NEWS ANALYSIS

Self-Serving Concessions And Penalty Avoidance

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Most lawyers want to see their clients fully acquitted of allegations of improper behavior. But in civil tax cases, sometimes simply avoiding penalties is good enough.

In alleged tax shelter cases, the penalties can be significant, so some taxpayers attempt to minimize the financial damage by conceding the underlying tax issue.

Unfortunately for taxpayers, the IRS is not a softhearted adversary content to let taxpayers pay the minimum amount of taxes owed when it believes abusive behavior was involved. Indeed, it has indicated in recent legal memoranda that it intends to be more aggressive in forcing tax shelter participants to pay for their misdeeds by refusing to allow concessions in penalty cases.

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Some courts' willingness to provide taxpayers an escape route from significant penalties initially rose out of concern for judicial economy. Faced with full dockets of cases arising from tax shelters involving master recording leases, livestock, and other improperly claimed assets that often involved hundreds of individual taxpayers, the Tax Court reasoned that a concession resolving the tax liability prevented the need for a trial to specifically identify the substantive grounds for which a deficiency existed in order to determine an applicable penalty.

Taxpayers today might wonder if courts are actually getting the penalty right, or whether judges are allowing an implicit distaste for tax shelters to affect how they construe the statutory framework for valuation penalties.

Beginnings

Starting several decades ago, the Tax Court has occasionally not allowed the IRS to impose a penalty when the taxpayer concedes the issue in dispute. An old iteration of the court's rationale for allowing taxpayer concessions as a reprieve from penalties came in *Todd*, in which the court asked, ''If a taxpayer were to concede that an asset was not placed in service and that no deductions or credits are allowable in order to avoid an addition to tax, could that concession reasonably be refused?'' Because it determined that an asset for which deductions had been claimed hadn't been placed in service, the court concluded that the complete disallowance of the attendant deductions and credits precluded imposition of a valuation penalty. (For *Todd v. Commissioner*, 89 T.C. 912 (1987), see *Doc 87-6738* or *87 TNT 208-10*.)

Two years later, the Tax Court in *McCrary* declined to sustain a section 6659(c) valuation overstatement addition to tax because it decided that the taxpayer's erroneous claim of an investment tax credit was not attributable to a valuation overstatement. Following the Fifth Circuit's affirmance of *Todd*, the Tax Court held that the calculation of an underpayment attributable to a valuation overstatement must be made after any other proper adjustment to tax liability. Thus, Congress's construction of the penalty seemed to prevent imposition on ''taxpayers whose overvaluation was irrelevant to the determination of their actual tax liability,'' the court stated. (For *McCrary v. Commissioner*, 92 T.C. 827 (1989), see *Doc 89-2925* or *89 TNT 84-13*.)

The IRS unsuccessfully argued in *McCrary* that taxpayers cannot ''selectively concede a ground for disallowance in order to avoid an addition to tax.'' While sympathetic to the IRS's administrative difficulty, the court held that ''there are certainly many cases in which taxpayers concede a single ground for disallowance of an item, thus avoiding the necessity of trial in a case.''

Agreeable Fifth and Ninth Circuits

The Fifth and Ninth circuits have become the only havens for taxpayers seeking easy avoidance of a gross valuation misstatement penalty. First, the argument for conserving judicial resources was adopted by the Fifth Circuit when it affirmed the Tax Court in *Todd*. The circuit court reasoned that:

> Congress may not have wanted to burden the Tax Court with deciding difficult valuation

> issues where a case could be easily decided on other grounds. Second, Congress may have wanted to moderate the application of the section 6659 penalty so that it would not be imposed on taxpayers whose overvaluation was irrelevant to the determination of their actual tax liability. [*Todd*, 862 F.2d 540 (5th Cir. 1988), *Doc 89-616*, *89 TNT 18-8*.]

But the leading case in the Fifth Circuit is *Heasley* (a quick follow-up to *Todd*), in which the taxpayers gave up challenging the IRS's disallowance of deductions and credits for an investment tax credit scheme they unwittingly fell for, but filed suit to stop the imposition of penalties. On appeal, the circuit court took issue with the questionable propriety of allowing a valuation overstatement penalty, concluding that because of the complete disallowance of the taxpayer's credits and deductions, the ''underpayment is not attributable to a valuation overstatement.'' Critical to the court's holding was that the taxpayers' ''actual tax liability does not differ one cent from their tax liability with the valuation overstatement included.'' (For *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990), see *Doc 90-4452* or *90 TNT 134-12*.)

