

Applying Old Theories in New Contexts: Interest Suspension Upheld Where Government Fails to Prove Fraud

By Hale E. Sheppard

Hale E. Sheppard discusses the recent decision in *C.E. Sala* upholding taxpayer's interest-suspension benefit and examines what the decision reveals about the government's potential strategy in future shelter litigation.

Introduction

The government simply despises everything about transactions it considers abusive. Indeed, in its zeal to eradicate these seemingly ubiquitous "tax shelters," the government often attacks all potentially liable parties. These include the transaction designers, promoters, opinion writers, return preparers and, of course, the participants. In challenging the latter, the government typically disallows the claimed losses, asserts significant penalties and charges interest. The government has a handful of arguments that it tends to raise in justifying its actions. Among the favorites is that the transaction, although entirely consistent with a literal reading of the applicable tax law, lacked "economic substance" and was conducted solely for tax-avoidance purposes. As one would expect, disallowing the taxpayer's losses often results in a multi-million dollar tax liability, along with penalties of jaw-dropping magnitude.

In the shadow of these enormous figures, the interest component has received relatively little attention. This neglect has also been fostered by Code Sec.

6404(g), which generally causes interest penalties to stop accruing to the taxpayer's detriment 18 months after she files the relevant tax return. The focus on interest has now returned, though, with the recent decision in *C.E. Sala*.¹ In this case of first impression, the government attempted to deprive the taxpayer of the interest-suspension benefit based on the (flawed) theory that it was a "case involving fraud." The fact that the taxpayer in *Sala* prevailed is intriguing, particularly to tax practitioners and their clients who currently find themselves embroiled in a dispute with the IRS over their involvement in a purported shelter. That the government's principal argument in a fraud case was that the transaction in question lacked economic substance is also noteworthy. The most interesting aspect of *Sala*, however, may be what it reveals about the government's potential strategy in future shelter litigation.

Overview of Interest Suspension

An individual taxpayer using a calendar year generally must file her federal income tax returns by April 15th each year.² She must pay the tax due at this time, too.³ If she fails to pay in full and on time, then interest begins to run on the underpayment amount.⁴ To make matters worse for the delinquent taxpayer,

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the interest is normally compounded daily.⁵ Thus, the accumulation of interest, particularly in tax shelter cases where the alleged underpayment often reaches many millions of dollars, is a major concern.

Individual taxpayers prone to making late payments have at least one reason to cheer, though. The IRS must generally suspend the accrual of interest if it does not provide notice to the taxpayer specifically indicating the taxpayer's liability and the basis for such liability within 18 months after the original due date of the return (if the return is filed on or before the due date) or the date on which the taxpayer actually filed her return (if the return is timely filed pursuant to a valid extension), whichever is later.⁶ This halt on interest begins the day after the 18-month notification period expires and does not end until 21 days after the IRS gives the taxpayer adequate notice of the proposed deficiency.⁷ In this context, adequate notice consists of math error notices, under-reporter program notices, revenue agent reports, 30-day letters and statutory notices of deficiency.⁸ Audit letters limited to identifying the items that are under examination, however, are deemed inadequate.⁹

A simple example may help clarify the concept. Say an individual taxpayer timely files her federal income tax return for 2001 on April 15, 2002. The IRS sends her a 30-day letter with an accompanying revenue agent's report on April 15, 2004. The taxpayer may ultimately be liable for the tax deficiency, but she will get a break on underpayment interest. This is suspended from October 16, 2003 (*i.e.*, the day after the 18-month notification period) through May 6, 2004 (*i.e.*, 21 days after the IRS provided the taxpayer adequate notice of the liability).

The legislative purpose for introducing the interest-suspension rule in 1998 was two-fold. First, Congress wanted to encourage the IRS to work more diligently by essentially imposing an economic penalty (*i.e.*, the amount of the forgone interest) in cases where the agency failed to promptly inform taxpayers of their tax obligations.¹⁰ Second, Congress was worried that delayed examinations would tarnish the agency's public image, creating the impression that it prioritized gathering money over ensuring justice. The relevant congressional report framed it more diplomatically, explaining that the Senate Finance Committee was "concerned that accrual of interest and penalties absent prompt resolution of tax deficiencies may lead to the perception that the IRS is more concerned about collecting revenue than in resolving taxpayers' problems."¹¹

It should come as no shock to anyone familiar with tax law that there are exceptions to the general interest-suspension rule. Of particular interest here is Code Sec. 6404(g)(2)(B), which provides that taxpayers are not entitled to the beneficial suspension "in a case involving fraud." Simply stated, interest never stops accruing where an individual taxpayer engaged in fraud. According to the IRS, this represents a situation in which the taxpayer is "clearly blameworthy" for the delayed notification, and thus not entitled to the benefit granted to those taxpayers who are not at fault for the IRS holdup.¹² In *Sala*, the government tried to place the taxpayer in just such a situation.

