Change, Complexity, and Increasing Uncertainty in the Tax Law: Their Impact on Our Tax System and What We Should Do About It

By Lawrence B. Gibbs

It is a truism that our tax law reflects our economy and our society. It also is true that our economy and society are complex and subject to change, increasingly so as the ramifications of our interconnectedness with the global economy and society have become more apparent. Perhaps the most dramatic, recent example might be the events of September 11 and their aftermath. In New York City and Washington, D.C. – the two cities symbolic of the complexity and change of American economy and society – we and the rest of the world watched events that in two hours changed our society and economy in ways so profound that we could not then and still cannot completely comprehend them. In short, the rate at which change and complexity are occurring in our daily lives often leaves us with a sense of increasing uncertainty.

The same, I submit, is true about our tax law. During the last 30 years, all of us who have worked in the tax area – in the private and public sectors – have watched as our tax law constantly changed and became more complex. More and more legislation, regulations and other forms of guidance, and court decisions have descended upon us all. The rate of change and increasing complexity in the tax law have accelerated as the pace of business in the private and public sectors has accelerated. The uncertainty resulting from the accelerated rate of change and complexity is apparent.

The part of our tax system that traditionally has been the least affected by change and complexity – our judicial system – recently has begun to show the effects of increasing change and complexity. I submit that the uncertainty caused by recent surprises in the tax decisions of our courts is likely to have the most profound impact on our tax system. The reason is that we all look to the courts for guidance to enable us to predict what the tax law will be in the future.

Let's look at some examples. A year ago, the IRS had won almost every case it had tried in the so-called corporate tax shelter area. By my count, the score stood at 12-1 in favor of the IRS. The Tax Court and the federal trial and appellate courts had almost unanimously adopted the Commissioner's economic substance argument. Today, one year later, by my count the score stands at 9-5.[1]

Perhaps the most significant turn of events involved the Merrill Lynch contingent installment sale marketed transaction that led to three of the Commissioner's most impressive initial victories in the corporate tax shelter area in *ACM Partnership*, *ASA Investerings Partnership*, and *Saba Partnership*. *ACM* involved the Colgate-Palmolive Company; *ASA*, Allied-Signal; and *Saba,* the Brunswick Corporation; three large, sophisticated, well-represented corporate taxpayers. In the *ACM* case, Judge Laro in the Tax Court upheld the IRS, the Third Circuit affirmed, and the Supreme Court denied the taxpayer's request for *certiorari.* In the *ASA* case and again in *Saba,* the Tax Court upheld the IRS. After the District of Columbia Circuit affirmed the Tax Court in the *ASA* case and Merrill Lynch entered into a well-publicized settlement with the IRS to resolve its liability growing out of these transactions,[2] the law appeared to be well settled that the Merrill Lynch contingent installment sale transaction was without economic substance and, therefore, was not a viable product for taxpayers.

That, of course, was before the recent decision by Judge Friedman, in the U.S. District Court for the District of Columbia in the *Boca Investerings Partnership* case. *Boca* upheld American Home Product's purchase of the Merrill Lynch structured transaction and rejected the Commissioner's economic substance doctrine. Like the prior *ASA* decision, the *Boca* decision is appealable to the D.C. Circuit. Although the *Boca* decision purports to distinguish *ASA* factually, I and others with whom I have discussed these cases thus far have been unable to come up with a way to predict which factual situations in the future will fall within the rationale of *Boca* and which will fall within the rationale of *ASA, ACM,* and *Saba*.

Earlier this year, a trilogy of federal appellate cases dealing with alleged tax shelters transactions were decided. The Eleventh Circuit issued two decisions by the same panel of judges, one in the *Winn-Dixie Stores* case, involving corporate-owned life insurance arrangement, and the other in the *United Parcel Service* case, involving an attempt by UPS to transfer offshore the portion of its business involving the insurance of its customers' packages. In *Winn-Dixie*, the Eleventh Circuit panel affirmed the Tax Court and upheld the Commissioner's economic substance doctrine. In *UPS*, the same panel reversed the Tax Court and rejected the Commissioner's economic substance doc-