The court concluded that ''whenever the IRS totally disallows a deduction or credit, the IRS may not penalize the taxpayer for a valuation overstatement included in that deduction or credit'' because the overstatement ''does not change the amount of the tax actually owed.''

When dealing with tax shelters, the IRS generally appears reluctant to apply discretion in the penalty arena. Nonetheless, the Fifth Circuit cautioned that an overbroad approach — perhaps because it is seen as overtly punitive — won't always be tolerated. ''The IRS should not exact every penalty possible in every case where taxpayers pay less than the full amount of tax due,'' the court chided, noting that the government used ''draconian efforts'' in a case that contained ''rather questionable facts.''

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More recently, the Fifth Circuit affirmed its previous holdings and solidified the already strong foundation for ignoring the potential applicability of a valuation overstatement penalty when the IRS has asserted several grounds for disallowing deductions from a transaction, including that it is a sham or that it lacks economic substance. In *Weiner*, the appellate court offered a ''conceptual lens'' for determining whether an underpayment is attributable to the alleged basis underlying a specific penalty. Although applied in the context of the now-repealed section 6621 interest addition for tax-motivated transactions, the court's holding — that ''multiple reasons provided for the disallowance'' of deductions by the IRS made it untenable to ''determine whether the underpayments are 'attributable to''' items involving valuation or basis that would trigger the penalty — might equally apply to the section 6662(h) gross valuation misstatement penalty. (For *Weiner v. United States*, 389 F.3d 152 (5th Cir. 2004), see *Doc 2004-20897* or *2004 TNT 208-7*.)

The Ninth Circuit is unusual in that it allows taxpayers to escape penalties completely if the grounds used to disallow a deduction or credit are lack of economic substance or a similar judicial doctrine. The IRS strongly disagrees with that generous approach. In an action on decision issued last year in *Keller*, IRS chief counsel argued that application of a valuation misstatement penalty should not be precluded when the grounds for disallowance are based on or related to a valuation overstatement, because that approach ''does not properly reflect the language or purpose'' of section 6662. (For AOD 2011-02, see *Doc 2011-21460* or *2011 TNT 198-18*. For *Keller v. Commissioner*, 556 F.3d 1056 (9th Cir. 2009), see *Doc 2009-4282* or *2009 TNT 37-17*.)

The Tax Court recently reiterated in *Bergmann* that it must follow Ninth Circuit precedent in cases appealable to that circuit and prevent imposition of a gross valuation penalty when deductions are disallowed because of tax avoidance or lack of economic substance. (For *Bergmann v. Commissioner*, 137 T.C. 136 (2011), see *Doc 2011-21424* or *2011 TNT 197-12*.)

Majority View

Most circuit courts (the Second, Third, Fourth, Sixth, and Eighth circuits) have decided that even if an item's adjusted basis becomes zero after disallowance, the valuation misstatement penalty can apply if a transaction lacks economic substance and the tax underpayment comes from disallowances measured with overvalued basis. In *Clearmeadow Investments*, the Court of Federal Claims summed up the prevailing judicial attitude toward valuation penalty maneuvers, granting the government summary judgment in a partnership proceeding involving a son-of-BOSS tax shelter. The court found that the transactions lacked economic substance and held that gross valuation misstatement penalties applied in the absence of any defenses that may be presented at the partner level. (For *Clearmeadow*

Investments LLC v. United States, 87 Fed. Cl. 509 (Fed. Cl. 2009), see *Doc 2009-13949* or *2009 TNT 117-14*.)

The Court of Federal Claims summarized the pro-government circuit holdings as commonly rejecting "any attempt to distinguish between the multiple grounds upon which a deduction based upon an overvalued interest may be disallowed, particularly where the overvaluation is intertwined with a tax avoidance scheme that lacks economic substance." Indeed, "it makes little sense to absolve a taxpayer from paying the penalty simply because there is more than one reason why a deduction based upon an overstated basis is inappropriate," the court said, adding that it is "particularly dubious that Congress intended to confer this largesse upon participants in tax shelters."

