation into UBS by mid-2008, but opted not to file any FBARs until *after* UBS announced that it planned to turn over its records to the IRS.

g. Sixth, Husband acted with "extreme recklessness" by failing to review his Forms 1040 before signing them.

h. Finally, it was "reckless" for Husband to place total reliance on the Mexican Accountants, particularly because he did not conduct any research on their credentials.

E. Third Fight – Federal Income Tax Litigation in Tax Court

1. The Tax Court addressed income tax matters in separate litigation.

2. The IRS claimed that Husband and Wife, as sole owners of Wilshire, had unreported Subpart F income stemming from the UBS account held in the name of Wilshire. The IRS also asserted penalties for negligence or, alternatively, substantial understatement of the correct tax liability.

3. The Tax Court held for the IRS on the tax and penalty issues.

VII. Ongoing International Disclosure Programs

A. Why Are Taxpayers Still Approaching the IRS?

1. The IRS continues gathering data through multiple mechanisms:

a. Computer analysis of e-filed FBARs

b. Cross-referencing of Form 8938 data and FBAR data

c. Receipt of account data from foreign banks under FATCA

d. Data from millions of disclosures made in prior years

e. Deferred prosecution agreements with foreign banks

f. Whistleblowers

g. Wikileaks, Panama Papers, etc.

B. Voluntary Disclosure Programs over the Years

1. Closed Programs

a. 2003 Offshore Voluntary Compliance Initiative ("OVCI")

b. Last Chance Compliance Initiative ("LCCI")

c. 2009 Offshore Voluntary Disclosure Program ("2009 OVDP")

d. 2011 Offshore Voluntary Disclosure Initiative ("OVDI")

e. 2012 Offshore Voluntary Disclosure Program ("2012 OVDP")

f. 2012 Streamline Filing Compliance Procedure ("SFCP")

g. 2014 Offshore Voluntary Disclosure Program ("2014 OVDP")

2. Current Programs

a. Streamline Foreign Offshore Program ("SFOP")

b. Streamline Domestic Offshore Program ("SDOP")

c. Delinquent FBAR Submission Procedure ("DFSP")

d. Delinquent Int. Info. Return Submission Procedure ("DIIRSP")

e. 2018 Updated Voluntary Disclosure Program ("UVDP")

C. Challenges of Participating Now

1. Taxpayers must prove that their non-compliance was "non-willful" in order to participate in current programs, except the UVDP.

2. The IRS and the courts have interpreted willful behavior broadly, identifying the following items as potential evidence of willful violations:

a. The taxpayer failed to inform his accountant about the existence of foreign accounts, assets, or companies, particularly when asked by accountant about such items during meeting.

b. The taxpayer failed to ask his accountant about potential U.S. tax and compliance issues with respect to foreign assets.

c. The taxpayer failed to complete the annual questionnaire/organizer distributed by his accountant or other return preparer.

d. The taxpayer incorrectly completed the annual questionnaire.

e. The taxpayer opened accounts in the name of a foreign company.

f. The taxpayer opened a numbered account.

g. The taxpayer had a nominee (*e.g.*, attorney, accountant, investment advisor, friend, relative, etc.) hold the foreign account for him.

h. The taxpayer told the foreign bank not to send account statements.

i. The taxpayer told the foreign bank not to invest in U.S. securities.

j. The taxpayer used a foreign passport (*i.e.*, not a U.S. passport) to open the account.

k. The taxpayer worked with a foreign attorney, accountant, or adviser in opening the foreign account.

l. The taxpayer provided the bank an address outside the United States as his residence for purposes of the foreign account.

m. The taxpayer only accessed the unreported foreign account while outside the United States, using a credit card linked to the account or taking cash withdrawals.

n. The taxpayer filed an FBAR reporting only some foreign accounts.

o. The taxpayer not only violated U.S. tax laws, but also had tax non-compliance in one or more foreign countries.

p. The taxpayer held foreign accounts or other assets in foreign countries with which he had no logical connection, such as living there, working there, operating a business there, etc.

q. The taxpayer used a computer program to self-prepare his returns, such as TurboTax, which specifically ask about foreign accounts.

r. The taxpayer reviewed the annual Form 1040 (including the specific information in Schedule B about foreign accounts and the need to file FBARs), signed the Form 1040 under penalties of perjury as being accurate and complete, yet took no actions whatsoever to learn more about a possible duty to file FBARs.

s. The taxpayer checked the box "no" in response to questions on Schedule B to Form 1040 about the existence of foreign accounts.

t. After the IRS started publicly attacking certain foreign banks, the taxpayer took actions to conceal the problems, such as transferring the funds to other foreign banks, converting the funds into foreign insurance policies, etc.

VIII. Fights over SECA Taxes and Pass-Through Entities

A. SECA – Components and Magnitude

1. Amounts earned by taxpayers for working generally are subject to so-called "employment taxes."

2. When dealing with employees, they are comprised of several items, including Federal Insurance Contributions Act ("FICA") taxes, which fund Social Security and Medicare.

