Penalties

Choice of Forum Matters: Tax Court and District Court Reach Different Conclusions on Same Facts Regarding Penalties

By Bryan C. Skarlatos and H. Stow Lovejoy

Taxpayers in a dispute with the IRS have a choice of forum in which to litigate. The Tax Court provides a pre-payment judicial review while taxpayers who pay in advance can sue for refund in Federal District Court. The choice of forum can have a material impact on the outcome of the litigation as is demonstrated by the Federal District Court decision in *McNeill*[1] ("*McNeill 1*") and the Tax Court decision in *McNeill*[2] ("*McNeill 2*").

The two *McNeill* decisions provide a unique opportunity to compare how different courts can have different interpretations of substantially identical facts because the two cases involved the same taxpayer who engaged in the same type of tax shelter transaction in 2002 and 2003. When the IRS disallowed the tax shelter losses and asserted penalties, various procedural steps resulted in the 2002 penalty being litigated in Federal District Court in Wyoming while the 2003 penalty was litigated in the Tax Court. Interestingly, the Federal District Court found that the taxpayer reasonably relied on his accountants and a law firm's opinion to avoid accuracy-related penalties while the Tax Court held that the taxpayer did not reasonably rely on those same professionals and, therefore, was subject to penalties.

BRYAN C. SKARLATOS is a Partner at Kostelanetz & Fink, LLP in New York.

H. STOW LOVEJOY, Esq., is Of Counsel at Kostelanetz & Fink, LLP in New York, New York.

Taxpayer Enters into a Tax Shelter Transaction That Is Challenged by the IRS

McNeill was a graduate of Annapolis who served in the Navy for almost 20 years, including commanding a nuclear submarine. He then went to work operating nuclear power plants for utilities, eventually rising to become CEO of PECO Energy and then co-CEO of Exelon Corporation. At Exelon, his duties included overseeing the company's chief financial officer, whose duties included accounting, tax, and tax strategies. When McNeill retired in 2002, he received a severance package that was valued at $66 million, including the vesting and exercise of stock options.

McNeill investigated investments and strategies that might help him reduce some of the tax burden from the severance package. At the end of 2002, he invested in a "distressed asset debt" (or "DAD") transaction pitched to him by BDO Seidman and managed by Gramercy Advisers. This transaction, using a

series of partnerships that invested in Brazilian consumer receivables, purported to generate a deductible ordinary loss that McNeill could use to offset a large part of his income from his retiring from Exelon. He entered the transaction in mid-December and was allocated the losses by the end of the year. McNeill's 2002 return deducted a loss of over $20 million based on an investment of $3 million in the DAD transaction.

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When he invested in the 2002 DAD transaction, McNeill received opinions from BDO and from De Castro, West, Chodorow, Glickfield & Nass, Inc. De Castro was one of two law firms that BDO had recommended to McNeill to provide him tax opinions concerning the transaction. McNeill selected De Castro, but BDO negotiated De Castro's legal fee on the basis of the expected tax loss. Ernst & Young (E & Y), who advised McNeill generally on taxes and investment strategy, prepared the McNeills' 2002 tax return and prepared an internal memorandum for its own purposes that concluded that the DAD transaction met the "realistic possibility of success" standard necessary to protect E & Y as the return preparer. McNeill did not receive a copy of this internal memorandum, but he believed that E & Y had reached a favorable conclusion as to the deductibility of the DAD loss because they signed his return as preparer. McNeill paid BDO and De Castro fees of $1.55 million, and he paid E & Y their normal tax return preparation fee.

In 2003, McNeill decided to make another investment in a DAD transaction. He invested another $3 million which generated a loss of around $10 million. Just as they did with respect to the 2002 return, the De Castro firm provided BDO with a tax opinion, and E & Y prepared the tax return for 2003 after determining, again for its own purposes, that the DAD transaction met the "reasonable possibility of success" standard allowing them to sign the McNeills' return. By now, however, the Treasury had issued regulations concerning "reportable transactions,"[3] and E & Y advised McNeill that he should file Form 8886, "Reportable Transaction Disclosure Statement," and that E & Y should not be listed as a material adviser because it had not provided any tax advice with respect to the DAD transaction.

The District Court Finds That McNeill Relied in Good Faith on His Tax Advisers

The IRS, in a Final Partnership Administrative Adjustment (FPAA), determined that the DAD transaction in 2002 did not provide the desired tax losses and that the partners owed accuracy-related penalties. McNeill, as tax matters partner of the DAD partnership, paid the tax, penalty and interest for 2002 and filed suit for redetermination in the U.S. District Court in Connecticut. McNeill later settled his suit in Connecticut, acknowledging that the losses from the DAD transaction were not allowable, but he pursued a separate refund suit for the accuracy-related penalty in the U.S. District Court for Wyoming.