Under the majority view, if a court determines that the transaction lacked economic substance or was similarly defective, a valuation penalty will be allowed.

The position adopted by the Fifth and Ninth circuits invites "the sort of gamesmanship that may be lurking in the shadows" by which a taxpayer late in the process — perhaps "in the face of a motion or on the eve of trial" — may make a tactical concession to avoid an imposed valuation penalty, the claims court said. It does not appear that *Clearmeadow* was appealed to the Federal Circuit.

Thus, under the majority view, if a court determines that the transaction lacked economic substance or was similarly defective, a valuation penalty will be allowed. For example, the First Circuit in *Fidelity International Currency Advisor A Fund* upheld the district court's penalty determination based on the conclusion that the foreign currency option loss generator at issue involved a sham partnership and lacked economic substance. (For *Fidelity International Currency Advisor A Fund LLC v. United States*, 661 F.3d 667 (1st Cir. 2011), see *Doc 2011-22298* or *2011 TNT 205-31*.)

Taxpayers hoping to avoid valuation penalties will be unable to do so if they end up agreeing to specific things. For example, if a taxpayer and the IRS settle a case in a manner that identifies lack of economic substance, sham, or other grounds that specifically implicate the value or basis of items giving rise to tax return adjustments, the penalty will likely apply.

There are times when a concession can't be used to escape a penalty. In cases involving application of at-risk rules in the partnership context, some courts have held that they lack jurisdiction to accept a concession in a partnership-level proceeding. (See orders made by the Tax Court on November 6 and 18, 2009, in *Tigers Eye Trading LLC v. Commissioner*, No. 14510-05; see also *Hambrose Leasing 1984-5 Ltd. Partnership v. Commissioner*, 99 T.C. 298 (1992), *Doc 92-8224*, *92 TNT 179-10*, and *Russian Recovery Fund Ltd. v. United States*, 81 Fed. Cl. 793 (Fed. Cl. 2008), *Doc 2008-11159*, *2008 TNT 99-11*.)

Although the Tax Court, in cases that are appealable outside the Fifth and Ninth circuits, has upheld the imposition of gross valuation misstatement penalties in concession cases, a 2011 decision appealable to the Second Circuit held that failure of a façade easement contribution on technical grounds precluded a valuation penalty. In granting the government's motion for summary judgment, the court said that not reaching the issue of valuation meant the section 6662(h) penalty could not apply. So there may be instances in non-concession cases in which the Tax Court will deny the imposition of a penalty when "the underlying premises for summary adjudication" considered don't address valuation. (For *Kaufman v. Commissioner*, 136 T.C. 294 (2011), see *Doc 2011-7123* or *2011 TNT 65-17*.)

Enabling Concessions

In circuits in which the appellate courts have accepted concessions as a legitimate path for valuation penalty avoidance, a key consideration in escaping an asserted penalty is to ensure that the grounds on which the concession are predicated are nonspecific enough to avoid judicial attribution to a valuation hook. It becomes necessary for practitioners representing clients in courts that accept pretrial penalty avoidance concessions to ensure that the settlement entered into with the IRS is vague on the disallowance grounds.

In *Schachter*, the Tax Court held a penalty inapplicable when there was a "mélange of alleged grounds" behind the deficiency notice, preventing the court from saying, post-concession, that an underpayment is attributable to a particular ground. Trials in those circumstances have no "useful purpose" when grounds exist that are so "disparate and disconnected" as to disallow claimed deductions, the court said. "The objectives of administrative efficiency and judicial economy have been well served by the closing agreement and petitioner's concession," it said. (For *Schachter v. Commissioner*, T.C. Memo. 1994-273 (1994), see *Doc 94-5720* or *94 TNT 116-11*.)

One might argue that the IRS opened itself up to potential whipsaw by propounding multiple grounds for an adjustment to a taxpayer's tax liability. Targeting tax shelter transactions in as many ways as possible may work against the Service's attempts to impose valuation penalties in circuits that adopt the *Heasley/Keller* framework. Critics of the economic substance doctrine and similar judicial doctrines have urged the IRS to avoid using those allegations when a transaction can be attacked on technical grounds. Although these aren't directly addressed in judicial opinions, the Fifth and Ninth circuits have devised approaches that effectuate the outcome advocated by these critics when it comes to leveraging the valuation overstatement penalty. But that strategy will likely become moot for transactions that get swallowed by the newly codified economic substance doctrine, under which the IRS could impose a 40 percent strict liability penalty for failure to properly disclose those transactions.