3. However, in situations involving sole proprietors, independent contractors, and partners, SECA taxes substitute FICA taxes.[68]

4. For 2020, the SECA tax rate was 15.3 percent of "net earnings from self-employment," which can represent a big payment for some taxpayers.[69]

B. Exclusion for Limited Partners

1. The term "net earnings from self-employment" normally means gross income derived by an individual from any trade or business carried on by such individual, minus certain business-related deductions, plus his distributive share from any partnership in which he is a partner.[70]

2. Section 1402(a)(13) *excludes* from "net earnings from self-employment," and thus from payment of SECA taxes, the distributive share to a "limited partner," as a limited partner, other than certain guaranteed payments.[71]

IX. The Long Road to Chaos

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[68] Section 1401(a) and (b); Revenue Ruling 69-184.
[69] Section 1401(a) and (b).
[70] Section 1402(a).
[71] Section 1402(a)(13).

A. SECA Taxes Start in 1950

1. Congress established the Social Security system in 1937. Originally, self-employed workers did not contribute to, and were not eligible to receive benefits from, the system.

2. This changed in 1950, when Congress introduced SECA taxes.[72] Distributive shares to *all* partners, both general and limited, were initially subject to SECA taxes.[73]

B. Limited Partner Exception Appears in 1977

1. Statutory Language

a. Things changed with the carve-out for limited partners.

b. In 1977, Congress enacted Section 1402(a)(13), which was an exception from SECA taxes for certain "limited partners."[74] This critical provision states the following:

i. "[T]here shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in Section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services."

2. Legislative Rationale

a. Why did Congress create Section 1402(a)(13)?

i. "Under present law, *each partner's share of partnership income* is includable in his net earnings from self-employment for Social Security purposes, *irrespective of the nature of his membership in the partnership*. The bill [introducing Section 1402(a)(13)] would exclude from Social Security coverage the distributive share of income or loss received by a *limited partner* from the trade or business of a limited partnership. *This is to exclude for [Social*

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[72] Congressional Budget Office. The Taxation of Capital and Labor Through the Self-Employment Tax (Sept. 2012), pg. 1.

[73] T.D. 7333 (Dec. 19, 1974); Treas. Reg. § 1.1402(a)-2(d).

[74] Social Security Amendments of 1977, Public Law No. 95-216, Section 313(b).

Security] coverage purposes certain earnings which are basically of an investment nature . . . . "[75]

b. Perhaps the most critical insight from Congress comes later in the same report. It clarifies the exact problem, the perceived abuse, which Congress endeavored to solve with Section 1402(a)(13):

i. "These advertisements and solicitations are directed mainly toward public [*i.e.*, government] employees whose employment is covered by public retirement systems and not by Social Security. Also, these advertisements frequently emphasize the point that those who invest an amount sufficient to realize an annual net income of $400 or more (the minimum amount needed to receive Social Security credit in a year) will eventually gain a high return on the Social Security contributions. Many of those who invest in limited partnerships will qualify for minimum [Social Security] benefits, which are heavily weighted for the purpose of giving added protection for people who have worked under Social Security for many years with low earnings. The costs of paying these heavily weighted benefits to limited partners must, of course, be bourne by all persons covered by the Social Security program. The advertising [for the sale of limited partnership interests] injures the Social Security program in the public view and causes resentment on the part of the vast majority of workers whose employment is compulsorily covered under Social Security, as well as those people without work income, who would like to be able to become insured under the Social Security program but cannot afford to invest in limited partnerships."[76]

c. A careful reading reveals that Congress was concerned that:

i. persons were selling limited partner interests solely for purposes of allowing individuals who were otherwise ineligible for the Social Security program to gain access,

ii. based on the minimum contribution they made to the partnerships and the minimum distributive shares they received, the limited partners were not investing in the

[75] U.S. House of Representatives, Committee on Ways and Means, Social Security Financing Amendments of 1977, 95th Congress, 1st Session, House Report 702 – Part 1 (Oct. 12, 1977), pg. 11 (emphasis added).
[76] U.S. House of Representatives, Committee on Ways and Means, Social Security Financing Amendments of 1977, 95th Congress, 1st Session, House Report 702 – Part 1 (Oct. 12, 1977), pgs. 40-41.

normal sense of the word, not risking money with hopes of getting passive income in return,

iii. the limited partners were not paying any significant SECA taxes given the minimum distributive shares they received,

iv. the purchasers of the limited partner interests would obtain unfairly large Social Security benefits, to the detriment of all workers financing the system,

v. many government workers were participating in this improper scheme, and

vi. allowing abuse of the Social Security system would trigger public resentment and claims of unfairness.

3. Broad Solution to Fix Narrow Problem

a. Why would anyone voluntarily pay SECA taxes? Well, it made sense back in those days, because the SECA tax rate was low, the individuals only planned to expose a very small amount of income (around $400 annually) to SECA taxes, and the value of the Social Security benefits, particularly on a weighted scale, was higher than the cost of the SECA taxes.[77]

b. To address the *very narrow problem* related to the exploitation of the Social Security program, Congress implemented a *very broad solution* in 1977. Namely, it introduced Section 1402(a)(13), which generally excludes from the definition of "net earnings from self-employment," and thus from payment of SECA taxes, the distributive share to a "limited partner."

C. First Proposed Regulations in 1994

1. After chewing on the matter for about two decades, the IRS issued its first set of proposed regulations about Section 1402(a)(13) in 1994 ("First Proposed Regulations").[78]

2. They contained rules for treatment of limited partners in partnerships, and members of limited liability companies ("LLCs") treated as partnerships.[79]

[77] Laura E. Erdman, "Reinterpreting the Limited Partner Exclusion to Maximize Labor Income in the Self-Employment Tax Base," 70(4) Washington and Lee Law Review 2389 (2013).
[78] 59 Fed. Reg. 67253, EE-45-94 (Dec. 29, 1994).
[79] 59 Fed. Reg. 67253, EE-45-94, Proposed Treas. Reg. § 1.1402(a)-18 (Dec. 29, 1994).