What Does "Economic Substance" Have to Do with Fraud?

Mr. Sala was an executive and officer of a database marketing company, which was acquired in 1999. As part of this acquisition, Mr. Sala received stock options. He sold these options in 2000, thereby generating approximately \$60 million of income. Mr. Sala was looking for a way to use this money wisely, both from an investment and tax perspective. Mr. Sala's friend and former accountant introduced him to the promoter of a tax-advantaged strategy involving the purchase and sale of foreign currency options ("Transaction"). The IRS contends that the Transaction was the same as or substantially similar to the infamous Son-of-Boss strategy described in Notice 2000-44. Before engaging in the Transaction, Mr. Sala, a sophisticated and experienced investor, completed a significant amount of due diligence, which entailed reviewing documents, asking numerous questions about potential risks and performance, consulting attorneys, and commissioning an opinion letter from a trusted advisor.

Ultimately, Mr. Sala decided to participate in the Transaction. He initially invested a relatively small amount, and then increased his investment once the original outlay yielded positive results. In the end, Mr. Sala made a small economic profit on the trades, which he reported, along with a tax loss of approximately \$60 million from the Transaction, on his federal income tax return for 2000. This loss essentially offset the \$60 million of income that Mr. Sala derived from the sale of his stock options during the same year.

Mr. Sala timely filed his return by April 15, 2001. Before receiving adequate notice of a deficiency from the IRS, Mr. Sala filed an amended return on Novem-

ber 18, 2003. Unlike his original return, the amended version did not claim any tax benefit from the losses produced by the Transaction. Along with filing this corrected return, Mr. Sala paid the additional taxes he owed, as well as interest on the underpayment accruing from the due date of the original return (*i.e.*, April 15, 2001) until the end of the 18-month notification period (*i.e.*, October 16, 2002).

The IRS then demanded that Mr. Sala pay approximately \$1.5 million in additional interest to cover the gap between the end of the 18-month notification period (*i.e.*, October 16, 2002) and the date on which he paid the additional amounts due with his amended return. In other words, the IRS took the position that Mr. Sala's case was one "involving fraud" and thus ineligible for interest suspension under Code Sec. 6404(g)(2)(B).

Mr. Sala paid the additional interest, sought the appropriate administrative relief, and eventually filed a suit for refund in federal district court. The sole issue at this juncture was Mr. Sala's Motion for Partial Summary Judgment regarding his entitlement to a refund of the (excessive) interest payments. As the court put it, the case "reduces entirely to whether Sala's underlying claim for a tax refund is a case involving fraud." No other court has addressed the fraud exception under Code Sec. 6404(g)(2)(B), thereby making this a case of first impression.

The court placed the burden on the government of proving by clear and convincing evidence that fraud existed. The government's primary argument was that the Transaction lacked economic substance. The court found this approach "curious" since it goes only to whether Mr. Sala was entitled to claim the loss, not to the only issue before the court, *i.e.*, whether there was fraud.

The government made a number of arguments, all of which the court considered far afield. First, the government argued that certain side deals struck by Mr. Sala demonstrate that he lacked a profit motive for entering into the Transaction. One side deal lowered Mr. Sala's share of the profits in exchange for lower management fees, while the other conditioned his participation in the Transaction upon receipt of a favorable tax opinion. The government contended that anyone truly seeking an economic gain would not negotiate down profit potential or secure an exit strategy. The court dismissed these arguments as "unpersuasive" and "little more than speculation" because Mr. Sala had negotiated similar deals in other investments, Mr. Sala's attorney

advised him to execute the agreements in question, and seeking a tax opinion could just as easily be considered an indication of Mr. Sala's intent to act legally as evidence of fraud. Importantly, the court explained that, even if the government were correct in that Mr. Sala was not truly interested in economic profit, this would only impact the economic substance issue, not fraud.