A likely sore spot with the IRS is the extent to which the logic of concessions has been taken. In *Bergmann*, the Tax Court accepted a concession as a penalty avoidance mechanism even though the taxpayer didn't specifically identify which grounds it was conceding. The court was willing to apply its concession rationale in a blanket manner when the IRS had one or more disallowance grounds not involving value or adjusted basis. In particular, agreeing that a transaction lacks economic substance has helped taxpayers avoid a higher penalty amount. The IRS has appealed the case to the Ninth Circuit.

It is hard to fault the IRS for wanting to settle cases without losing the ability to argue for penalties that it believes are appropriate. But as the Ninth Circuit observed in *Keller*, IRS complaints of taxpayers opportunistically avoiding a possibly higher valuation penalty by making a concession are less forceful when the taxpayer's action leads to collection of the full asserted unpaid tax liability. In a note, the circuit court said that ''the Commissioner agreed to the stipulation at the time and must live with the consequences of that agreement now.''

> ***'The IRS can understand the choices being made by a taxpayer in structuring a concession, and it should come as no surprise that conceding on one specific ground is made to obtain a benefit in another fashion,' Allison said.***

Mark D. Allison of Caplin & Drysdale said that although the IRS is making a big deal about taxpayers trying to avoid valuation penalties, the agency shouldn't make it seem as if it has been caught unaware by taxpayers making concessions. ''The IRS can understand the choices being made by a taxpayer in structuring a concession, and it should come as no surprise that conceding on one specific ground is made to obtain a benefit in another fashion,'' he said. ''This is not a new development in how settlements in tax litigation are negotiated.''

The government's arguments for applying the gross valuation penalty are stronger when a court determines that complete disallowance of a tax benefit inherently implies an overvaluation, Allison said. ''But where a court renders a decision in response to multiple theories posited by the government and it is not evident that there is any one justification relied on by the court to implicate the gross valuation penalty, the argument is less forceful,'' he said. ''The taxpayer is giving up the tax entirely for some perceived benefit on the penalty. If that's not appropriate, courts would have to conduct mini-trials at the penalty phase simply to determine how various disallowance rationales apply or correlate to the penalty, and that kind of approach belies judicial efficiency.''

IRS Retrenches

The IRS has decided that enough is enough. It intends to push back harder against the judicially accepted penalty loophole. Last fall, in CC-2012-001, IRS chief counsel stated that when the grounds for disallowing a taxpayer's claimed deductions or credits are an integral part of an underpayment that is attributable to overvaluation, section 6662 valuation misstatement penalties should be imposed. Taxpayers that attempt to concede before trial on disallowance grounds unrelated to valuation ''invite the use of abusive litigation tactics,'' the notice told IRS trial attorneys. (For CC-2012-001, see *Doc 2011-21199* or *2011 TNT 195-33*.)

The IRS obviously believes that judicial acceptance of concessions to avoid valuation penalties will remain restricted to the Fifth and Ninth circuits, and so it intends to use its litigating position to isolate the precedent in those circuits — and possibly reverse it. The IRS believes strongly enough in its position that it is already mentioning seeking Supreme Court review if the Fifth Circuit doesn't fold. (For prior coverage, see *Tax Notes*, Nov. 7, 2011, p. 677, *Doc 2011-22817*, or *2011 TNT 210-5*.)

The IRS's new resolve on the issue seemingly reverses a more lenient position adopted more than two decades ago. Although the specific topic of taxpayer concessions was not addressed in Litigation Guideline Memorandum (LGM) TL-25, the IRS said that in order to apply a valuation overstatement penalty when tax benefits are disallowed, ''there must be evidence in the record that there was in fact an overstatement of the value or adjusted basis of an asset claimed on the return.'' (For the memorandum, see *Doc 1999-27928* or *2000 TNT 121-107*.)