3. Under the First Proposed Regulations, the amount subject to SECA taxes generally included an individual's distributive share from any trade or business carried on by an LLC of which the individual was a member.[80]

4. A member of an LLC would be treated as a "limited partner" for purposes of Section 1402(a)(13) if the member met two criteria.

   a. First, the member could not be a "manager" of the LLC.[81]

   b. Second, the pertinent entity could have been formed as a limited partnership instead of an LLC, and the member could have qualified as a limited partner instead of a member.[82]

D. Second Proposed Regulations in 1997

1. After reviewing written comments from the public about the First Proposed Regulations and holding a hearing, the IRS decided to revamp its approach.

2. In 1997, it withdrew the First Proposed Regulations and released a new set ("Second Proposed Regulations").[83]

3. This time, the IRS provided guidance covering *all* entities classified as partnerships for federal tax purposes, not just LLCs.

   a. The updated rules arguably encompassed limited partnerships, LLCs, limited liability partnerships ("LLPs"), limited liability limited partnerships ("LLLPs") and other entities that had emerged since Congress introduced the "limited partnership" exception to SECA taxes 20 years earlier, back in 1977.[84]

4. New Definition of "Limited Partner"

   a. The Second Proposed Regulations maintained the exception in Section 1402(a)(13) that "limited partners" ordinarily are not exposed to SECA taxes on their distributive shares.[85]

   b. However, they changed the definition of "limited partner." The Second Proposed Regulations stated that an individual was *presumed* to be a limited partner, *unless*:

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[80] 59 Fed. Reg. 67253, EE-45-94, Proposed Treas. Reg. § 1.1402(a)-18(a) (Dec. 29, 1994).
[81] 59 Fed. Reg. 67253, EE-45-94, Proposed Treas. Reg. § 1.1402(a)-18(b)(1) (Dec. 29, 1994).
[82] 59 Fed. Reg. 67253, EE-45-94, Proposed Treas. Reg. § 1.1402(a)-18(b)(2) (Dec. 29, 1994).
[83] 62(8) Fed. Reg. 1701 (Jan. 13, 1997); 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96.
[84] 62(8) Fed. Reg. 1701 (Jan. 13, 1997); 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96 (stating that "[t]hese proposed regulations apply to all entities classified as a partnership for federal tax purposes, regardless of the state law characterization of the entity.")
[85] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(g).

i. he was personally liable for the debts or other claims against the partnership based on his status as a partner, *or*

ii. he had authority under state law to engage in contracts for the partnership, *or*

iii. he participated in the partnership's business for more than 500 hours during a year.[86]

5. Service Partners in Service Partnerships

a. The Second Proposed Regulations indicated that an individual who is a "service partner" in a "service partnership" would *not* be a limited partner.[87]

b. The term "service partner" meant a partner who provided services either to a partnership or on behalf of a partnership's business.[88]

c. A "service partnership," meanwhile, was a partnership substantially all of whose activities involved the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.[89]

6. IRS Rationales

a. The Preamble to the Second Proposed Regulations explained that the IRS wanted the same standards to apply to owners of an interest in a limited partnership and owners of any other entity treated as a partnership, such as an LLC.

b. To achieve the desired "conformity," the IRS adopted a method that looked to the relationship between the individual, the partnership, and the partnership's business.[90]

c. The IRS further explained that it decided to use "functional tests" to ensure that different individuals, owning interests in similar entities formed under different state laws, would be treated the same.[91]

d. It then noted that "functional tests" were necessary because of the proliferation of new types of business entities after Section

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[86] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(2).
[87] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(5).
[88] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(6)(i).
[89] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(6)(ii).
[90] 62(8) Fed. Reg. 1703 (Jan. 13, 1997); REG-209824-96; Preamble – Explanation of Provisions.
[91] 62(8) Fed. Reg. 1703 (Jan. 13, 1997); REG-209824-96; Preamble – Explanation of Provisions.

1402(a)(13) was enacted in 1977 and because of the evolution of limited partnership statutes in various states.

E. Congress Imposes a Moratorium in 1997

1. In a demonstration of governmental gridlock and political pandering, Congress stopped the IRS in its proverbial tracks.

2. Congress enacted a law in 1997 stating that "[n]o temporary or final regulation with respect to the definition of limited partner under Section 1402(a)(13) . . . . may be issued or made effective before July 1, 1998."[92]

3. This created a moratorium on regulations for about 18 months.

4. If that were not enough, Congress explained in the legislative history, in a segment labeled "Sense of the Senate," that the IRS should withdraw the Second Proposed Regulations and "Congress [not the IRS] should determine the tax law governing self-employment income."[93]

5. In summary, Congress flexed its muscle to halt the IRS in 1997, declaring that only the legislative branch (*i.e.*, Congress), and not an agency of the executive branch (*i.e.*, the IRS), had authority to create law. Lamentably for the entire tax system, Congress has not issued any legislation to resolve the "limited partner" matter in two and one-half decades and the IRS, likewise, has not advanced any regulatory actions.

