Penalties

When Should a Taxpayer Know That a Tax Shelter Is Too Good to Be True?

By Bryan C. Skarlatos and H. Stow Lovejoy

Taxpayers who have underpaid their taxes can avoid accuracy-related penalties under Code Sec. 6662 by demonstrating that they acted with reasonable cause and in good faith. In general, the most important factor in determining whether a taxpayer acted with reasonable cause and good faith is the taxpayer's effort to assess the proper tax liability. Taxpayers often attempt to assess the proper tax liability by hiring and relying on the advice of a tax advisor. However, even when a taxpayer hires a tax advisor, courts are skeptical of taxpayers' claims of good faith reliance on advice when the tax advice is "too good to be true."

In *McNeill*,[1] a federal District Court held that a "Distressed Asset Debt" ("DAD") transaction that generated large tax losses was a sham, in part because the taxpayer did not intend to make a profit. Nevertheless, after focusing on the taxpayer's level of education and sophistication, the court decided that the taxpayer acted in good faith because he did not know enough about taxes and tax shelters to realize that the tax shelter was "too good to be true." The court's decision differs from other recent decisions holding that similarly sophisticated taxpayers who invested in tax shelter transactions did not act in good faith because they should have known that that shelter was too good to be true.

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Former CEO Buys into a DAD Investment

McNeill was a graduate of Annapolis who served in the Navy for almost 20 years, including commanding a nuclear submarine. With that background, McNeill went to work operating nuclear power plants for utilities, eventually rising to become chairman of the board of PECO Energy and then of Exelon Corporation. As is common with chief executives, he was granted a generous severance package upon his retirement from Exelon in 2002, giving rise to substantial taxable income in that year.

McNeill decided to consider investment opportunities with "positive tax benefits." He chose the DAD transaction, which was suggested to him by BDO Seidman and managed by Gramercy Advisers. The DAD transaction involved three levels of partnerships and high-basis, low-value Brazilian debt. The transaction was structured to generate an ordinary loss of $22.2 million, roughly $20 million of which would flow through to McNeill and his wife. McNeill went ahead with the deal in December 2002. He purchased 89% of the entity holding the debt for less than $300,000, although he also contributed an additional $2.7 million to the entity immediately after he purchased the 89%. The period from McNeill's purchase of the entity to the realization of the loss was 17 days, just before year end.

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BDO Seidman provided McNeill with a written opinion that the DAD transaction and resulting losses complied with the Code and also recommended that McNeill receive an opinion from a law firm. At BDO's suggestion, McNeill chose De Castro, West, Chodorow, Glickfield & Nass, Inc. to provide a tax opinion, in part because they had extensive experience with DAD transactions. After McNeill signed a letter of representations that the law firm prepared concerning his motivation for making the investment and other matters, De Castro provided opinion letters approving the treatment of the losses on the McNeills' 2002 income tax return.

However, even when a taxpayer hires a tax advisor, courts are skeptical of taxpayers' claims of good faith reliance on advice when the tax advice is "too good to be true."

McNeill also sought the advice of Ernst & Young with respect to the transaction. E & Y performed an internal review of the tax treatment of the DAD transaction. According to the court, McNeill knew that the outcome of the review was satisfactory because E & Y's signature appeared on the bottom of his 2002 tax return.

Although the District Court Disallowed the Loss, It Found That the Taxpayer Acted with Reasonable Cause and Good Faith

Not surprisingly, the IRS determined that the DAD transaction did not provide the desired tax losses. Among the grounds used to disallow the loss were the absence of profit motive, the absence of business purpose and the absence of economic substance. The IRS's Final Partnership Administrative Adjustment was determined to be correct in a proceeding in District Court in Connecticut, but under the TEFRA procedures, McNeill was able to contest the penalty separately in District Court in Wyoming. McNeill asserted that there was reasonable cause for the position that resulted in the penalty and that he acted in good faith taking that position.

In deciding that McNeill had reasonable cause and acted in good faith, the court looked at his knowledge as a taxpayer, his effort to assess his proper tax liability, and his reliance on qualified tax professionals. As for McNeill's knowledge, the court found him to be a *naïf*: he may have commanded a nuclear submarine and may have run two electric utilities, but he was "not experienced, knowledgeable, sophisticated, or educated about a partnership-based DAD transaction and tax strategy like that at issue in this case." This purported lack of knowledge and sophistication colored the court's analysis of McNeill's efforts to assess his tax liability and his reliance on tax advisers.

The government objected to the advice that McNeill received from both DeCastro and E & Y. In the case of De Castro, the court found that the firm had advised him that there was no conflict of interest and that McNeill reasonably expected to be advised of a conflict if one occurred. Therefore, the court concluded that there were no grounds to find that McNeill knew or should have known that De Castro was an interested party and could not be relied upon.