Second, the government argued that Mr. Sala only sought a tax advantage, whereas Mr. Sala indicated that he desired both a tax and investment opportunity. The court again rejected the government's argument, based largely on the fact that the government's own witness acknowledged the Transaction had profit potential. The court concluded that the mere fact that Mr. Sala sought a tax-advantaged investment is not evidence of fraud.

Third, the government suggested that series of steps in the Transaction smacked of fraud. Mr. Sala acquired the foreign currency options in his own name and then transferred them to an S corporation he controlled. According to the government, these steps had no purpose other than generating a tax loss since Mr. Sala lost any possible liability protection when he acquired the options in his own name. The court seemed somewhat persuaded by this argument, but ultimately concluded that while the government may have undermined Mr. Sala's explanations for utilizing an S corporation, "this is not clear and convincing evidence of fraud."

Fourth, the government claimed that Mr. Sala's behavior in searching for the Transaction was evidence of his intent to mislead. It argued, in particular, that Mr. Sala knew the Transaction was a listed transaction under Notice 2000-44 and, therefore, should have been registered with the IRS. Before entering into the Transaction, Mr. Sala consulted with at least three advisors: the person organizing the transaction, who stated that the Notice did not apply; the attorney preparing the opinion letter, who concluded that it was more likely than not that the Transaction would be upheld if the IRS were to challenge it; and a trusted tax attorney, who reviewed the opinion letter and concluded that it was reasonable. The court, citing Supreme Court precedent, stated that a taxpayer may reasonably rely on substantive tax advice from counsel. It then concluded that the government fell short of the mark: "At most, the Government's evidence shows that Sala was on notice that the IRS might challenge the tax losses offered by [the Transaction] but, armed with a favorable tax opinion, he chose to proceed

anyway. This may be evidence that Sala was willing to incur some risks, but it does not show fraud.”

Fifth, the government tried to convince the court that the opinion letter was unworthy of reliance because Mr. Sala failed to reveal various details about the Transaction to the drafter and because the opinion did not address the fact that the structure of the Transaction depended on whether the participants were seeking capital or ordinary losses. The court rejected this argument since the government failed to show that the discrepancies impacted the legal conclusions in the opinion. The court pointed out, though, that Mr. Sala’s reliance on the opinion does not mean that he is entitled to the losses he claimed on his return because technical compliance with tax law does not necessarily make the underlying transaction substantive. However, reliance “does show that Sala lacked the intent necessary for fraud.”

Sixth, the government raised examples of Mr. Sala’s inconsistent statements regarding meetings and conversations with legal and tax professionals. The court gave little credence to this argument, finding that the statements were not “consequential or persuasive,” they were all “minor inconsistencies” related to meetings that occurred years before, and they did not show an effort at concealment. The court reasoned that these inconsistencies may serve to discredit Mr. Sala, but they “are not sufficient to create clear and convincing evidence of fraud.”

Finally, the government focused on a letter from an attorney at KPMG (*i.e.*, the accounting firm that prepared Mr. Sala’s tax return), which supposedly contained an admission that the Transaction was fraudulent. The court held that such letter was insufficient to demonstrate fraud. More importantly, the court emphasized that the government had an attribution problem; that is, “any KPMG admission that [the Transaction] was fraudulent does not show that Sala was aware that it was fraudulent.”

Based on the foregoing, the court granted Mr. Sala’s Motion for Partial Summary Judgment.

What Can Taxpayers Learn from *Sala*?

Gleaning the significance of a tax case often requires transcending the surface. Subtleties are important, as are omissions. Indeed, these two items may be more telling than the court’s ultimate holding. This is true with *Sala*, whose real value derives from three interesting, yet obscure, points.

New Angles to Defeat Interest Suspension

In the late 1990s, the IRS was heavily criticized for harassing taxpayers and dragging out audits.¹³ To thwart these practices, Congress introduced the general interest-suspension rule in Code Sec. 6404(g) as part of the IRS Restructuring and Reform Act of 1998 (“RRA”).¹⁴ It seemed like no sooner had Congress granted the interest holiday than it started taking steps to limit it, particularly when it came to transactions that the IRS considers abusive. For example, a new exception was added by the American Jobs Creation Act of 2004 (“Jobs Act”), which disallowed interest suspension in cases involving undisclosed “reportable transactions” or “listed transactions.”¹⁵ To the chagrin of the IRS, this suspension only applied to interest accruing after October 3, 2004. The IRS did not fret long, though, because Congress made another major change the next year. The Gulf Opportunity Zone Act (“GOZA”) was enacted in December 2005. With certain limited exceptions, this legislation retroactively repealed interest suspension for those involved in undisclosed reportable transactions or listed transactions.¹⁶ It essentially made the restriction in the Jobs Act effective at the time of the RRA, even though the former did not become law until approximately six years later.