LAWRENCE B. GIBBS, who formerly served as Commissioner of Internal Revenue, is a member of Miller & Chevalier, Chartered in Washington, D.C. His comments were adapted from his luncheon remarks to a Joint TEI-IRS Issue Discussion Forum in Detroit, Michigan, on November 15, 2001.

trine. The third decision in the trilogy, by the Eighth Circuit in the *IES Industries* case, involved American Depository Receipts transactions creating foreign tax credits. The Eighth Circuit reversed a decision by the federal district court in Iowa and rejected the Commissioner's economic substance doctrine, a result directly contrary to the conclusion reached by Tax Court Judge Cohen in the *Compaq* case, currently on appeal to the Fifth Circuit. Perhaps, some will claim to be able to align the facts and rationales of these decisions, but try as we might, I and others with whom I have discussed these cases cannot do so.

The most recent judicial surprises, however, do not arise in the corporate tax shelter area. For example, the recent decision of the Federal Circuit in the *Rite-Aid* case overturned consolidated return legislative regulations.[3] The decision caught a number of tax practitioners by surprise and has led to calls for legislation to override the decision. Finally, the recent Supreme Court decision by Justice Thomas in the *Gitlitz* case sustained an apparent double tax benefit to shareholders of an S corporation.[4] The outcome in the *Gitlitz* decision was unexpected by many tax practitioners and has led to a pending legislative proposal to reverse the effect of the decision.[5] These are but a few examples of recent decisions that are sufficiently surprising to many tax practitioners to prompt concern about the lack of predictability of the outcomes of future tax cases.[6]

The common denominator in all these cases is that, although the law literally seems to entitle the taxpayer to the result sought by the taxpayer, the result seems too good to be true. Historically, in such cases, the courts have fashioned doctrines such as economic substance, business purpose, step transaction, form over substance, and a host of similar judicial doctrines to attempt to "reach the right result." As the tax law has changed more frequently and grown more complex, however, as businesses have changed more rapidly to accommodate ever-changing competitive circumstances, and as these two phenomena have interacted with one another, the limitations of the judicial doctrines have become apparent. Professor Martin McMahon in his recent article, "Random Thoughts on Applying Doctrines to Interpret the Internal Revenue Code," summarized very well the feeling of many of us after reading these recent decisions involving judicial doctrines: "Substance controls over form, except, of course, in those cases in which form controls."[7]

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Apart from the difficulty of knowing when judicial doctrines do and don't apply, another phenomenon has become apparent to complicate the situation. Over the years, academics and practitioners have debated the limits of judicial doctrines intended to reach the right result when the literal provisions of a statute, regulations, or other applicable law did not do so.[8] Some "judicial activists" defend the propriety of having judges formulate or apply anti-abuse judicial doctrines in order to enable courts to reach the right result is such situations. Other so-called plain-language advocates assert that in such situations the law should be treated as the law, so that if the law reached an improper result, the legislature and not the courts should change the law. This dialogue about the appropriate limits of judicial restraint extends not only to the tax area but also to other areas of the law as well. With the Federalist Society's anticipated support of the plain-language approach, the election of President Bush, and his appointment of judges and administrators at the Department of Justice with attitudes presumed sympathetic to the plain language approach, this phenomenon is taking on new relevance.

Consider, for example, the comments of Judge McKee in the Third Circuit decision in the *ACM* case:

> I can't help but suspect that the majority's conclusion is, in its essence, something akin to a "smell test." If the scheme in question smells bad, the intent to avoid taxes defines the result as we do not want the taxpayer to "put one over." . . . The fact that ACM may have "put one over" in crafting these transactions ought not to influence our inquiry. Our inquiry is cerebral, not visceral. To the extent that the Commissioner is offended by these transactions he should address the Congress and/or the rulemaking process, and not the courts.[9]

Before taxpayers get too carried away by the rhetoric, however, they should recall that Judge McKee's comments are from his dissent. That said, the point is still relevant that, had one other judge agreed with Judge McKee, the result in *ACM* would have been different. The margin of victory or defeat often is slim in these cases.

