STATEMENT

OF

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BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

CONCERNING

COMBATING ABUSIVE TAX SHELTERS

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Mr. Chairman, Ranking Member, Members of this Committee: thank you for inviting me to be with you today to discuss the work of the dedicated men and women of the Tax Division of the United States Department of Justice in the ongoing battle against the abusive tax shelters that undermine the integrity of our tax system.

My overarching goal as Assistant Attorney General for the Tax Division is quite simple: to restore respect for the tax laws. People who comply with the laws and pay the bills of this great nation should have the assurance that the government is doing something about people who are not, either by simple or by sophisticated means.

My remarks today begin with a brief description of the role the Tax Division in tax enforcement in general, followed by a review of our recent activity in the tax shelter arena, ranging from what I call our information litigation to our merits litigation.

THE TAX DIVISION

Under the authority of the Attorney General, the Justice Department's Tax Division is responsible for the conduct of virtually all litigation involving the federal tax laws. The only exception is cases brought in the United States Tax Court: IRS attorneys handle those. The Tax Division of the United States Department of Justice is responsible for all other litigation involving the tax laws, affirmative or defensive, including appeals from Tax Court decisions.

Tax Division attorneys represent the United States government in federal district courts, the bankruptcy courts, the Court of Federal Claims, and the United States Courts of Appeals. We defend federal tax claims in bankruptcy, and IRS agents in suits brought against them for actions taken in the performance of their duties. We bring legal actions to collect taxes due. We bring injunction suits to stop illegal activities before they can do further harm to the Federal Treasury. The Tax Division assists the Solicitor General of the United States in Supreme Court cases involving or affecting the administration or enforcement of federal tax laws.

To promote nationwide consistency in the criminal enforcement of the tax laws, Tax Division authorization is required before the Department of Justice investigates or prosecutes a tax charge. We delegate authority to United States Attorneys to handle most grand jury investigations and criminal tax prosecutions, with Tax Division prosecutors often supervising or assisting. Tax Division prosecutors also personally litigate a small proportion of tax prosecutions.

At any given time, we have about 7,000 civil cases in progress and about 700 cases before the United States Courts of Appeal. This past fiscal year, we authorized the prosecution of more than 1,100 defendants, an increase of 17% from the prior year, which itself was an increase of 16% over the year before that. To accomplish all of this, the Tax Division employs about 550 people, of whom about 350 are attorneys.

Of all Tax Division activities, the most relevant to the subject of today's hearing are these: we help the IRS obtain information it needs to accomplish its examination function by obtaining judicial enforcement of administrative summonses or obtaining leave of court for the Internal Revenue Service to serve John Doe summonses. And we defend the United States in refund suits and in tax claims in bankruptcy. The comments that follow address these two areas of endeavor.

Abusive tax shelters

Abusive tax shelter cases involve both corporations and individuals. A coordinated and effective effort is essential to prevent substantial losses to the federal fisc and to deter other taxpayers from using such shelters in the future.

The Tax Division coordinates closely with the Internal Revenue Service in all of our work. The Tax Division's summons enforcement team, comprised of senior lawyers, provides guidance to the IRS and to Tax Division attorneys in connection with the issuance and enforcement of tax shelter promoter summonses and John Doe summons issued to promoters. The Division's tax shelter coordinator maintains regular contact with IRS Tax Shelter program personnel, ensures that the IRS is consulted on major litigating decisions, provides guidance to our lawyers, and orchestrates training and planning sessions. We also have an extremely close working relationship with the IRS on the offshore credit card summons cases, and on efforts to shut down tax schemes and scams. The degree of coordination and cooperation between the IRS and the Tax Division has probably never before been this close and extensive.

Information Litigation: Summons Enforcement Actions

The Tax Division plays an important role in curbing abusive tax shelters by obtaining judicial enforcement of IRS summonses. Since 1984, tax shelter organizers have been required to register certain tax shelters with the IRS before offering them to the public. In addition, organizers and sellers of potentially abusive tax shelters are required to maintain a list of all shelter purchasers, and to make that list available to the IRS on 20-days notice. Failure to comply with these requirements can result in penalties.

The Tax Division has brought summons enforcement actions against some of the nation's largest accounting firms to obtain information for IRS examinations of compliance with the tax shelter registration and list maintenance requirements and to commence examinations of the customers. In cases against BDO Seidman and Arthur Andersen, the district courts enforced the summonses and ordered these entities to turn over the documents needed by the IRS to ensure compliance with the law. Privilege issues relating to compliance with the enforcement orders in these cases are still being litigated. Privilege issues are also being litigated in a pending case with KPMG.

These summons enforcement actions will help the IRS not only to determine the promoters' liability for penalties but also to audit their tax shelter customers, and thereby recoup taxes otherwise lost to the Federal Treasury.