While it considered it a close question, the Federal District Court held that McNeill had reasonable cause and acted in good faith in reporting the loss from the DAD transaction. First, the court held that, even though McNeill was the commander of a nuclear submarine and became the head of a large public company, he was not experienced, sophisticated, or educated about highly structured tax-driven transactions and therefore was entitled to rely on his tax advisers. Next, the court determined that McNeill neither knew nor should have known that De Castro was an interested party and therefore that he could rely on their advice. The court also allowed McNeill to rely on E & Y's oral assurances concerning BDO and Gramercy as tax advice. Finally, even though the tax benefits of the DAD transaction may have been too good to be true, the court opined that McNeill could not be expected to closely analyze the transaction if his expert tax advisers did not advise him that the deal was too good to be true. As a result, the court found that McNeill reasonably relied on his expert tax advisers in good faith and therefore was not subject to an accuracy-related penalty because he had acted with reasonable cause and in good faith.

The Tax Court Finds That McNeill Did Not Rely in Good Faith on His Tax Advisors

The IRS also issued an FPAA with respect to the 2003 DAD transaction, disallowing the loss and imposing a penalty. McNeill paid the disputed amount of tax and began a proceeding on behalf of the partnership in the same District Court in Connecticut where the 2002 transaction was docketed, but he did not pay the penalty. As a result, while the proceeding with respect to the underlying

liability was still outstanding, the IRS issued a Final Notice of Intent to Levy with respect to the accuracy-related penalty for the 2003 DAD transaction, and McNeill filed a request for a Collection Due Process hearing. After being denied relief in the CDP hearing, he filed a petition in Tax Court contesting the penalty on the ground that he reasonably relied in good faith on E & Y and De Castro.

The Tax Court held that McNeill did not rely on good faith on either adviser. With respect to E & Y, McNeill argued that he could rely on the fact that they prepared and signed his return. However, the Tax Court ruled that E & Y never gave McNeill advice regarding the DAD transaction because its analysis of the DAD transaction was performed only for its own internal purposes and it never provided E & Y with a copy of its internal memorandum. This was further confirmed when, at E & Y's direction, McNeill did not list E & Y on Form 8886 in its list of persons "who promoted, solicited, recommended participation, or provided tax advice" with respect to the DAD transaction.

The Tax Court also found that McNeill could not rely on De Castro's advice because the firm was not independent. The Tax Court determined that De Castro was a promoter and had an inherent conflict of interest because it determined its fee as percentage of the tax savings. According to the court, McNeill knew or should have known that De Castro was not an independent advisor for a number of reasons. First, BDO recommended De Castro and told McNeill that the firm always gave favorable opinions. Second, BDO, not McNeill, negotiated the fee with De Castro. Finally, with respect to the 2003 transaction, BDO did not offer Mr. McNeill the opportunity to use a law firm other than De Castro.

The Tax Court held that, even if De Castro was an independent adviser, McNeill did not rely in good faith on the firm's advice because the DAD transaction was too good to be true. The Tax Court reasoned that he should have considered the $10 million tax loss suspect, based on the relatively small investment and the short time-frame of the transaction, particularly when he paid such large fees to BDO and De Castro. Circumstances such as these put a reasonable taxpayer under a duty of inquiry, so that a good-faith investigation of the underlying viability, financial structure, and economics of the investment is required. Of course, McNeill did not perform such an investigation.

Conclusion

The Tax Court Held McNeill to a Higher Standard

Why did the District Court conclude that McNeill relied in good faith on E & Y and De Castro while the Tax Court held the exact opposite on identical facts? In essence, the District Court put the responsibility on the advisors: E & Y was McNeill's long-time tax and investment advisor and reviewed the DAD transaction and signed the return while the De Castro firm had an ethical obligation to inform McNeill that it was a promoter or if it became aware of any conflicts. Further, neither adviser pointed out to McNeill that the results might be considered too good to be true, so he did not consider looking into the transaction more deeply. In contrast, the Tax Court placed responsibility squarely on McNeill: he knew that E & Y disavowed providing tax advice with respect to the DAD transaction when he asked about the Form 8886, and he should have picked up on the many indications that De Castro was not an independent adviser.

In the end, the relative tax sophistication and experience of the courts made the difference. The U.S. District Court, reviewing what was for it a relatively rare tax shelter case, found that McNeill, perhaps not unlike the judge herself, was "not knowledgeable or sophisticated about acquiring a partnership interest in distressed debt designed and implemented by investment managers and tax lawyers" and therefore should not be held to a higher standard of inquiry. On the other hand, to the Tax Court, for whom highly structured tax shelters are all too common, McNeill had the experience and sophistication necessary to understand that the DAD transaction was suspect, requiring additional inquiry.

The Tax Court has specialized tax knowledge and experience that often is preferable for untangling knotty tax structures. However, that same knowledge and experience also can lead a court to conclude that successful and intelligent individuals should be able to know when a tax transaction is just too good to be true.

ENDNOTES

1 *McNeill*, 237 FSupp3d 1171 (D.C. Wyo. 2017).
2 *McNeill*, TC Memo. 2017-206.
3 Reg. §1.6011-4.