F. Various Groups Offer Proposals from 1998 to 2005

1. Several groups offered proposals in hopes of influencing Congress to take action during or soon after the moratorium.[94] Such action never occurred.

2. The proposals are nuanced. None is exactly the same, but they can be divided into *three options* for defining the SECA tax base.[95]

a. The first is employing a "material participation" standard, which would apply rules similar to those currently utilized in passive activity loss-limitation cases under Section 469. With this option, individuals who materially participate in the business of the entity would be treated like *general* partners under existing law, while non-material participants would enjoy preferential treatment like

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[92] Taxpayer Relief Act of 1997, Public Law 105-34, Section 935 (Aug. 5, 1997).
[93] U.S. House of Representatives. Taxpayer Relief Act of 1997, Conference Report, 105th Congress, 1st Session, Report 105-220, July 30, 1997, pg. 765.
[94] *See, e.g.,* New York State Bar Association Tax Section, Legislative Proposal Regarding Employment Taxes and Professional Services Businesses (Sept. 21, 2010).
[95] Congressional Budget Office. The Taxation of Capital and Labor Through the Self-Employment Tax. Publication 4168 (Sept. 2012), pgs. 18-23.

limited partners. The distributive share of the latter would escape SECA taxes.[96]

b. The second main option is the "reasonable compensation" standard. Currently, corporations must report "reasonable compensation" earned by their shareholders, and employment taxes, called FICA taxes in that context, are imposed on such compensation. Some proposals suggest applying the same standard to entities classified as partnerships, thereby exposing to SECA taxes *only* the amount deemed to be reasonable compensation paid by the partnership for services rendered by the partner.[97]

c. The third option employs a "safe harbor" calculation of capital income to partners. Here, partnerships would apply a standard formula to determine the amount of income that would be considered a return on the capital investment by the partners, and thus free from SECA taxes. Partners would identify their capital base by adding the values of their capital assets, just as partnerships do when providing a balance sheet to the IRS. The partners would then multiply the total value of their capital base by 150 percent of the maximum Applicable Federal Rate for the relevant year. This, in theory, would show a reasonable rate of return on capital investment in partnerships by the partners. To put things in perspective, the rate of return in 2004 would have been 5.37 percent using the safe harbor formula.[98]

G. <u>IRS Gives Taxpayers Hope in 2003</u>

1. An IRS official stated during a public event in 2003 that "[if] the taxpayer conforms to the latest set of proposed rules [*i.e.*, the Second Proposed Regulations], we generally will not challenge what they do or don't do with regard to self-employment taxes."[99]

H. <u>IRS Rulings and Courts Cases</u>

1. The IRS has issued various rulings, and the courts have published several decisions, involving "limited partners" and SECA taxes over the years.

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[96] Congressional Budget Office. The Taxation of Capital and Labor Through the Self-Employment Tax. Publication 4168 (Sept. 2012), pg. 19.

[97] Congressional Budget Office. The Taxation of Capital and Labor Through the Self-Employment Tax. Publication 4168 (Sept. 2012), pgs. 21-22.

[98] Congressional Budget Office. The Taxation of Capital and Labor Through the Self-Employment Tax. Publication 4168 (Sept. 2012), pg. 23.

[99] Allison Bennett. Taxpayers Can Rely on Proposed Regulations for LLC Self-Employment Taxes, Clark Says, 114 Daily Tax Report G-3 (June 13, 2003).

2. However, as a result of the congressional moratorium, the analysis in these instances centered solely on the outdated text of Section 1402(a)(13) from 1977 and a portion of legislative history.

3. Three Main Categories of Authorities

   a. The first involves situations where individual taxpayers got involved in an informal partnership.

      i. The taxpayers considered it a simple investment, did not participate in the activity, fully reported the resulting income on their Forms 1040 (U.S. Individual Income Tax Returns) and paid income taxes, but did not pay SECA taxes.

      ii. The IRS argued that investing in working interests of mineral wells equates to carrying on a trade or business, either as a partner or through an agent, and the taxpayers were not "limited partners" under Section 1402(a)(13).

      iii. The Tax Court explained that (i) the definition of "partnership" in the Internal Revenue Code is broad, encompassing syndicates, groups, pools, joint ventures and other organizations through which any business, operation or venture is carried out, (ii) various individuals combining funds to finance mineral exploration creates a pool or joint venture, which falls within the meaning of partnership, (iii) because the individuals were in a partnership, the amounts they received were distributive shares, (iv) all partners generally must pay SECA taxes on their distributive shares, and (v) the individuals do not qualify for the limited partner exception under Section 1402(a)(13) because they never filed the documents or took other necessary actions under applicable state law to establish a "limited partnership." Thus, the individuals were all general partners in a general partnership, subject to SECA taxes on their shares.[100]

   b. The second category features situations where individuals, who were partners in a limited partnership, bifurcated the amounts that they received from the partnership.

      i. They subjected certain amounts to self-employment taxes, classifying them as distributions to general partners, guaranteed payments, or wages. They shielded other amounts from SECA taxes pursuant to the limited partner exception in Section 1402(a)(13). The individuals in these

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[100] *See, e.g., Johnson v. Commissioner*, T.C. Memo 1990-461, *Perry v. United States*, T.C. Memo 1994-215, *Norwood v. Commissioner*, T.C. Memo 2000-84.

types of cases often were actively engaged in the business of the partnerships, but they also made significant capital contributions to, or investments in, the partnerships.