Although we contend that the list-maintenance requirement Congress enacted clearly precludes any claim of identity privilege for tax shelter customers regardless of whether the promoters happen to be accountants or lawyers, the issue continues to be the subject of vigorous litigation. In two cases involving accounting firms, and one involving a bank, clients sued to intervene in an attempt to prevent the firms and the bank from divulging their names to the IRS, claiming that their identities were privileged. The Seventh Circuit rejected this claim in the *BDO Seidman* case and held that the identities of participants are not protected by privilege and must be disclosed to the IRS. The United States District Court for the Northern District of Illinois in *Arthur Andersen* subsequently issued an opinion following the decision of the Seventh Circuit. The United States District Court for the Western District of North Carolina found, in *Wachovia*, that customers of a bank that had facilitated a tax shelter transaction could not prevent the bank from disclosing their identities to the IRS. The Court in *Wachovia* also concluded there was no attorney-client relationship between the bank's customers and Jenkens & Gilchrist, the law firm that had rendered an opinion on the tax shelter transaction.

A few months ago, at the request of the IRS, the Tax Division obtained a district court order allowing the IRS to serve a "John Doe" summons on the law firm Jenkens & Gilchrist. The summons requires Jenkens & Gilchrist to disclose the identities of persons who participated in tax shelters organized or sold by the law firm. The Division subsequently filed an action asking the court to enforce compliance with the John Doe summons and with five administrative summonses the IRS had issued as part of the its examination of Jenkens & Gilchrist's possible promotion of tax shelters.

Last week, the federal district court in Chicago entered an order authorizing the IRS to serve a John Doe summons on the law firm Sidley Austin Brown & Wood to identify participants in listed transactions and other potentially abusive transactions organized or sold by the firm's Chicago office.

As a result of the enforcement orders entered by the courts in the summons cases, the IRS has been able to obtain documents relating to potentially abusive transactions and the identities of taxpayers who may have participated in these transactions. But privilege claims concerning a substantial number of documents have yet to be resolved by the courts.

These suits are complex, difficult, and resource-intensive to prepare and file. Bringing these suits is only the first step in what has become hotly contested litigation. ‑ The resource demands continue until all aspects of a case are resolved.

The Tax Division has made it a priority to file these suits promptly and to represent the IRS effectively in the ensuing litigation. The cases must be and are prepared with great care because of their importance to the enforcement of the internal revenue laws, and the need to satisfy the courts that the requests are legally justified.

Substantive Litigation: Appellate Litigation and Defense of Tax Shelter Refund Suits and Tax Claims in Bankruptcy

The Tax Division plays an important role in the government's efforts to combat abusive tax shelters. Tax Division attorneys will handle any defense of tax shelter refund suits in the district courts and the Court of Federal Claims, as well as any defense of tax claims in bankruptcy proceedings , and also any appeal of a Tax Court decision. While each tax shelter case the Division handles involves millions of dollars of tax revenue, its impact goes far beyond the taxpayer and the years in issue. Each of these cases has the potential to set precedent that will affect other taxpayers who might still be under IRS examination or elsewhere in the administrative or judicial pipeline.

More and more cases involving large abusive tax avoidance transactions are being filed in the district courts and in the Court of Federal Claims rather than in the Tax

Court. The Tax Division is now actively engaged in the litigation of 27 abusive tax shelter cases.

Compared to other tax cases, abusive tax shelter cases are especially costly to litigate. Taxpayers have been known to staff the cases with a dozen attorneys and several very-highly paid expert witnesses. The Tax Division staffs these cases at the outset with at least two attorneys, and usually three attorneys, to handle the discovery and other pretrial work in a timely and efficient manner. We must also hire our own private sector experts to testify about the purported business purpose, the values of any assets or liabilities at issue, foreign law, and other subjects.

Disputes about discovery are frequent. In many of these cases, tens of thousands of documents are relevant to transactions at issue. The sheer volume and complexity of the factual records in these cases make it essential to scan the case documents into electronic form and create computer databases that facilitate the management and sorting of the data. All in all, the cases are extremely resource intensive.

Substantive Successes

The Tax Division has had some notable successes in litigating abusive tax shelter cases.

1. In *Boca Investerings Partnership v. United States*, a case involving a contingent installment note shelter, the District of Columbia Circuit held that the taxpayer's formation of a "partnership" with a foreign entity not subject to United States tax to shelter a large capital gain lacked economic substance and would not be given effect for tax purposes. The foreign partnership purchased private placement notes (PPNs), and the PPNs were immediately exchanged for contingent payment installments. The exchange is supposed to generate large capital losses under the ratable basis recovery rule in Section 453 of the Internal Revenue Code, with the losses allocated to the United States taxpayer and gains allocated to the foreign partner. The decision aligns the District of Columbia Circuit with the Third Circuit, which in the *ACM Partnership* decision earlier denied similar benefits to a taxpayer participating in the same tax shelter scheme. Merrill Lynch marketed this scheme to many of its corporate clients. (This shelter is described in Notice 2001-51, 2001-2 C.B. 190.)