To prevail under the Jobs Act and GOZA, the government must first demonstrate to the court that the transaction in which the taxpayer participated was either an undisclosed reportable transaction or a listed transaction, and then address the thorny issue of the validity of retroactive legislation. This is no easy task. Perhaps to avoid this challenge, the government in *Sala* argued instead that the case involved “fraud,” which triggers entirely different evidentiary issues. In short, it appears that the government is now trying to use two different means to come to the same end, *i.e.*, denial of interest suspension.

Extending the Statute of Limitations Under Code Sec. 6501(c)(1)

If the government had managed to prove fraud in *Sala*, it would have gotten a “twofer,” an added bonus. That is, it could have denied interest suspension under Code Sec. 6404(g)(2)(B) and extended the statute of limitations for assessment under Code Sec. 6501(c). The limitations period was not an issue in *Sala* because the taxpayer filed a qualified amended return, but it frequently is in tax shelter cases. This is largely because many shelters utilized

today are tremendously complex, entailing multiple entities, transactions and returns. Participants in such structures do not simply fail to report income; rather, they inundate the IRS with numerous tax and information returns in an attempt to muddle the true source or amount of losses, or the basis in particular assets.¹⁷ Consequently, the IRS has trouble doing its job within the allotted time, especially in the international realm.¹⁸

The IRS generally has three years from the date on which a return is filed to identify the taxpayer, conduct the audit, and assess additional taxes, interest and/or penalties.¹⁹ There are certain exceptions, of course. For instance, the assessment period is extended in cases of willful tax evasion, substantial omissions from gross income, and undisclosed listed transactions.²⁰ For reasons that are beyond the scope of this article, meeting each of these standards presents certain difficulties for the IRS. Therefore, the government may try to extend the assessment period indefinitely by arguing that a case involved a “false or fraudulent return.”²¹ The fact that it did so in *Sala* may be indicative of things to come.

Selective Disregard of Unfavorable IRS Pronouncements

Maybe the most interesting thing about *Sala* was not what the government argued, but rather what it chose not to mention. As the saying goes, silence speaks volumes. This is particularly true in the context of tax litigation.

Rev. Rul. 2005-4 was issued in January 2005, years before *Sala*.²² This IRS pronouncement discussed how the filing of an amended return would impact interest suspension under Code Sec. 6404(g). To illustrate the point, Rev. Rul. 2005-4 presented the following situation. An individual taxpayer files his tax return for 2002 on April 15, 2003. The IRS did not provide the taxpayer notice of any tax deficiency. On November 26, 2004, which was approximately 20 months after filing the original return, the taxpayer filed an amended return and paid the additional taxes due. The IRS made the result in this scenario absolutely clear:

TP filed an amended return on November 26, 2004, more than 18 months after the filing of an income tax return. The Service did not provide TP with the notice required to be provided under section 6404(g) prior to October 14, 2004, the date on which the notification period expired.

Section 6404(g) suspends the imposition of interest and time sensitive penalties beginning on October 15, 2004, until November 26, 2004, the date on which TP filed the amended return and paid the additional tax due.

In his Opening Brief in support of his motion for partial summary judgment, Mr. Sala relied heavily on Rev. Rul. 2005-4 since the facts there were essentially identical to those in his case. In its Response, the government did not (reluctantly) acknowledge Rev. Rul. 2005-4 and then try to distinguish it from Mr. Sala’s situation or otherwise minimize its importance. Instead, it simply ignored its own ruling that was directly on point. Like its decision to argue economic substance in a fraud case, the government’s disregard of Rev. Rul. 2005-4 seems “curious,” particularly given the weight afforded revenue rulings by the IRS and the courts.