The IRS encouraged imposition of the penalty when the denial of deductions or credits was not directly related to overvaluation — such as when the transaction lacked economic substance, the taxpayer lacked beneficial ownership, or the transaction wasn't a sale. But it recognized that connecting a penalty to those underpayments required an actual judicial determination providing nexus. The government's adoption of a broader stance for imposing valuation penalties contradicts its prior legal advice of limiting penalty application.

A few years later, the IRS revisited the matter in LGM TL-68, which said that taxpayer concessions before trial might lead to the Service not asserting a valuation misstatement penalty when the deduction or credit is ''independent of and wholly separable'' from ''overvaluation or a tax motivated transaction.'' (For the memorandum, see *Doc 98-6587* or *98 TNT 52-82*.)

In CC-2012-001, the IRS cautioned that its prior advice seemingly accepting pretrial concessions should be evaluated carefully in each circumstance because ''many cases involve extensive discovery or trial preparation that consumes significant resources.'' In other words, the IRS might argue for imposed penalties when the attempted concession follows a protracted exam or appeals process.

Practitioners dislike the new position. Regarding CC-2012-001, Mary E. Wood, an attorney at Meadows, Collier, Reed, Cousins, Crouch & Ungerman LLP, said that ''in typical fashion, the IRS is flip-flopping on its previous position in LGM TL-68, which advised that when a taxpayer conceded a deduction or credit prior to trial on grounds unrelated to valuation, the valuation penalty would not be pursued.'' In taking its aggressive stance, ''the IRS is labeling such concessions as abusive litigation tactics,'' Wood said.

The chief counsel notice and the action on decision in *Keller* are ''further examples of the IRS's attempt to strong-arm taxpayers into making concessions early in the audit or litigation process, essentially depriving them of their right to rely on relevant authority, develop their case, and make legitimate tactical decisions regarding concessions when they deem appropriate,'' Wood said. In issuing those two documents, ''the IRS is attempting to circumvent the decisions issued by the Fifth and Ninth circuits,'' she said.

''The IRS is using its one-size-fits-all approach and allowing its aggressive stance on tax shelter cases to infiltrate the handling of non-tax-shelter matters,'' Wood continued. In light of the chief counsel notice, ''practitioners can only hope that the IRS uses reasonable discretion in examining non-tax-shelter cases on a case-by-case basis as mandated by the notice,'' she said.

But Edward M. Robbins Jr., a principal at Hochman, Salkin, Rettig, Toscher & Perez PC, said the IRS's treatment of valuation penalties is simply the result of earlier policy decisions to get tougher on penalties. He noted that former IRS Commissioner Mark Everson instructed IRS Appeals officers not to trade penalties for other things in settlement negotiations; instead, they were to focus on whether hazards of litigation might justify penalty abatement. (See CC-2004-036, *Doc 2004-18840*, *2004 TNT 186-9*.)

'The IRS is using its one-size-fits-all approach and allowing its aggressive stance on tax shelter cases to infiltrate the handling of non-tax-shelter matters,' Wood said.

''It's taken some time, but I think IRS exam agents and chief counsel are now more or less behind that instruction, so if a taxpayer concedes a valuation issue on the merits, that is not going to affect the penalty determination,'' Robbins said.

Shelter-Oriented Results?

Recent cases involving taxpayer concessions made to avoid a valuation misstatement penalty make little mention of judicial economy as a rationale for the tactic. Instead, the IRS seems to have stepped up its appeals to judicial sensitivity to negative factual inferences when transactions have involved tax shelter activity.

Bryan C. Skarlatos of Kostelanetz & Fink LLP said the IRS's efforts to win courts over using notices and additional litigation is ''just part of the war on tax shelters.'' Courts will likely continue to adopt the IRS's position, but that is more a result of the judicial attitude toward tax shelters than belief in the statutory language.

In *McCrary*, the IRS argued that ''Congress wanted to make tax shelters based on property overvaluations less attractive.'' Allowing a taxpayer to significantly overvalue the adjusted basis of an item on a tax return without suffering an addition to tax would supposedly frustrate the policies behind a valuation penalty, the Service claimed. That sentiment is still valid today, as the IRS has said in both internal memos and ongoing litigation that when disallowance of deductions or credits could be based on valuation grounds, a valuation misstatement penalty should be considered and possibly imposed.