When the government urged that McNeill should have known that representations and assumptions in the letter that De Castro prepared for him to sign were untrue, the court disagreed. The court found that McNeill was persuaded by reading about Gramercy and by E & Y's oral advice that he had "substantial business reasons" for investing in the structure, that he had the opportunity to make a return on the investment without regard to tax benefits, and that his decision was made solely on the economics of the DAD transaction without taking into account his other investments or transactions. The court held that he did not know or have reason to know that the representations were false. The court similarly brushed away objections to McNeill's reliance on E & Y's "oral advice indisputably given … concerning BDO, Gramercy, and the application of the tax law to the Gramercy DAD transaction."

The government's final argument was that a reasonable, prudent taxpayer with McNeill's knowledge and financial and business sophistication would have realized that the DAD transaction, which generated a $20 million dollar loss on a $300,000 investment in 17 days (and with professional fees calculated as a percentage of the tax loss), was simply "too good to be true." As noted above, the court disagreed with the characterization of McNeill as sophisticated, at least with respect to the DAD tax shelter. And it pointed out that although it may have been clear that the deal was "too good to be true," that fact "was not commented on by tax law experts either at E & Y or De Castro, both of whom owed Mr. McNeill a fiduciary duty to provide him with objective, professional advice, free from conflict of interest, and knew the partnership tax provisions well enough to paper the deal to their satisfaction." That is, McNeill hired experts because he did not understand partnership tax law; those experts in tax law did not tell him the deal looked too

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good to be true; so McNeill was not expected to know the deal was too good to be true. Based on the foregoing, the court concluded that McNeill and his wife carried their burden of proof in showing that they had reasonable cause and acted in good faith, so that accuracy-related penalties were to be refunded.

What Is Good Faith Reliance on Professional Advice?

This decision presents an interesting perspective on the reasonable cause and good faith defense when it involves reliance on professional advice. The court acknowledged that in order to establish reasonable cause and good faith defense, "the taxpayer's reliance on the advice must itself be objectively reasonable," citing *Stobie Creek Investments, LLC*.[2] The court also stated that reliance would not be objectively reasonable "if the taxpayer knew or should have known that the transaction was 'too good to be true,' based on all the circumstances, including the taxpayer's education, sophistication, business experience, and purposes for entering the transaction," again citing *Stobie Creek*. Presented with a highly intelligent and experienced former chief executive of an electric utility, however, the court decided that his education and business experience were for naught because the education, sophistication and business experience necessary to make a judgment were education, sophistication and experience with respect to the tax law and the structured transaction in question. The taxpayer apparently could not be expected to determine whether the results of a DAD transaction were "too good to be true."

Other courts have not limited the "too good to be true" test to such a narrow group of individuals. In *Stobie Creek*, the Federal Circuit Court of Appeals found "a highly educated professional with extensive experience in finance" capable of knowing that a tax shelter was "too good to be true," despite the written advice of tax professionals. In *Candyce Martin 1999 Irrevocable Trust*,[3] trusts whose trustee was an experienced management labor lawyer asserted reliance on the advice of a tax lawyer who relied on other professionals. The court found that the taxpayers should have known that a tax shelter transaction that resulted in a $300 million tax basis for a $900,000 offsetting options transaction was "too good to be true," with the result that the taxpayers had not "demonstrated good faith under the circumstances and in light of the underlying purposes of entering into the transaction." Similarly, in the analogous situation of defining negligence, Reg. §1.6662-3(b)(1) requires no specialized knowledge from a taxpayer: "Negligence is strongly indicated where … a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a return which would seem *to a reasonable and prudent person* to be 'too good to be true' under the circumstances." (Emphasis supplied.)

Conclusion

The District Court in *McNeill* effectively holds that a taxpayer cannot be expected to know that the tax savings from a tax shelter are "too good to be true" unless that taxpayer has some training and sophistication in tax matters. While not all courts will agree with this analysis, it can never hurt to evaluate and develop a taxpayer's education and sophistication, particularly with respect to taxes. Some taxpayers do honestly and in good faith believe that smart tax professionals can spin gold out of straw, especially when it comes to our exceedingly complex tax laws.

ENDNOTES

1 *McNeill*, 119 AFTR2d ¶2017-943 (DC Wyoming Feb. 24, 2017).
2 *Stobie Creek Investment, LLC*, CA-FC, 2010-1 USTC ¶50,455, 608 F3d 1366.
3 *Candyce Martin 1999 Irrevocable Trust*, DC-CA, 2011-2 USTC ¶50,670, 822 FSupp2d 968, *rev'd on other grounds*, CA-9, 2014-1 USTC ¶50,134, 739 F3d 1204.

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