According to the Internal Revenue Manual and Treasury regulations, revenue rulings are “official interpretations” by the IRS National Office of tax provisions, related statutes, treaties, and regulations.²³ These rulings are designed to help IRS personnel apply the tax laws correctly and uniformly, and to attain maximum voluntary compliance from taxpayers by clearly explaining how the IRS is construing certain items.²⁴ In terms of their significance, revenue rulings do not have the force and effect of Treasury regulations. However, they are published “to provide precedents to be used in the disposition of other cases, and may be cited and relied upon for that purpose.”²⁵ Moreover, the IRS has expressly acknowledged that taxpayers “generally may rely upon Revenue Rulings published in the [Internal Revenue] Bulletin in determining the tax treatment of their own transactions and need not request specific rulings applying the principles of a published Revenue Ruling to the facts of their particular cases.”²⁶ The Tax Court has also emphasized the importance of revenue rulings, especially in situations where the IRS (*i.e.*, the very party that issued the rulings in the first place) attempts to ignore them. On several occasions the Tax Court has treated revenue rulings as concessions by the IRS.²⁷

Conclusion

Thanks largely to the general interest-suspension rule in Code Sec. 6404(g), the issue of interest has garnered

little attention thus far. However, as tax shelter litigation continues, this aspect will surely acquire additional importance. *Sala* constitutes the government's first attempt at depriving a taxpayer of interest suspension based on the fraud exception under Code Sec.

6404(g)(2)(B). While the court's holding will undoubtedly be of interest to similarly situated taxpayers, the real value of *Sala* stems from its more esoteric points. Focusing on these may provide guidance on the government's tactics in future tax litigation.

ENDNOTES

¹ *C.E. Sala*, DC-CO, 2007-1 USTC ¶50,514.

² Code Sec. 6072(a).

³ Code Sec. 6151(a).

⁴ Code Sec. 6601(a).

⁵ Code Sec. 6622(a).

⁶ Code Sec. 6404(g)(1)(A). Please note that Code Sec. 6404(g)(1)(A) was amended by P.L. 110-28 and applies to notices provided by IRS after the date that is six months after May 25, 2007. The amended Code section gives the IRS 36 months after the original due date of the return (if the return is filed on or before the due date) or the date on which the taxpayer actually filed her return (if the return is timely filed pursuant to a valid extension), whichever is later.

⁷ Code Sec. 6404(g)(3).

⁸ CCN N(35) 000-172 (March 22, 2000); IRM §20.2.6.6.4 (08-01-2006).

⁹ *Id.*

¹⁰ Senate Report 105-174, 105th Cong., 2d Sess., Apr. 22, 1998, at 64.

¹¹ *Id.*

¹² FSA 200201010 (Sept. 28, 2001).

¹³ See, e.g., S. Hrg. 105-529 ("IRS Restructuring"), 105th Cong., 2d Sess., Jan. 28, 29 and Feb. 5, 11 and 25, 1998), S. Hrg. 105-190 ("Practices and Procedures of the Internal Revenue Service"), 105th Cong., 1st Sess., Sept. 23, 24 and 25, 1997.

¹⁴ Act Sec. 3305 of the Restructuring and Reform Act of 1998 (P.L. 105-206).

¹⁵ Act Sec. 903(c) of the American Jobs Creation Act of 2004 (P.L. 108-357).

¹⁶ Act Sec. 303(a)(1) of the Gulf Opportunity Zone Act of 2005 (P.L. 109-135); see also U.S. Joint Committee on Taxation, *Technical Explanations of the Revenue Provisions of H.R. 4440, the 'Gulf Opportunity Zone Act of 2005,' as Passed by the House of Representatives and the Senate*. JCX-88-05 (Dec. 16, 2005), at 67-68.

¹⁷ Hale E. Sheppard, *Only Time Will Tell: The Growing Importance of the Statute of Limita-*

tions in an Era of Sophisticated International Tax Structuring, 30(2) BROOKLYN J. INT'L LAW 453-84 (2005).

¹⁸ U.S. Government Accountability Office. *Additional Time Needed to Complete Offshore Tax Evasion Examinations*. GAO-07-237 (Mar. 2007).

¹⁹ Code Sec. 6501(a).

²⁰ Code Sec. 6501(c)(2); Code Sec. 6501(e); Code Sec. 6501(c)(10).

²¹ Code Sec. 6501(c)(1).

²² Rev. Rul. 2005-4, IRB 2005-4, 366 (Jan. 24, 2005).

²³ IRM §32.2.2.3.1 (08-11-2004); Reg. §601.601(d)(2)(i)(a).

²⁴ IRM §32.2.2.2 (08-11-2004); Reg. §601.601(d)(2)(iii).

²⁵ Reg. §601.601(d)(2)(v)(d).

²⁶ Reg. §601.601(d)(2)(v)(e).

²⁷ *G.A. Rauenhorst*, 119 TC 157, at 171-73, Dec. 54,899 (2002).

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