The net result of these developments is to make predictability of the outcomes in tax cases – how shall I say it – less precisely predictable. I believe that some level of reasonable predictability of outcomes is important in the tax area. Taxpayers trying to avoid litigation in planning their transactions need to know not only what the rules are; they also need to believe that the rules are sufficiently capable of delineation and enforcement that they will not be chumps if they continue to try to comply with the law.[10] More aggressive taxpayers need to know and believe that, if they step over the line in their tax planning, they will face the time, additional legal costs, and likelihood of having to pay at least additional tax and interest if they decide to litigate the tax consequences of their transactions. In the face of the increasing uncertainty about the outcome of tax litigation, compliant taxpayers are more likely to feel the competitive pressures to become more aggressive, and aggressive taxpayers, not to mention the promoters of tax products, are more likely to be emboldened to become even more aggressive. As the Treasury Department reminded us a few years ago, the result could be a "race to the bottom" leading to even more widespread noncompliance.[11] That, I submit, is in no one's best interests.

In light of these developments, what can and should we as tax practitioners in the public and private sectors do about the effect of these developments on our tax system? Some have suggested that the confusion created by the complexity of our tax law and the inability of the courts to provide clear guidance call for further consideration of more drastic solutions, such as the replacement of our income tax system with a consumption-based tax system, or a change in corporate tax accounting to conform it more closely to financial accounting.[12]

My proposal is more modest. In light of the present and foreseeable uncertainty of the tax law in cases in which the law supports the taxpayer's position but the position leads to results that appear to be too good to be true, I submit that both sides have an interest in trying to resolve or settle the cases administratively, without litigation. I recognize that either the taxpayer or the government in some situations may have an overriding need to obtain a court decision. In most cases, however, it is to neither side's benefit to risk the time, energy, and resources on the increasingly uncertain outcomes that the courts are providing in the tax area.

For these reasons, I applaud the recent announcements by Larry Langdon, Richard Skillman, and Pam Olson indicating their desire and efforts to find short-term administrative fixes to avoid litigation while pursuing long-term solutions in some of the most difficult areas of our tax law, such as the expense capitalization or *INDOPCO* area[13] and the research and experimentation tax credit area.[14] Such approaches should reduce controversy and increase the likelihood of finding acceptable compromises short of the courthouse. Similarly, I applaud their efforts to eliminate penalties for corporate taxpayers that are willing to try to find negotiated solutions for transactions that were entered into before the IRS published notices classifying the transactions as tax shelters.[15]

Finally, I fully support the approach that Larry Langdon, Debbie Nolan, and their LMSB executives, as well as Dan Black, Earl Blanche, and other Appeals executives, have taken to emphasize new techniques to permit the taxpayer and the IRS to try to resolve their cases more quickly in the pre-filing and post-filing processes.[16] In this regard, I would say to corporate tax executives: If your advisers tell you that your transaction, which seems to be aggressive but permissible under applicable provisions of law, should be litigated because they can assure that you are more likely to win, don't believe it. Conversely, I would say to the IRS: One of the biggest impediments I encounter day-to-day are IRS attorneys who tell their clients in LMSB that the taxpayer's transaction is an abusive transaction that the IRS will win in litigation. Don't believe it.

In most cases, corporate tax executives and their advisers have to weigh the cost and other considerations involved in litigation in light of the increasing uncertainty of the outcome against the cost of trying to resolve or settle the case administratively with the IRS. In the final analysis, the dynamics of such a weighing process will generally prompt most taxpayers to try to resolve or settle their cases with the IRS, if possible.

Unfortunately, I do not see the same impetus on the other side of the table. For one thing, some IRS attorneys believe that taxpayers that "have taken advantage of" the technical provisions of the tax law to reach a result that the IRS attorney considers to be too good to be true are "bad taxpayers" deserving of punishment. Such an attitude – when conveyed to the client, the LMSB team – often is not conducive to resolution in LMSB or settlement in Appeals. Secondly, some IRS attorneys argue that, even if the taxpayer is "right on the law," the courts will decide in favor of the IRS, using one of the judicial doctrines to do so. Finally, some IRS attorneys often state that, even if they lose a case, there is no downside for the government since it will simply prove that Treasury and the Congress need to "fix" the law and permit the revenue to be scored by congressional staffs to facilitate doing so.