ii. The IRS and the courts generally ruled in these situations that a longstanding Revenue Ruling establishes that partners are not employees of partnerships, existing rules do not permit inconsistent characterization of amounts from partnerships to limited partners based on wearing both a worker and investment hat, and the "reasonable compensation" principles applicable to corporations do not apply to partnerships.[101]

c. The third category addresses how the "limited partner" exception under Section 1402(a)(13) applies to entities that were not formed as limited partnerships under state law, such as LLCs.

i. The analysis varied in each case, but the focus normally centered on the degree of the individual's participation in the business of the entity and whether, the income he receives was "basically of an investment nature."[102]

d. Importantly, all the authorities described above are of questionable value to the IRS in future tax disputes with partnerships.

i. This is because several came in the form of Chief Counsel Advisories. The Internal Revenue Code expressly states that "written determinations" of this sort ordinarily cannot be used or cited as precedent.[103]

ii. Other authorities consist of "Memorandum Opinions" by the Tax Court, which also fall short of the precedential bar.[104]

4. Most Famous Case

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[101] *See, e.g., Riether v. United States*, 919 F. Supp. 2d 1140 (2012), Chief Counsel Advice 201436409, Chief Counsel Advice 201640014, *Castigliola v. Commissioner*, T.C. Memo 2017-62.

[102] *See, e.g.,* PLR 9432018, PLR 9452024, PLR 9525058, *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011), *Howell v. Commissioner*, T.C. Memo 2012-281, *Hardy v. Commissioner*, T.C. Memo 2017-16.

[103] Section 6110(k)(3) and Section 6110(b)(1)(A).

[104] The Tax Court issues three main types of decisions, namely, T.C. Opinions, T.C. Memorandum Opinions, and T.C. Summary Opinions. Only the first type, called a "published" opinion, generally constitutes binding precedent for Tax Court purposes. *See* Section 7463(b); *Nico v. Commissioner,* 67 T.C. 647, 654 (1977) (stating that "we consider neither Revenue Rulings nor Memorandum Opinions of this Court to be controlling precedent"); *Huffman v. Commissioner*, 126 TC 322, 350 (confirming that "memorandum opinions are not binding").

a. The seminal case in this area is *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*.[105]

b. Three individual partners and one corporate partner formed an LLP under Kansas law to operate their law practice ("Law Firm").

c. The Law Firm filed a timely Form 1065 for 2004, showing revenues primarily generated by the performance of legal services.

d. The Law Firm made distributions to the partners that year, did not report them as "net earnings from self-employment" by the Law Firm, and thus did not subject them to SECA taxes.

e. The Law Firm amended its agreement to eliminate the corporate partner starting in 2005, to create two classes of ownership interests (*i.e.*, General Managing Partner Interests and Investment Partner Interests), and to provide for equal allocation of distributive shares. Each of the three individual partners held both types of interests in the Law Firm and had equal authority.

f. The Law Firm made distributions to the individual partners in 2005, which were devoid of SECA taxes again.

g. The IRS audited the Law Firm and made some adjustments, the most important of which was recharacterizing the distributive shares in 2004 and 2005 as "net earnings from self-employment," not protected by the "limited partner" exception in Section 1402(a)(13).

h. The Law Firm challenged the IRS in Tax Court. The Law Firm argued that its three partners, who were partners in an LLP formed under Kansas law, should be treated as "limited partners" under Section 1402(a)(13) because (i) their interests are specifically called limited partner interests in the Law Firm's organizational documents, and (ii) the partners each had limited liability under Kansas law. In other words, the Law Firm endeavored to focus the issue solely on state law titles and exposure.

i. The Tax Court disagreed with the Law Firm.

    i. It began by explaining the major differences between general partners and limited partners, in terms of management power and personal liability, concluding that a limited partner interest "is generally akin to that of a passive investor."[106]

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[105] *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011).
[106] *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137, 147 (2011).

ii. The Tax Court indicated that an LLP is a different beast; it is essentially a general partnership that affords limited liability protection to all partners.

iii. The Tax Court went on to explain that the predecessor to Section 1402(a)(13), which uses the phrase "limited partner," was enacted *before* LLPs and other modern entity forms came into existence.

iv. It then recognized that the IRS attempted to address this issue in 1997 by issuing the Second Proposed Regulations, but Congress prevented the IRS from finalizing them.

j. Without any additional guidance since then, from Congress or the IRS, the Tax Court indicated that it must engage in an exercise of statutory interpretation to determine what, exactly, Congress meant when it used the term "limited partner" in the context of SECA taxes and Section 1402(a)(13). It looked to just one portion of the legislative history, which stated the following:

i. "The bill would exclude from [SECA tax] coverage the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership. *This is to exclude for [SECA tax] coverage purposes certain earnings which are basically of an investment nature*."[107]

k. The Tax Court believed that this "insight" showed that Congress intended to ensure that individuals who merely invested in a partnership and did not actively participate in its business operations would not receive credits toward Social Security coverage.

l. The Tax Court went on to explain that the legislative history does not support the notion that Congress contemplated excluding partners who performed services for a partnership, in their capacity as partners, from SECA taxes.[108]

m. The Tax Court held that the Law Firm derived nearly all its revenue by providing legal services, the partners contributed only a nominal amount of capital in exchange for their partnership interests, and the distributive shares that they received were not, to cite the legislative history, "earnings which are basically of an investment nature." Accordingly, the Tax Court concluded that the partners must pay

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[107] *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137, 150 (2011) (citing the Social Security Amendments of 1977, Public Law 95-216, Section 313(b)) (emphasis added).