The Second Circuit in *Gilman* provided an honest judicial assessment of courts' natural inclination to favor penalty application in shelter transactions even when the statutory language is unclear. The court upheld the imposition of valuation penalties on the taxpayer's sham sale/leaseback transaction but conceded that ''it is fairly questionable whether what occurred in these cases was a 'valuation overstatement.'" If no sale has occurred, "to say that a taxpayer has a zero basis in an asset he is found not to have acquired seems strained," the court wrote. (For *Gilman v. Commissioner*, 933 F.2d 143 (1991), see *Doc 91-4280* or *91 TNT 114-7*.)

But the circuit court contended that because of the IRS's technical alternative arguments — "arguments typically made in tax shelter disputes" — the "appropriateness of the penalty seems more justified." The court questioned the reasonableness of accepting complete disallowance by the IRS because it has a "perverse effect of sparing the taxpayer the overvaluation penalty."

Conflicted, the Second Circuit said that "overvaluation in a sham transaction is different in kind, not merely degree," than a classic example of overvaluation, such as inflated basis of artwork for a charitable deduction. But the court ultimately reasoned that the valuation penalty "reinforces the Congressional objective of lessening tax shelter abuses," even if "applying the penalty somewhat strains the natural reading of the statutory phrase."

The government's string of court victories may have been precipitated by shelter-driven results, but the question is whether the penalty framework is consistent with that justification. The predecessor valuation overstatement penalty of section 6659 was adopted as part of the Economic Recovery Tax Act of 1981 to specifically target "about 500,000 tax disputes outstanding which involve property valuation questions of more than routine significance" — that is, individual tax shelters with large dollar basis inflations. (See H.R. Rep. No. 97-201.)

> ***'Gilman** provides an honest analysis of the competing factors at play here — uncertainty toward applying penalties to disallowed items versus bias against tax shelter transactions,' Skarlatos said.*

Section 6659 was modified and moved into the current section 6662(e) and (h) valuation penalties as part of the civil tax penalty overhaul in the Revenue Reconciliation Act of 1989, which collapsed many separate penalty provisions into a broader accuracy-related penalty scheme to avoid penalty stacking. Although the conference report said the new valuation overstatement penalty was "generally the same as the valuation overstatement penalty provided under present law," the new statute broadened the penalty to all taxpayers and raised the basis thresholds to avoid penalizing "good faith valuation disputes." (See H.R. Rep. No. 101-247.)

The lack of specific reference to tax shelter motivations in the legislative history may indicate that Congress believed there was no need to instruct future penalty adjudicators that those situations were the primary target of the law. The Second Circuit in *Gilman* said it viewed the penalty simplification provision as making "no change to preclude application of the penalty to tax shelter transactions," but that is hardly a ringing endorsement of the shelter-as-a-primary-motivation rationale, because the court noted that a valuation overstatement was only "an example of a circumstance warranting the revised" accuracy-related penalty.

"*Gilman* provides an honest analysis of the competing factors at play here — uncertainty toward applying penalties to disallowed items versus bias against tax shelter transactions," Skarlatos said. "We continue to see the pendulum swing back and forth in the IRS's administrative efforts."

Up Next?

The Federal Circuit is likely to stake out its own position on the issue soon. Oral arguments were heard January 9 in *Alpha I*, a son-of-BOSS case. During litigation over IRS adjustments to partnership items, Alpha I conceded the IRS's adjustments to its capital gains through the section 451 at-risk rules and then persuaded the court to adopt the Fifth Circuit position to not apply a valuation misstatement penalty when the concession doesn't involve basis or valuation. The court agreed that it was not judicially necessary to "make valuation determinations for the sole purpose of imposing penalties" because a concession "obviates the need to conduct a trial on valuation issues and therefore achieves the very efficiencies and economics that the elimination of penalties sought to encourage." (For *Alpha I LP v. United States*, 84 Fed. Cl. 622 (Fed. Cl. 2008), see *Doc 2008-25009* or *2008 TNT 230-11*.)