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To reiterate, I recognize the need for and the authority of tax officials to decide to litigate cases in appropriate situations. My thesis, however, is that growing uncertainty in the outcomes of litigated cases is a factor that government officials should be taking into account in deciding which cases to litigate. A corollary of this thesis is that the decision to litigate should not be delegated to IRS attorneys advising LMSB audit teams. Rather, I would propose that, if a taxpayer makes an offer to settle a case that an IRS attorney advising the LMSB team believes involves an abusive transaction, any decision to discontinue efforts to resolve the case should be reviewed at a higher level within LMSB. In my experience, a higher level of LMSB review often results in a greater willingness and ability to find administrative solutions to avoid litigation.[17]

Tax policy usually is better left to policymakers in the administrative and legislative processes than to judges in the judicial process.[18] Recent judicial surprises not only make bad tax policy, but they embolden taxpayers and advisers to become even more aggressive in their tax planning. In light of the speed with which change and complexity in our tax law are occurring and the increasing uncertainty they produce, government officials and taxpayers should work together to find good solutions to hard problems administratively through the give-and-take process of dispute resolution and settlement processes, particularly in the increasing number of cases involving transactions in which the apparent tax result under existing law favors the taxpayer but that result appears too good to be true.

In conclusion, the present difficulties with which we in the public and private sectors are dealing with one another on a day-to-day basis are the byproducts of the

extraordinary change, complexity, and uncertainty in the tax area that all of us have chosen to serve. Just as the events of September 11 have offered us the opportunity to discover our similarities instead of dwelling upon our differences, so too there is an opportunity for all of us as tax professionals – in public and private practice – to jointly discuss our mutual concerns and problems in a constructive dialogue to resolve or settle our cases and develop worthwhile solutions.

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1 Court decisions upholding government's economic substance doctrine: *Florida Industries Investment Corp. v. Commissioner,* 87 AFTR2d 2001-1568 (11th Cir. 2001), *aff'g* 78 CCH T.C.M. 605 (1999); *American Electric Power v. United States,* 136 F. Supp.2d 762 (S.D. Ohio 2001); *CM Holdings, Inc. v. United States,* 86 AFTR2d 2000-6470 (D.C. Del. 2000); *Compaq Computer Corp. v. Commissioner,* 113 T.C. 214 (1999); *The Limited, Inc. v. Commissioner,* 113 T.C. 169 (1999); *Saba Partnership v. Commissioner,* 78 CCH T.C.M. 684 (1999); *Winn-Dixie Stores, Inc. v. Commissioner,* 113 T.C. 254 (1999), *aff'd,* 354 F.3d 1313 (11th Cir. 2001); *ASA Investerings Partnership v. Commissioner,* 76 CCH T.C.M. 325 (1998), *aff'd,* 201 F.3d 505 (D.C. Cir 2000); *ACM Partnership v. Commissioner,* 73 CCH T.C.M. 2189 (1997), *aff'd in part and rev'd in part,* 157 F.3d 231 (3rd Cir. 1998), *cert. denied,* 526 U.S. 1017 (1999). Court decisions rejecting the government's economic substance doctrine: *United Parcel Service v. Commissioner,* 254 F.3d 1014 (11th Cir. 2001), *rev'g and remanding* 78 CCH T.C.M. 262 (1999); *IES Industries, Inc. v. United States,* 353 F.3d 350 (8th Cir. 2001), *rev'g and remanding* 84 AFTR2d 99-6445 (D.C. Ia. 1999); *Boca Investerings Partnership v. United States,* Docket No. 97-0062 (D.C.D.C. Oct. 5, 2001); *Duke Energy v. United States,* 49 F. Supp.2d 837 (W.D.N.C. 1999); *Salina Partnership LP, FPL Group, Inc. v. Commissioner,* 80 CCH T.C.M. 686 (2000) (government loses economic substance position but wins on technical grounds).