[108] *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137, 150 (2011).

SECA taxes on their distributive shares and the exception under Section 1402(a)(13) does not apply.[109]

I. <u>IRS Gives Taxpayers More Hope in 2011</u>

1. An attorney in the IRS's National Office announced during a conference organized by the American Bar Association in 2011 that, despite the holding in *Renkemeyer*, the Second Proposed Regulations had not been withdrawn and taxpayers "could rely" on them.[110]

J. <u>Compliance Campaign in 2018</u>

1. The IRS claims that certain taxpayers are inappropriately taking advantage of Section 1402(a)(13).

   a. According to the IRS, some entities treated as partnerships are classifying *all* members as "limited partners," thereby avoiding SECA taxes on partnership distributions altogether.

   b. Other partnerships are taking a more moderate approach, arguing that only a portion of the distributions should be subject to SECA taxes. They accomplish this by labeling some amounts as wages or guaranteed payments to partners, while the rest is classified as a distributive share to "limited partners" and thus exempt from SECA.

2. The IRS, therefore, initiated a Compliance Campaign in 2018 to halt these practices, summarizing the problem as follows:

   a. "Partners report income passed through from their partnerships. Unless an individual partner qualifies as a "limited partner" for [SECA] tax purposes, the partner's distributive share is subject to [SECA taxes]. Some individual partners, including service partners in service partnerships organized as state-law limited liability partnerships, limited partnerships, and limited liability companies, have inappropriately claimed to qualify as "limited partners" not subject to SECA tax."[111]

K. <u>Concept Unit in 2019</u>

1. The IRS introduced a Concept Unit to assist in implementing the Compliance Campaign. It contained a few noteworthy items.

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[109] *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137, 150 (2011).
[110] Monte A. Jackel. "Has Politics Trumped Policy?" 131 Tax Notes 745 (May 16, 2011); Shamik Trivedi. "After Renkemeyer, Passthroughs Can Still Rely Safely on Proposed Regs, Officials Say," 131 Tax Notes 675 (May 16, 2011).
[111] *www.irs.gov/businesses/corporations/lbi-active-campaigns*

a. First, it acknowledged that Section 1402(a)(13) does not define the term "limited partner" and final regulations are non-existent, such that IRS personnel must rely solely on legislative history and case law in making determinations.[112]

b. Second, the Concept Unit states that it is not restricted to just limited partnerships and LLCs; it applies to *all* entities treated as partnerships for federal tax purposes, including joint ventures, LLCs, LLPs, LLLPs, limited partnerships, and other entities.[113]

c. Third, the Concept Unit instructs IRS personnel to ignore the long list of the taxpayer-favorable decisions regarding limited partners and the passive activity loss-limitation rules under Section 469. The Concept Unit states that "the material participation rules under [Section] 469 have no bearing on whether an individual partner may be subject to self-employment taxes under [Section] 1402."[114]

d. Fourth, the Concept Unit devotes three pages to a discussion of the Second Proposed Regulations, which were never finalized.[115] Interestingly, the IRS appears to have decided to overlook the incomplete status of the Second Proposed Regulations.

i. "Taxpayers, however, may rely on the 1997 Proposed Regulations. In other words, the IRS will respect a partner's status as a limited partner if the partner qualifies as a limited partner under the 1997 Proposed Regulations."[116]

L. Removal from List of Priorities in 2019

1. In what cannot be a coincidence, the IRS discretely removed the "limited partner" and SECA tax issue from its list of priorities, just around the time that it announced its Compliance Campaign.

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[112] Internal Revenue Service. LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, February 13, 2019, pg. 10.
[113] Internal Revenue Service. LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, February 13, 2019, pg. 3.
[114] Internal Revenue Service. LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, February 13, 2019, pg. 13.
[115] Internal Revenue Service. LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, February 13, 2019, pgs. 19-21.
[116] Internal Revenue Service. LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, February 13, 2019, pg. 19 (emphasis added).

2. For many years, the annual "Priority Guidance Plan" published by the IRS contained the following entry: "Guidance on the application of [Section] 1402(a)(13) to limited liability companies."[117]

3. This disappeared after 2018, without the IRS issuing guidance.[118]

M. Administration Urges Congressional Action in 2021

1. The Biden Administration issued its revenue proposals ("Green Book").[119]

2. One goal was to "rationalize" conflicting rules relating to SECA taxes. The Green Book explains that, because Section 1402(a)(13) only refers to "limited partners," questions have arisen regarding whether it encompasses members of LLCs and owners of other pass-through entities.[120]

3. The Green Book contains various proposals aimed at solving the problem. One such proposal is passing legislation that would cause limited partners and members in LLCs who "materially participate" in a business to pay SECA taxes on their distributive shares until reaching a certain threshold.[121]

N. IRS Threatens More Litigation in 2021

1. Attorneys from the IRS's National Office announced in 2021 that the IRS intends to continue auditing and litigating "limited partner" and SECA tax cases because it has been "fairly successful" in this area.[122]

O. Summary of Steps in the Journey to Chaos

1. Many might be asking themselves at this point, can things really be this jumbled? The short answer is, yes, they can be and they are. A summary of the long journey to chaos helps put things into perspective.

   a. Congress introduced SECA taxes in 1950, and they originally affected distributive shares to *all* partners.