2. In *Nicole Rose Corp. v. Commissioner*, the Second Circuit rejected a corporation's

use of an abusive tax shelter to avoid tax on gain realized on the sale of a manufacturing business, and upheld the assessed negligence penalty. The court found that the corporation engaged in a sham computer leasing transaction designed to generate an apparent tax loss at a small economic cost to itself.

3. The district court held in *CM Holdings* (D. Del.) that interest on loans to fund corporate owned life insurance (COLI) policies was not deductible and the Third Circuit affirmed. The COLI cases involve taxpayer claims of large interest deductions on purported policy loans against life insurance policies taken out on all of the corporation's employees. In the 1980's and early 1990's, many Fortune 500 companies purchased COLI policies covering thousands of employees, used purported loans to pay the premiums, and deducted interest on the policy loans. Congress phased out the interest deduction on broad-based COLI policies beginning in 1996. The government's position is that such loans lack economic substance and thus do not give rise to interest deductions under § 163. In another COLI case, *American Electric Power Co.* (S.D. Ohio), the district court agreed with the government's position and the Sixth Circuit affirmed. The district court in *Dow Chemical* (E.D. Mich.) recently issued an adverse decision in another COLI case, but any government appeal would be heard by the Sixth Circuit, the same court that decided *American Electric Power Co.*

Pending Cases

The Tax Division's inventory of pending cases involve a variety of abusive tax shelter techniques:

<u>Lease stripping shelters.</u> In a lease stripping shelter, the taxpayer claims large deductions from a multi-party transaction intended to allow the income from a lease to be allocated to a tax-neutral entity such as a foreign corporation or Indian tribe, and allow the related deductions to be claimed by the taxpayer. (This shelter is described in Notice 2003-55, 2003-34 I.R.B. 395, modifying and superceding Notice 95-53, 1995-2 C.B. 334.)

<u>Basis shifting shelters.</u> Basis shifting shelters involve a taxpayer's attempt to use §§ 302 and 318 (relating respectively to corporate stock redemptions and the constructive ownership rules) to shelter large capital gains. (This shelter is described in Notice 2001-45, 2001-2 C.B. 129.)

Contingent liability shelters. A contingent liability shelter scheme is comprised of a series of transactions in which a taxpayer claims a loss from the sale of a minority interest in one of its subsidiaries through the use of a complex set of intra-corporate actions that is intended to accelerate a deduction of what otherwise would be a contingent loss. (This shelter is described in Notice 2001-17, 2001-1 C.B. 730)

Basis pump shelter (a.k.a. Short Sale Strategy). A basis pump shelter involves a taxpayer's attempt to create a loss to offset against anticipated gain on the sale of an asset. It contributes the asset to a partnership. It also contributes the rights and obligations associated with a "short sale." The taxpayer then causes a technical termination of the partnership, pursuant to section 708(a)(2)(B) of the Code, by substituting one subsidiary-partner for another. The taxpayer argues that as a result of the termination, the partners' bases in their partnership interests are allocated to the partnership assets in accordance with section 732 of the Code. By not treating the obligation to close the short-sale as a liability for purposes of section 752 of the Code, the taxpayer is able to "pump up the basis" in the partnership interests. When a partnership interest is sold, the carefully scripted events create an artificial loss.

"Son of BOSS". In one typical form of a Son of BOSS shelter, a taxpayer purchases and writes economically offsetting options and then purports to create substantial positive basis by transferring those option positions to a partnership. On the disposition of the partnership interest, the liquidation of the partnership, or the taxpayer's sale or depreciation of distributed partnership assets, the taxpayer claims a tax loss, even though the taxpayer has not incurred a corresponding economic loss. (This shelter is described in Notice 2000-44, 2000-2 C.B. 255 and is now addressed in Temporary Regulations section 1.752-6.)

CONCLUSION

The Tax Division is fully committed to restoring and maintaining the integrity of the federal tax system. This means succeeding in our summons enforcement litigation, and in our tax shelter litigation. We have made progress, but considerable challenges remain.

The IRS has made shutting down abusive tax shelters one of its major strategic initiatives. The IRS cannot do it alone. And the Tax Division cannot initiate the necessary actions on its own. Through legal necessity and shared commitment, the Tax Division and the IRS are partners in these efforts.

I will be pleased to respond to any questions Members of the Committee might have.