2 *See, e.g.*, IRS News Release IR 2001-74 (Aug. 8, 2001); *IRS, Merrill Reach Pact on Shelters,* WALL ST. J (Aug. 29, 2001); *Tax Shelters: IRS, Merrill Lynch Settle Registration Case; Firm Required To Pay 'Substantial' Penalty,* 167 BNA DAILY REP. FOR EXEC. G-1 (Aug. 29, 2001).

3 *Rite Aid Corp. & Subsidiary Corps v. United States,* 255 F.3d 1357 (Fed. Cir. 2001), *rev'g* 46 Fed. Cl. 500 (2000).

4 *Gitlitz v. Commissioner,* 531 U.S. 206 (2001), *rev'g* 182 F.3d 1143 (10th Cir. 1999).

5 *See* § 341 of H.R. 3090, *Economic Security and Recovery Act of 2001,* at H. Rep. No. 107-251, 107th Cong., 1st Sess. 51, 106-07 (Oct. 17, 2001).

6 *See, e.g., United Dominion Industries, Inc. v. United States,* 121 S. Ct. 1934 (2001), *rev'g* 208 F.3d 452 (4th Cir. 2000); *Sutherland Lumber-Southwest, Inc. v. Commissioner,* 88 AFTR2d 2001-5026 (8th Cir. 2001), *aff'g* 114 T.C. 197 (2000); *Hillman v. Commissioner,* 250 F.3d 228 (4th Cir. 2001), *rev'g* 114 T.C. 103 (2000).

7 McMahon, *Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code,* 54 SMU L. REV. 195 (2001).

8 *See, e.g.*, Aprill, *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines,* 54 SMU L REV. 9 (2001); Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters,* 54 SMU L. REV. 47 (2001); Weisback, *Formalism in the Tax Law,* 66 UNIV. CHICAGO L REV. 860 (1999); Gunn, *Tax Avoidance,* 76 MICH. L. REV. 733 (1978).

9 157 F.3d at 265.

10 See Novack, *Are You a Chump?* 167 FORBES 122 (Mar. 5, 2001)

11 Department of the Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis, and Legislative Proposals,* at iv (July 1999) ("A view that well-advised corporations can and do avoid their legal tax liabilities by engaging in these tax-engineered transactions may cause a 'race to the bottom.' If unabated, this could have long-term consequences to our voluntary tax system far more important than the short-term revenue loss we are experiencing.").

12 *See* Yin, *Getting Serious About Corporate Tax Shelters: Taking A Lesson From History,* 54 SMU L. REV. 209 (2001).

13 *See IRS May Put Some Capitalization Issues on Hold During Guidance Effort, Official Says,* 211 BNA DAILY REP. FOR EXEC. G-1 (Nov. 2, 2001).

14 *See Government Near Agreement on New Version of Research Tax Credit Rules, Langdon Says,* 210 BNA DAILY REP. FOR EXEC. G-1 (Nov. 1, 2001).

15 *See Corporate Tax Shelter Amnesty?* 2001 TNT 205-2 (Oct. 23, 2001); *IRS to Unveil New Disclosure and Penalty Shelter Strategy Within Weeks, Langdon Says,* 210 BNA DAILY REP. FOR EXEC. G-3 (Nov. 1, 2001).

16 In addition to LMSB's Pre-Filing Agreement, Comprehensive Case Resolution, and Industry Issue Resolution programs and Appeals' Early Referral and Mutually Accelerated Appeals processes, the most recent is the joint LMSB and Appeals program for Fast Track Mediation and Settlement. *See* IRS Notice 2001-67, 2001-49 I.R.B. 544 (Dec. 3, 2001).

17 Indeed, the so-called Rules of Engagement used by LMSB and its attorneys encourage taxpayers and their advisers to take their cases to a different level within LMSB in appropriate circumstances.

18 It is not my intent to criticize in any way the judiciary for its recent opinions. Many of the issues being presented to the courts involve close, difficult questions, and I believe it is the job of the courts to decide cases and not to make tax policy. Indeed, because of the difficulty of, and the uncertainty of the answers to, these questions, I suggest that the government and the taxpayers should make every effort to settle or resolve these questions administratively, rather than prevail upon the courts to continue to use inadequate doctrines to deal with the questions.