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[117] *See*, *e.g.*, U.S. Treasury Department, Office of Tax Policy and Internal Revenue Service. 2015-2016 Priority Guidance Plan (July 31, 2015), pg. 11.
[118] U.S. Treasury Department, Office of Tax Policy and Internal Revenue Service. 2019-2020 Priority Guidance Plan – Fourth Quarter Update (Sept. 2, 2020).
[119] U.S. Treasury Department. General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (May 2021).
[120] U.S. Treasury Department. General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (May 2021), pg. 65.
[121] U.S. Treasury Department. General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (May 2021), pgs. 66-67.
[122] Kelley R. Taylor, "Clarity regarding 'Limited Partner' under SECA Remains Elusive," 2021 Tax Notes Today Federal 112-2 (June 11, 2021).

b. Congress discovered after several years that certain persons were selling limited partner interests solely for purposes of allowing individuals, who would otherwise *not* be eligible for the Social Security program, to obtain access. In other words, given the financial circumstances in that long ago era, individuals were taking steps to make themselves subject to SECA taxes.

c. To halt this *narrow* problem, Congress introduced a *broad* solution; that is, it enacted Section 1402(a)(13) in 1977. This provision generally excluded from SECA taxes distributive shares to "limited partners." Thus, it became advantageous for taxpayers to fall into this category, at least from a tax perspective. Notably, Congress did not define or caveat the term "limited partner" in the legislation.

d. More time passed, state laws regulating the actions of limited partners became more flexible, and new types of business entities, such as LLCs, appeared. The IRS thought it was time for some guidance. Therefore, it issued the First Proposed Regulations in 1994, followed by the Second Proposed Regulations in 1997.

e. Congress, facing outside pressure, imposed a moratorium on the IRS in 1997. As a result, the IRS never finalized the Second Proposed Regulations, never re-issued them, and never presented any alternative regulations.

f. Various groups offered legislative proposals to Congress starting in 1998, hoping to help shape legislation during the moratorium or soon after it had expired. They suggested a "material participation" standard, a "reasonable compensation" requirement, a "safe harbor" for calculating investment income to partners, or some combination thereof. Congress did not act.

g. IRS officials publicly stated in 2003 that the IRS did not intend to challenge partnerships regarding SECA taxes as long as they followed the Second Proposed Regulations.

h. The IRS issued some rulings, and the courts published several decisions, focused on "limited partners" and SECA taxes during the ensuing years. Technically speaking, none of those authorities should be of help to the IRS in future disputes against partnerships because, as Chief Counsel Advisories and Tax Court Memorandum Opinions, they lack precedential value.

i. The most famous case was *Renkemeyer*, decided in 2011. That Tax Court case arguably lacked broad value, though, because it only dealt with "service partners," working for a "service partnership,"

who made small capital contributions, and who were fully engaged in the management of the business.

j. As it did earlier in 2003, the IRS announced in 2011 that partnerships "could rely" on the Second Proposed Regulations. Some understood this to mean that, from the IRS's point of view, an individual was presumptively a limited partner, unless he was personally liable for partnership obligations, or he had authority to enter into contracts for the partnership, or he participated for more than 500 hours annually in the partnership's business.

k. Another half-decade passed, and the IRS changed course again. It claimed that certain taxpayers were inappropriately employing the "limited partner" exception under Section 1402(a)(13), the solution to which was to unveil a Compliance Campaign in 2018.

l. In a move that might be considered erratic, the IRS then issued a Concept Unit to its personnel in 2019. It stated that taxpayers "may rely" on the Second Proposed Regulations, and the IRS "will respect a partner's status as a limited partner if the partner qualifies as a limited partner under the [Second] Proposed Regulations."

m. That same year, 2019, the IRS removed from its list of priority projects the issuance of new administrative guidance regarding "limited partners" and Section 1402(a)(13).

n. Approximately two years later, in 2021, the Biden Administration released its so-called Green Book containing various legislative suggestions. Among them was rationalizing the conflicting rules regarding SECA taxes by adding a "material participation" standard, as the IRS had attempted to do back in 1997 with the Second Proposed Regulations, and as the JCT had proposed in 2005.

o. Finally, in 2021, attorneys from the IRS's National Office warned of more audits and litigation by the IRS on the "limited partner" issue, fueled by the fact that it has been "fairly successful" in exploiting taxpayers amid the turmoil caused, ironically, by the inaction of the IRS and Congress for decades.

X. Pending Tax Court Case

A. Initial Remarks

1. The stage is set for perhaps the most significant judicial decision regarding SECA taxes and partnerships in over a decade. Many eyes are focused on a pending Tax Court case, *Sirius Solutions, LLLP v. Commissioner*.[123]

B. Just the Facts, Ma'am

1. Sirius Solutions, LLLP ("Sirius") is a limited liability limited partnership formed in Delaware in 2002 and governed by a Limited Partnership Agreement. Sirius is a consulting firm consisting of over 200 employees located in various offices. It is managed by Sirius Solutions GP, LLC ("General Partner"), which must act through a Board of Directors.

2. The Limited Partnership Agreement generally prohibits limited partners from participating in management or control of the business. The Limited Partnership Agreement also broadly forbids limited partners from transacting business for, acting on behalf of, or binding Sirius. Finally, the Limited Partnership Agreement does not permit any "guaranteed payments" to partners, and Sirius made no such payments.

