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Practitioners Parse Promoters' Wins in Sale-Leaseback Tenant Improvements Transaction

by Shamik Trivedi

Summary by taxanalysts®

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For their part in designing, implementing, and subsequently defending a sale-leaseback transaction marketed to various corporate retailers, Daryl J. Haynor, a former accountant with KPMG LLP, and Jon Flask, an attorney, were indicted in October 2009 on charges of conspiracy to defraud the IRS under 18 U.S.C. section 371 -- commonly referred to as a *Klein* conspiracy -- and with corruptly endeavoring to obstruct and impede the administration of the tax law under section 7212(a).

A jury in the U.S. District Court for the Southern District of Ohio on February 4 returned verdicts of not guilty for Flask on both counts and not guilty for Haynor on the conspiracy count. Judge Sandra S. Beckwith acquitted Haynor on the second count.

The third defendant, Michael Parker, a former executive of TransCapital Corp., a tax-advantaged investments company based in northern Virginia, pleaded guilty to the 2009 conspiracy charge. The government alleged that from 1998 through 2006, Haynor, Flask, and Parker marketed and implemented a tax shelter known as the sale-leaseback of tenant improvements strategy (SLOTS) that enabled various companies to generate massive loss deductions. Haynor and Parker also defended the transactions in audit conferences.

The SLOTS transactions would allow a corporate taxpayer to engage in a common sale-leaseback, whereby the taxpayer would sell leasehold improvements to a single-purpose entity (SPE) created by TransCapital, which would then lease the leasehold improvements back to the taxpayer. The taxpayer would sell the improvements for less than their book value, with the difference being claimed as a deduction, the government claimed.

The SPE purchasing the improvements would obtain financing by selling the rights to lease payments to a financial institution. That would generate income for the SPE, which would be offset with the sale of the improvements at a "substantial loss" to a third party, the government alleged. The SLOTS transactions, designed and marketed by Flask and Haynor, would ultimately result in more than $240 million in deductions for corporate taxpayers such as Kroger Co., Rite Aid Corp., Sterling Jewelers Inc., Dollar Tree Inc., and SuperValu, a grocery store.

Those second sales, in which the SPE sold the leasehold improvements to a third party, were at the heart of the government's case against Haynor and Flask. The government alleged that Haynor and Flask withheld significant facts about that sale from the taxpayers and the IRS. At trial, the government alleged that a 2002 field service advice memorandum (FSA 200217024) addressed a SLOTS transaction and found that it lacked economic substance, partly because the second sale generated a huge loss. The government also said that at subsequent audit conferences, the defendants, knowing about the IRS memorandum, made false statements about the second

sales.

The jury thought otherwise, and in ordering Haynor's acquittal for the tax obstruction charge, Beckwith reasoned that the field service advice memo mentioned second sales "almost in passing at the end." Further, the IRS did not issue any specific document requests on the second sale for the audit underlying the memo, she said. "The evidence at trial revealed that the IRS had voiced little if any substantive concern about [the residual sales] of the SLOTS transactions before any of the three audit conferences" cited by the government, she said. Even if Haynor knew of second sales, the IRS did also, Beckwith said.

Mark D. Allison of Caplin and Drysdale said he sees the government's prosecution of the case as based on "the alleged coverup rather than the substantive act itself." The criminal prosecutions stemming from tax shelter cases in recent memory, like in the son-of-BOSS context, involve individuals' roles in the subsequent audit of the taxpayer, he said, adding, "I got the sense . . . that the focus of the government was on what was said during the audit and any alleged misrepresentations about the transaction." (Prior analysis .)

"The flavor of this seems to be that the IRS was annoyed that there was not more forthrightness in the audit from the same people who happened to also be involved in the transaction," Allison said. He said that leads the IRS to believe that if a practitioner is misrepresenting the facts in the audit, the practitioner is also misrepresenting the facts in the underlying transaction.

This is "really a cautionary tale of the dangers of trying to defend yourself or your own transaction, because you're walking this fine line between being a representative . . . and being the fact witness," Allison said. The taxpayer's representative in an audit "really should not be the person who is involved in the underlying transaction," he said, adding, "You want distance between the fact witness and your independent representative."

Thomas E. Zehnle of Miller & Chevalier represented Flask at trial. Sale-leasebacks are common in the business world, Zehnle said, citing the airline industry as one that often engages in the transaction for aircraft. The SLOTS transaction was not so different, he said.

The issue in this case was the novel nature of the sale-leaseback because it involved the build out of leasehold improvements to the retail space that was then leased, Zehnle said. "You could lease the shell [of the retail space], but then the Krogers and the Rite Aids had to pay millions of dollars to build these things out," he said. "That's what made it unique, and no doubt, that's what caught [the government's] attention."

"This wasn't a case where taxes just vanished," Zehnle added. The taxpayers "essentially accelerated their tax deductions," he said. Those corporate taxpayers also had a business purpose, because when they sold the assets, they got a cash infusion that could be used to expand the business, he said. Those points had to be carefully made to the jurors, he said, and he highlighted the importance of carefully selecting jurors in complex shelter cases. (Prior coverage .)

Neither the *Klein* conspiracy nor the tax obstruction charge under section 7212(a) are "substantive crimes," because a finding of willfulness is technically not necessary, Zehnle said. "If you have a good-faith belief that you're doing something and you're not violating the law, which I think happens a lot in these shelter cases . . . then you cannot be found guilty of a substantive tax offense," he said.

Another practitioner who asked not to be identified said there was "no way" the government was going for a substantive tax charge in the case. All the SLOTS clients conceded the issue on audit but thought that at least on the front end -- that being the initial sale-leaseback to the SPE -- the transaction worked, the practitioner said.

In any case, companies are not doing SLOTS deals anymore, and there were not that many to begin with, the practitioner said. "I always thought they had more economic substance than a lot of tax shelters because there are real assets and there is a true disconnect between the economic usefulness of the assets and the way you get to depreciate them for tax purposes. What this transaction is trying to do is bring those two things together," the practitioner said.

The most telling part of Beckwith's acquittal order was in essence that "the IRS didn't ask and didn't care" about the residual sale, the practitioner said. "So now you're going to prosecute someone for not volunteering it?" asked the practitioner. On that point, a corollary exists between a New York district court's holding in *Coplan* and the current case, the practitioner said.

In *Coplan*, the government succeeded in obtaining guilty verdicts against four former Ernst & Young LLP practitioners on a *Klein* conspiracy and other assorted charges, including obstruction and making false statements. In November 2012 the Second Circuit overturned the convictions of two of the four. (*U.S. v. Coplan*, No. 10-583-cr (2d. Cir. 2012), *rev'g* No. 07-CR-453 (S.D.N.Y. 2009). Prior coverage.)

"If you know the IRS wants to know something, are you supposed to tell them what you think they want to know, even if they don't ask you?" the practitioner said. "I think it's a view the government has. I don't think it's correct, but it's a view it has. I think maybe this will curtail pursuing that view in criminal cases."

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