In the Fifth Circuit, a jumble of issues await resolution in *NPR Investments*, including questions involving the continued applicability of *Heasley*. The district court held that "when NPR's loss is conceded on grounds other than valuation or basis, by NPR agreeing that it did not enter the transactions at issue with a profit motive, the valuation misstatement penalties of Section 6662 are inapplicable because any underpayment is not attributable to a valuation misstatement." (For *NPR Investments LLC v. United States*, No. 5:05-cv-00219 (E.D. Tex. 2010), see *Doc 2010-4106* or *2010 TNT 38-12*.)

In a briefing for oral arguments in *NPR Investments* last year, the government argued that a concession on non-valuation grounds does not invalidate the effect on basis adjustments made at the partner level by a final partnership administrative adjustment. Rather, "alternative means to the same result'' of disallowed items on a return do not make basis overstatements on a partner's return ''any less conclusive,'' the government stated. The government brief contended that an example in reg. section 1.6662-5(d), issued after the Fifth Circuit's rationale in *Heasley*, is a ''superseding principle'' that ''an underpayment of tax resulting from total disallowance of a deduction can be attributable to a valuation overstatement.'' In effect, the government views its regulation as a reason for the circuit to end its adherence to *Heasley*, arguing that the ''agency construction of 6662 directly contradicts both the result and reasoning'' of that case.

Practically, one wonders if the IRS will ultimately require that closing agreements or stipulations specifically describe what is being agreed to regarding the owed tax liability.

James N. Mastracchio, a partner and co-chair of the tax controversy practice at Baker & Hostetler LLP, told Tax Analysts that ''the imposition of penalties generally has become more routine in the exam process and expected,'' whereas in the past the IRS used more discretion. Even though it is discouraged by the Internal Revenue Manual, using penalties as a negotiation tool in the audit process ''is part of the practice these days,'' he said, adding, ''Penalty claims are frequently raised in exams.''

The aggregate effect of asserted penalties puts a tremendous burden on taxpayers, and it ''becomes costly to defend against each element'' in a proposed adjustment or deficiency notice, Mastracchio said. When sham or economic substance issues are raised, the taxpayer must also successfully assert a reasonable cause argument, and if that fails, overvaluation penalty calculations become purely mathematical, he said. That might induce a taxpayer to find a way to settle a case rather than litigate, he added.

Jeffry J. Erney, a partner at Baker & Hostetler and a former senior IRS trial attorney, said that when the IRS has coordinated an issue, it has largely given up its flexibility in settling with taxpayers at the examination level. As a result, ''nearly every case ends up going to Appeals because the IRS paints with a broad brush, treating all taxpayers the same regardless of their factual situation,'' he said. ''Once an issue is coordinated, the IRS now just automatically piles on any possible penalty.''

So is the concession maneuver really a good way to promote judicial economy? Judges in recent years seem less concerned about getting rid of shelter cases than about seeing participants pay their dues when the IRS throws the book at them. In circuits where taxpayers have favorable judicial precedent, the best opportunity for them to succeed on the concession issue seems to be to concede early in a manner that avoids identifying any specific ground for the concession that could involve a valuation finding.

Conclusion

The number of alleged tax shelter cases flooding the judicial system has increased frustration among courts regarding aggressive transactions, as judges want to address the cases expeditiously to clear the docket for other matters. One way to reduce the backlog is to push the cases through with minimal judicial resources when the parties can settle or one side concedes an issue. It is certainly within the discretion of a trial court to accept a taxpayer's concession and take the case off the docket. In the future, taxpayers might have greater incentive to concede the case and pay the underlying tax liability with a lower penalty if they can avoid the threat of a codified economic substance penalty.

> ***'Once an issue is coordinated, the IRS now just automatically piles on any possible penalty,' said Erney.***

If Congress intended penalty policy to foster voluntary compliance and efficiency in litigation by helping resolve cases early to reduce judicial backlogs and save government resources, concession seems an acceptable approach for those courts that accept taxpayers' attempts. But the IRS's view that a litigation tactic should not allow taxpayers who engage in abusive tax avoidance behavior to minimize penalties is a responsible position for a tax administrator.

As taxpayers continue to test the legitimacy of penalty avoidance concessions in court, perhaps the IRS should exert more pressure on Congress to address the issue. With two circuits generally accepting taxpayer concessions meant to avoid the 40 percent gross valuation misstatement penalty, IRS efforts may be better spent convincing Congress that the valuation penalty area should undergo legislative changes. ■