3. At the start of 2014, the only year in dispute with the IRS, nine individual limited partners and the General Partner owned Sirius. Two individual partners retired and liquidated their ownership interests during the year, and two others voluntarily withdrew as partners and became full-time employees. Thus, at the end of 2014, five individual partners and the General Partner remained.

4. All limited partners made capital contributions to Sirius, some of which were significant. In addition to providing cash, some partners contributed services to Sirius.

5. Sirius made distributions of "net cash flow" to the limited partners in 2014 in accordance with their ownership interests. Such distributions were subject to business risk and were irregular. The distributions were not linked to, or dependent on, hours worked, revenues generated, or any other formula related to services provided by the limited partners. Indeed, those who provided few or no services received the same pro-rata distributions.

6. Sirius took the position on its Form 1065 for 2014 that the distributions to the limited partners were not subject to SECA thanks to the exception in Section 1402(a)(13).

7. The IRS later audited Sirius, disagreed with its position, and issued an unfavorable final notice involving distributions of about $6 million.

C. Summary Judgment Motion and Opposition

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[123] *Sirius Solutions, LLLP v. Commissioner*, Tax Court Docket No. 11587-20.

1. Sirius disagreed with the IRS's position, of course, and challenged it by tendering a Petition with the Tax Court.

2. The parties completed their initial pleadings, the trial was postponed, and Sirius submitted a Motion for Summary Judgment during the reprieve. Sirius asked the Tax Court to determine, without the need for a trial, that distributions to individuals who are limited partners according to relevant state law (in this case, Delaware) are excluded from SECA taxes under Section 1402(a)(13) as a matter of law.

3. The IRS opposed the Motion for Summary Judgment.

D. Arguments by the IRS

1. The tax code does not define limited partner for purposes of Section 1402(a)(13). The term is nuanced, complex, and based on the functions performed by particular individuals; state law does not determine it.

2. The IRS agrees with Sirius in that the term limited partner should be given its "ordinary meaning," but it disagrees on how it should be determined. The IRS urges the Tax Court to ignore the large number of dictionary definitions introduced by Sirius and, instead, focus solely on its earlier decision in *Renkemeyer*. The IRS insists that such case looked to the legislative history from 1977, concluded that limited partners are equivalent to passive investors, and held that it is necessary to utilize a "functional test" that evaluates the actions and abilities of the partners, not merely their state law titles. In other words, the IRS seems to lobby for use of a facts-and-circumstances test and the substance-over-form doctrine.

3. The Tax Court has "continued to follow and build upon" the holding in *Renkemeyer* in subsequent cases.

4. Reports by the Joint Committee on Taxation, Private Letter Rulings, and Instructions to tax and information returns do not constitute federal tax authorities, and the Tax Court should ignore them.

5. The regulatory moratorium in 1997 does not mean that Congress "confirmed" or "made clear" the proper definition of limited partner. Rather, the moratorium merely shows that Congress was concerned that the Second Proposed Regulations might contains rules that exceed the IRS's regulatory authority.

6. The only legislative history that might be relevant to this case is that from the time Section 1402(a)(13) was enacted, in 1977, not from 20 years later when the moratorium occurred, in 1997.

7. Contrary to what Sirius suggests, federal courts do not commonly look to state law in applying federal tax law. In fact, federal law supersedes state

law thanks to the Supremacy Clause of the U.S. Constitution. State law controls only when federal law, by express language or necessary implication, makes interpretation of federal law dependent on state law. Section 1402(a)(13) never mentioned state law, and entity-classification at the federal level is done in accordance with specific tax regulations.

8. If the Tax Court were to accept the contention by Sirius that state law (in this case, Delaware partnership law) dictates the outcome for purposes of Section 1402(a)(13), this would spark a bad overall result. Specifically, the IRS urges the Tax Court to ponder 50 different states, with 50 different partnership laws, rendering 50 different results.

9. The Revenue Proposals of the Biden Administration, as found in the Green Book, do not constitute precedent and do not warrant inclusion in the analysis. Even if the Tax Court were to consider the Green Book, Sirius allegedly misinterprets what it signifies. The IRS claims that the presidential suggestions are designed to ensure consistent tax treatment for all business income from pass-through entities, not solely to address the definition of limited partner for purposes of Section 1402(a)(13).

10. Material facts remain in dispute, such that resolution of this case, without a trial, through a Summary Judgment Motion, is improper. Moreover, because the "functional test" described in *Renkemeyer* mandates a review of all relevant facts and circumstances, including the actions and abilities of the partners, a trial is necessary to develop more evidence.

E. Conclusion

1. Now, after *not* issuing final regulations *for nearly 45 years* the IRS continues its attacks in *Sirius Solutions, LLLP v. Commissioner*.

2. In doing so, the IRS is asking the Tax Court to apply a "functional test" and special standards for "service partnerships," two concepts it introduced in the Second Proposed Regulations in 1997, which *never* took legal effect.

3. It is also requesting that the Tax Court give credence to certain administrative rules and court decisions that lack precedential authority.

4. In the same breath, the IRS is urging the Tax Court to ignore reports by the Joint Committee on Taxation, Private Letter Rulings, IRS Instructions to relevant returns, the Green Book, and state law directly on point.

5. Partnerships and partners eagerly await the Tax Court's decision.